Folder Title:	Mexico - Country Files - Correspondence - Volume 1
Folder ID:	1779794
Series:	Country files
Dates:	12/08/1982-12/28/1988
Sub-Fonds:	Records of President Barber B. Conable
Fonds:	Records of the Office of the President
ISAD Reference Code:	WB IBRD/IDA EXC-11-49S
Digitized:	6/24/2021

MEXICO = 1987+(6)(5)(4)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 28, 1988

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi MAQ

FROM: Rainer B. Steckhan, Acting RVP, LAC Steckhan

EXTENSION: 38074

SUBJECT: MEXICO - US$500 Million Finance and Trade Sector Loan (FTSL)
US$500 Million Industrial Sector Policy Loan (ISPL)
US$500 Million Public Enterprise Reform Loan (PERL)

1. I attach for your review the minutes of the Operations Committee held on December 21, 1988 to review the Region's proposal for the above three operations which were submitted by Mr. S. Shahid Husain under a memorandum dated December 15, 1988. I have also attached for your information a policy matrix for each of the three proposed operations, reflecting the Regional Loan Committee's decision that all first tranche conditions be met by Board presentation for all three proposed loans. While the minutes of the OC meeting cover the major issues relating to these three operations, I would like to underline the importance of an adequate macroeconomic framework, satisfactory external financing arrangements, and lending conditionality.

Macroeconomic Framework

2. We believe that Mexico's new economic program announced on December 12 and the 1989 budget point in the right direction. However, further evaluation of the details is necessary before we can make a judgment. We propose to start this assessment in January and in parallel with the beginning of the proposed negotiations of the above three loans. We are in close touch with the IMF on the macroeconomic framework and will endeavor to reflect the IMF's views in the documents.

External Financing

3. Mexico's financing needs are substantial at US$6 billion per year and are obviously very sensitive to external factors. The success of Mexico's adjustment program and recovery of growth critically depends on the availability of external resources. Hence, the Region proposes to use the above three loans as seed money and to present them to the Board only once Mexico and Japan have agreed in principle on matching cofinancing, and once Mexico has developed a consistent medium term financing plan. As a condition of second tranche release, the Government would have to show that (a) commitments have actually been obtained for the required financing for 1989-90, and (b) it has reached agreement in principle with its major external creditors on a viable medium term financing plan. Arrangements with the Fund involving the significant use of resources would improve the financing picture, lessen the burden on the Bank for monitoring the short-term adjustment effort, and help secure the required external financing.

In his get acquainted visit to the World Bank and the U.S. Authorities on December 22, the new Finance Minister Pedro Aspe told you that Mexico would do what was necessary to get full financing for their program. In this connection, we should soon know what Mexico's intentions are with respect to the IMF.

Lending Conditionality

4. The OC instructed the Region that before negotiations are concluded the specific policy content, including time-bound targets, are reviewed by the SVPOP for all three operations. Greater degree of specificity in lending targets and consistency among the three loans will be essential to achieving significant progress in the Government's adjustment program and to ensure enforcibility.

Timetable for Negotiations

5. Subject to your approval, we intend to circulate the notice of invitation to negotiate for the three proposed operations to the Executive Directors and to distribute draft legal documents and policy matrixes to the Government authorities in the first week of January, so that negotiations can be initiated in mid-January, as soon as the authorities are ready. Given the complexity of the issues, the importance of a comprehensive financing plan, and the size of the package, we expect negotiations to take much longer than usual. In addition, Mexico is in violation of several covenants on existing policy-based loans (i.e., Agricultural and Steel Sector Loans), and we have advised Mexico that these matters will have to be settled before we can go to the Board with the proposed three loans.

cc. Messrs. Husain (o/r), Segura (LAC), Martinez, Binswanger, Knotter, Halperin, van Wijnbergen, Varallyay (LA2)

MEXICO

It might be useful to ask Moeen to introduce the subject and then ask Messrs. Stern, Fischer and Shihata in this order to speak and raise their questions.

There are a host of detailed, time-bound targets which still have to be clarified following or before negotiations by the Senior Vice President for Operations and approved by you, and the violation of several covenants on existing policy-based loans has to be solved. You should ask Messrs. Stern's and Fischer's opinions on the specific conditionality included in the three loans.

However, there are two basic issues:

(a) Should we complete our assessment of the new economic program and have full agreement on medium-term macroeconomic framework as conditions for Board presentation or is it sufficient if this is a condition of second tranche release as it stands at the moment?

Also, to what extent should we insist on IMF involvement and IMF monitoring of the macroeconomic framework as a condition of our involvement for either first or second tranche release? The present proposal is clearly a deviation from the Fischer report and your promises to the Board. The development policy letter is only in outline form (Annex VI). How much time is needed to formulate a medium-term framework?

(b) It is not clear to what extent we can or ought to use our \$1.5 billion to assist Mexico in putting together a medium-term financing plan which must involve fresh money and debt reduction. The package proposes only as a first tranche condition, agreement in principle on matching Japanese co-financing and the presentation by Mexico of a consistent medium-term financing plan. It is only a second tranche conditionality that commitment has been obtained for 1989 and 1990 financing and viable a medium-term financing plan. Again, this is inconsistent with the Fischer report, and it can hardly be said -- as in Costa Rica -- that the commercial Banks are unwilling.

Here, we must make a judgment whether the Bank should play an active role in helping Mexico to put together a medium-term financing plan by tying even the disbursement of the first tranche to substantive progress toward a viable medium-term financing plan. This would mean a much more active role in New York, together with the U.S. Treasury and Japan than has been played to date.

Mr. Conable

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

~~CONFIDENTIAL~~

Mtg. on 1/3 at 2:30 pm

DATE: December 30, 1988

TO: Mr. Ernest Stern, Mr. Moeen A. Qureshi, Mr. W. David Hopper, Mr. Ibrahim Shihata, Mr. Stanley Fischer

FROM: Rainer B. Steckhan, Acting RVP, LAC

Steckhan

EXTENSION: 38074

SUBJECT: MEXICO - Political and Economic Background Note

1. As background for next week's restricted President's Council meeting on the proposed three Sectoral Adjustment Loans to Mexico, you may find attached note on "Mexico - Political and Economic Challenges of the New 'Sexenio'" helpful. It was prepared by our Resident Representative in Mexico City, Marko Voljc.

2. On the domestic scene, Mexico has embarked on a very courageous and coherent economic adjustment program over the last years. The prospects are for at least initial continuity of the effort by the new Government which, for the first time, will have to share power with an "emerging" Congress. On the international scene, Mexico has been one of the most cooperative debtor countries in Latin America (despite mounting pressure for a tougher stance), and will need in 1989 a "mega" financing package in support of economic reform and growth.

3. The Bank has supported Mexico's adjustment program with a rapidly expanding program of economic advice and lending. Last fiscal year, Mexico was the second largest IBRD borrower, with a total lending program of more than $2 billion.

4. Mexico has asked the Bank to play a leading role in putting together a new financing package. Thus, FY89 could not only be another year of record World Bank lending to Mexico, but also a test for innovative Bank approaches to debt reduction in Mexico in support of sound economic reform in a politically less predictable situation.

Attachment

cc. Messrs. Husain (o/r), Selowsky, Segura (LACVP), Martinez, Binswanger, Knotter, Halperin, Van Wijnbergen, Varallyay (LA2), Wessels (LAT)

*IMPORTANT

CONFIDENTIAL

MEXICO AFTER DECEMBER 1

POLITICAL AND ECONOMIC CHALLENGES OF THE NEW "SEXENIO"

Introduction

1. After the controversial and contested presidential elections in July, Carlos Salinas de Gortari was sworn in as Mexico's President on December 1, beginning a six-year term in which he, his government, and his party will have to demonstrate the capacity to lead the country on its path of political modernization, resumed economic growth, and improved social welfare for its population. This note attempts to analyze briefly the challenges faced by the new Mexican Administration. Specifically, it presents (i) an overview of the main political developments in the recent weeks, which are likely to affect the country's future economic policies; and (ii) the economic situation at the beginning of 1989, and the likely direction of the key economic policies.

I. RECENT POLITICAL DEVELOPMENTS

1. Presidential Inauguration: Legitimacy and Mr. Salinas's Commitments

2. Mr. Salinas took office amidst opposition protest about the legitimacy of his government, but in an atmosphere of unprecedented continuity and close collaboration with the outgoing president and his administration. In his inaugural speech, the President emphasized the continuity of many of the key policies initiated by his predecessor, but he also spelled out three major commitments which should characterize his six-year term: (a) political modernization via democratization of the society, its laws and institutions; (b) economic modernization which should be achieved through stability and economic recovery; and (c) social modernization via improved welfare for the population.

3. The three "social compacts" outlined by Mr. Salinas on December 1 will now have to be put in operational programs. Some of the most pressing economic and social welfare issues are already being addressed in the proposed 1989 economic policies as outlined in the 1989 Budget. Other, particularly political, reforms, will require more time, and will probably be the result of negotiations with the principal opposition parties. Perhaps the two most important immediate challenges facing the new administration will be the modification of the electoral code (see para. 16) and the handling of the external debt issues (paras. 36-39 below).

4. Overall, the transition of power after a difficult period of virtually no economic growth since 1982, a considerable deterioration of the standard of living and social welfare for a large share of the population, and this summer's elections, has been rather peaceful; however, the opposition (both right and left) has made its strength felt in the Congress as well as in the streets. In his drive to modernize the economy and democratize the country's political system, Mr. Salinas and his party

will undoubtedly be faced with challenges never before experienced by the Institutional Revolutionary Party (PRI) during its sixty-year domination of the country's political scene. It is harder than ever to predict how President Salinas will fare.

2. Composition of the New Cabinet: the Best and the Brightest

5. Before Mr. Salinas took office, there was a considerable degree of speculation as to who he would choose for the key posts in his government. Given his (apparently) relatively weak position vis-a-vis his own party as well as the rest of the political community, it was speculated that the new President would have to give in to various pressure groups and appoint cabinet members which might not be his closest collaborators committed to carry out his policies of modernization and democratization.

6. These speculations turned out to be by-and-large exaggerated. On the one hand, Mr. Salinas managed to place a group of his closest associates in key posts (Finance Ministry (SHCP) headed by Mr. Pedro Aspe, Programming and Budgeting Ministry (SPP), Mr. Ernesto Zedillo; Trade and Industrial Development Ministry (SECOFI), Mr. Jaime Serra; Ecology and Urban Development Ministry (SEDUE), Mr. Patricio Chirinos; and the Federal District (DDF), Mr. Manuel Camacho). On the other hand, he gave senior jobs to representatives of a broad array of other political factions within PRI, mostly at less important positions. He handed the Agriculture Ministry to Mr. Jorge de la Vega, the former chairman of the PRI and a link to the old guard, and the Education Ministry to Mr. Manuel Bartlett, the former Interior Minister and main rival in the bid for the Presidency. Mr. Salinas also strengthened the role of his own office (Presidencia) by creating a coordinating group (Oficina de Coordinacion), which will supervise the execution of the key programs of his Administration. The head of the coordinating group (Jose Cordoba) is expected to be de facto the most influential member of Mr. Salinas's cabinet.

7. The above appointments are likely to guarantee President Salinas, at least initially, the loyalty of the party machine (which was not enthusiastic about the selection of Salinas as the PRI presidential candidate in late 1987), and the needed control over the government apparatus. The majority of his key economic officials are also considered pro-business, a fact which should assure the new President the support of the private sector (Salinas appointed a respected business leader, Mr. Claudio S. Gonzalez, as his special adviser for direct foreign investments, and a self-made millionaire and former Mayor of Mexico City, Mr. Carlos Hank, as Minister of Tourism).

8. Another important characteristic of the new government is the impressive academic background of some of Mr. Salinas's principal ministers and other key officials. The heads of SHCP, SPP, SECOFI, the Central Bank, the Presidencia, and many of their associates hold degrees from some of the most prestigious US and European universities. Other key officials possess ample political experience as well as solid academic background (e.g., the heads of the Foreign Affairs, Labor, Agriculture, Education, and Interior Ministries, and the Mayor of the Federal District). All in all, it appears that the new government is well equipped for the challenges facing it in the carrying out of the political and economic modernization reforms Carlos Salinas has set out as his Administration's medium-term program.

9. In sum, the "change of the guard" in Los Pinos (official presidential residence) in late 1988 was characterized by a very smooth transition. Because of his close involvement and friendship with Mr. de la Madrid, Mr. Salinas embraced the thrust of most of his predecessor's policies. As a result of this close collaboration, there have been much fewer personnel changes in most of the ministries than usual. Perhaps the most notable exception among economic ministries is SECOFI, where new appointments have been made all the way down to the director level (i.e., the fourth level of responsibility). One can, therefore, hope that a considerably different style and orientation in conducting industrial and trade policies will evolve from an agency which for decades has been the epitomy of protectionism and heavy-handed bureaucracy. Also, unlike practically all of his predecessors in Mexico's recent history, Carlos Salinas did not create any new ministry nor did he abolish any of the existing ones.

10. Despite continuity in policies, institutions and many personalities, some officials from the Diaz Ordaz, Echeverria and Lopez Portillo years did resurface somewhat surprisingly. For instance, Mr. Antonio Ortiz Mena (a two time Finance Minister and the former President of IDB) became head of the country's largest commercial bank (Banamex), Mr. Andres de Oteyza, one of the principal architects of the industrial policies in the 1970s, has been appointed head of Airport Services (ASA), and Mr. Carlos Tello, the mastermind of the 1982 bank nationalization, has been put in charge of a newly created National Solidarity Program. The new Minister of Tourism, Mr. Hank, too, held important government jobs in several administrations (Governor of the State of Mexico, Mayor of Mexico City). But these appointments (with the possible exception of the Tourism Ministry) may just turn out to be "token payments" to gain support of various interest groups of the ruling party.

3. Political Parties: Towards a True Pluralism?

11. As a result of the very narrow victory in July, the ruling party (PRI) now only holds 260 out of 500 seats in the Chamber of Deputies. After the initial shock, it appears that the ruling party has somewhat recovered and regrouped. No defections of PRI deputies to the leftist coalition group have been reported since late summer 1988. The state gubernatorial elections in Veracruz, Tabasco and Jalisco in the last three months have been won by the PRI by a comfortable margin, triggering the opposition's outcry that the ruling party is again resorting to the traditional practice of electoral fraud.

12. It is obvious that while Mr. Salinas and his associates epitomize the reform-minded current within PRI, dominating the executive power as well as several congressional commissions, the traditional party strongmen are still in positions of power: the two congressional majority leaders (Mr. Emilio Gonzalez - Senate and Mr. Guillermo Jimenez - Chamber of Deputies) are old-style party politicians closely associated with labor leader Mr. Fidel Velazquez. Despite the relative fiasco that the PRI experienced in July, there has been no purge of the old guard: Mr. de la Vega, who until November 30 was party chairman and Mr. Bartlett, who was the Interior Minister during the previous government, were both openly criticized by Mr. Salinas's team for opposing the modernization and democratization efforts by the presidential candidate and for the poor

handling of the situation prior, during, and after the elections. Nevertheless, they both got cabinet positions in the Salinas Government.

13. In the months following the elections, Mr. Salinas's main political objective has been to convince the opposition to accept the July results. The objective was quite simple: the recognition by the opposition of the legitimacy of the Salinas Presidency would enhance the new Administration's capacity to introduce above mentioned reforms which, in turn, would greatly reduce the power of the traditional forces within the PRI. The results of this effort so far have been mixed: Mr. Salinas may be getting the upper hand in his internal struggle to obtain bigger control over and to modernize/democratize his party, but the opposition wants an accelerated process of electoral reform and clean state and municipal elections in the coming months and years before it can be convinced that Mr. Salinas is indeed genuinely committed to political pluralism.

14. The leftist coalition, the big winner of this summer's elections (with 139 seats in the 500 seat Lower House) has kept its activities within the law. Its principal leader, Mr. Cuauhtemoc Cardenas, has been working hard to develop and solidify an organization which could truly act as an opposition block to the PRI. In fact, Mr. Cardenas officially transformed his coalition in late October into a new party, the Partido Revolucionario Democratico (PRD), an alliance of different progressive trends, with the objective of the restoration of the "historical ideas of the Mexican revolution, complete respect for the constitution and the legitimacy of the government and those who govern." For now, Mr. Cardenas's party is a limited challenge to the PRI. This already became apparent in the recent congressional hearings on the 1989 Budget.

15. To make his and his party's ideas more widely known, Mr. Cardenas has not only engaged in a post-election campaign throughout the country, but also went on a trip to the Northeastern US (Washington, New York, Boston) to give lectures and interviews about his Movement at Universities, think tanks, and financial circles. His US trip was criticized bitterly by his ex-colleagues from the PRI, thus giving Mr. Cardenas and his Movement extra domestic publicity. Time will tell whether and how soon Cardenas will be able to develop a cohesive national party.

16. The National Action Party (PAN), with its 101 seats in the Lower House of the parliament has emerged as a strong opposition group since this summer's elections. While their power base is still cofined to the northern states and large metropolitan areas, the PAN has in the past weeks emerged as perhaps the most vocal of the opposition groups. PAN leader Manuel Clouthier last week went on a well publicized hunger strike to force the authorities to agree to an initiation of electoral reforms. A few days later, Mr. Salinas accepted the opposition's proposal to have a Congressional consultative process set up by no later than mid-1989 to reform the Federal Electoral Code. The PAN also showed its strength in the Congressional debates about the 1989 Budget, where its representatives appeared best prepared and most militant in their attacks on the Government's policies.

4. Labor Unions and University Students: the Winter of Discontent?

17. The unions, traditionally a PRI stronghold and the ruling party's staunchest supporters, are undergoing a crisis which is at least as deep as that of the PRI itself. Having lost to a large degree its political influence within the Party and particularly with the executive branch of the Government, labor union leadership is facing increasing lack of confidence by its membership. Dissent is running high among various unions. As a result, several old-style leaders have either been forced to resign or have all but lost their influence and prestige among their rank and file. This seems to be increasingly the case with the grand old man himself, Mr. Fidel Velazquez, until recently the undisputed supreme leader of workers and the most skillful Mexican politician of this century.

18. The recent strike of the government workers reflected the above mentioned crisis in the labor movement quite clearly. The government workers who were demanding a 100% wage hike and the payment of the end-of-sexenio bonus disobeyed their leader's request for more modest demands and for a resumption of work. At the same time, the rest of the labor movement showed little sympathy for the cause of government workers, who are viewed as a privileged group within the working class. The strike was ended with the Authorities not having given in to any of the requests, the bureaucrats' leader discredited, and a rift among various unions.

19. The above, however, does not imply that the unions have ceased to be a powerful political force in Mexico. Given the serious deterioration in workers' purchasing power and welfare, the situation can become explosive if Labor perceives the new President's policies as leading toward further deterioration of their standards of living. It was with this in mind that Mr. Salinas emphasized his commitment to improved welfare of the population. The recent clashes among the Cardenistas (mostly working class) and the police and the military, albeit modest in size and not too violent, are no doubt a serious warning to the authorities. They are also a warning to the PRI and union leadership (which is practically all PRI) that workers may well begin to organize themselves in independent or Cardenista-dominated unions.

20. University students and their teachers at UNAM (roughly 350,000 students on the Mexico City campus alone), too, launched a strike, demanding wage increases (100%) and better financial conditions for the students. After more than three weeks, the strike was ended a few days prior to the Inauguration, with the teachers accepting a 10% increase in their salaries. A new rector will take over January 1, but the discontent among the student and teacher population continues to fester. There again, Mr. Cardenas enjoys support of many who believe that the PRI has "betrayed the Mexican revolution."

5. Challenges for the Future: Hope and Caution

21. Based on the above, it is clear what the main challenges facing the country and its leadership will be in 1989 and beyond. The election year 1988 and its results have shown with all clarity the depth of the discontent of a sizeable portion of the population, the less privileged Mexicans, with the economic crisis and how its burden is being shared.

There is also a growing discontent with the country's political institutions and, particularly, with the party which has ruled Mexico since the late 1920s. Reversal of the economic deterioration of the standard of living of a large part of sociaty and political as well as economic modernization will be imperative if Mexico is to preserve its remarkable social peace and economic potential.

22. Mr. Salinas and his associates are well aware of these challenges. The composition of the Cabinet, the thrust of the 1989 Budget, and subsequent policies he and his government will be putting in place seem to indicate that many of the issues the country is facing will be addressed head on in the early stages of the new Administration.

23. The risks the government will be facing are formidable, however. First, there are still powerful forces within the PRI which are not convinced that the party of the institutionalized revolution should share power with any other political group, let alone concede defeat in elections. This may be a serious stumbling block as Mr. Salinas and the rest of the PRI reformists propose changes in the electoral legislation. Second, the leftist opposition, which has emerged as a result of the crisis of the past six years and which appears to be the principal challenger to the ruling party, seems to be more attracted to populist policies with the state as the principal engine of social and economic development rather than to a modern society with its democratic institutions and a growing role for the private sector. Such an opposition may be able to hamper the government's attempts to deregulate the economy and permit greater participation of the private sector (both domestic and foreign) in the badly needed economic recovery and reform process. Third, unless the new Administration is able to show positive results (e.g., improved standards of living, job creation, political opening) of its reforms relatively soon, the social discontent could erupt in an uncontrolled way and put in serious jeopardy the Administration's modernization efforts as well as the country's social equilibrium. Unlike in most other Latin American countries, Mexico's military leaders have kept a very low profile in recent decades, concentrating more recently on modernization of their equipment.

II. ECONOMIC POLICIES AND CHALLENGES

1. 1988 - The Year of the Pacto

24. 1988 was not only an election year in Mexico - it was also the year of the "Pacto." The main objective of the Economic Solidarity Pact (ESP) was to reduce the inflation rate, which at the end of 1987 was hovering at unprecedented levels. In this respect, the Pacto was a success: while for the year as a whole, the CPI reached 159.2% in 1987, in 1988 it fell to 51%. In the three months prior to the Pacto, the CPI exceeded 8%, in December 1987 it stood at 14.5%, and in January 1988 it peaked at 15.5% a month. In the last five months of 1988, the monthly CPI was about 1%. There has been some acceleration in inflation lately, however, preliminary data for the first two weeks of December show an increase in the CPI of 1.5%.

25. The mixture of orthodox and heterodox policies introduced under the Pacto made it possible to mitigate the cost of reducing inflation drastically. Despite the restrictive demand management policies, the

economy is expected to have grown slightly (.4%) in 1988, compared to a 1.4% growth in 1987. However, given an almost 2% population growth, the per capita growth rate was again negative.

26. The virtual freeze of the exchange rate during 1988 and the fall in the international oil prices resulted in a considerable deterioration in Mexico's trade and current accounts. Preliminary data show that merchandise imports grew 52%, reaching pre-crisis levels from the early 1980s (US$18.6 billion). Merchandise exports are expected to reach US$21.1 billion (a 3.6% growth over 1987). Non-oil exports grew 15.2%, reaching US$13.9 billion, while petroleum exports reached some US$7.2 billion. The resulting trade surplus of US$2.5 billion is less than a third of the previous year's surplus and the lowest in the last seven years. The current account shows a deficit of US$3.2 billion, compared to the 1987 surplus of US$3.9 billion.

27. Public finances show a generally satisfactory performance, although many of the (ambitious) targets set by the Pacto were not achieved. The overall public sector deficit stood at 10.8% of GDP, down from 15.8% the previous year. The operational deficit reached 2.8% of GDP, and the primary surplus 7.4% of GDP. As a result of restrictive policies, public sector consumption fell almost 1% in real terms, public investment almost 7% (preliminary overall figures for 1988 are +.5% in real terms for total consumption and -1.5% for total investment).

2. The Stability and Economic Growth Pact: Preparing for "Soft Landing?"

28. In mid-October, President-elect Salinas agreed to extend the Pacto ESP by a month (i.e., through end-1988) in order to allow for some time after the inauguration to put in place his own stabilization program. He did not wait too long, though. Less than two weeks into his presidency, the Stability and Economic Growth Pact (PECE) was announced, outlining the new policies to govern during the first seven months of 1989. Like its predecessor, the PECE, too, is an agreement between the government, labor, farmers, and business. It represents the first stage of a gradual defreeze of the key economic variables (the so-called "nominal anchors") and a partial decontrol of other prices. As its name implies, the emphasis of the next stage of Mexico's stabilization program will only gradually (but inequivocally) shift from reducing inflation to setting a stage for renewed growth. PECE's main points are summarized below.

29. (a) Public finances will continue to be controlled very strictly. In fact, the 1989 Budget (see paras. 30-33 below) is by some 2.8% smaller in real terms than the (already very restrictive) 1988 public expenditures.

(b) Public sector tariffs and prices (one of the key nominal anchors under the PSE) will remain unchanged through July 1989 for households. There will be some adjustment in power and water tariffs and gasoline and gas prices for commercial and industrial users. Energy rates for the nation's industries and businesses were hiked by almost 30% on December 29. The price hike will not affect though residences, factories that grind corn for tortillas, or agricultural irrigation operations.

(c) A crawl in the exchange rate (another key nominal anchor under the previous Pacto) will be introduced beginning January 1. There will be an average 1 peso depreciation a day vis-a-vis the US dollar, resulting in a cumulative depreciation of some 9% between January and July 1989.

(d) Import tariffs will be modified, with most of the items which currently have a zero or 5% tariff rate to be increased to 10%. The maximum rate of 20% will remain unchanged.

(e) The signatories of the new Pacto have agreed that the business sector will absorb all the resulting cost increases.

(f) To reduce the cost of doing business in Mexico, an all-encompassing deregulation and bureaucratic simplification of the economy will be undertaken.

(g) The minimum wages (the other nominal anchor under the previous Pacto) will be increased by 8% on January 1 for the year as a whole. Collective labor contracts, too, will only be reviewed once a year.

(h) Productivity in agriculture will be stimulated by regional incentives (so far unspecified) and adjustment in guaranteed prices (also not spelled out).

30. The initial reaction to the PECE has been mixed. The business sector seems to be particularly pleased, since they were asking for some adjustment in the exchange rate and modest minimum wage increase. It is not clear, however, to what extent they will respect the commitment of no price increases. There have been reports about substantial increases in prices of a number of products (so-called "reetiquetacion") amidst consumer and labor protests, and SECOFI closing down some of the large department stores. Farmers seem to be quite unhappy with vague promises of some adjustment of guaranteed prices and no increase in water and fertilizer prices. To make their case known and felt, they have, in the past few weeks, blocked several highways in the North of the country for several hours. The labor unions, too, have been complaining on the grounds that the expected inflation and cost of living increase for 1989 are considerably higher than the 8% increase in minimum wages. The recently negotiated collective wage contracts, on the other hand, have been in the 15 to 20% increase range, triggering the suspicion that the underlying inflation may be inching up again, not just as a result of the announced crawl in the exchange rate but because of the increases in the cost of labor.

3. The 1989 Economic Policy: Is Recovery in the Making?

31. In mid-December, the new authorities submitted the 1989 Budget to Congress for approval. The voluminous documentation accompanying the 1989 public sector revenue and expenditure legislations spells out the following principal macroeconomic objectives and assumptions for 1989 (a more detailed analysis will have to be done in early 1989):

(i) GDP growth: 1.5%; (ii) Inflation rate: 22% average, 18% December-December rate; (iii) Fiscal accounts (as a share of GDP): overall deficit - 6.4%, operational deficit - 1.6%, primary surplus 6.7%; (iv) Balance-of-payments performance: current account - US$4.8 billion deficit, trade account - in balance, international price of oil - US$10 per barrel, net increase in external indebtedness - US$7 billion (with a possibility of increasing it to US$10.5 billion - see para. 38 below). The thrust of the principal economic policies as contemplated and derived from the budget objectives and targets is summarized below.

32. Public Sector Income Policy. The objective is to increase government non-oil revenues, reduce some tax rates to encourage productive activities, amplify the tax base, achieve administrative simplification, and introduce bigger equity and decentralization. Specifically, the corporate income tax will be applied entirely on the new (inflation-adjusted) base; real investment expenses will be 100% deductible from the income base (except for the three metropolitan areas); a new 2% tax will be applied on the net assets of those firms who do not report profits; enterprise dividend payments will no longer be tax deductible and dividend payouts to individuals will be taxed additionally; firm revenue tax rates will be reduced from 39.2% in 1988, to 37% next year, and to 35% in 1991; the VAT in the border areas will be increased from 6% to 10%; and the income tax rate for medium and low-income earners will be reduced by ten points. Despite these measures, the overall revenues as a percentage of GDP are expected to be 2.1 points lower than in 1988, mostly because of lower revenue from petroleum (2.2% of GDP).

33. Public Sector Expenditures. The main objectives here are to: reduce inflationary pressure and begin gradual economic recovery; improve social welfare of the neediest; widen and improve services in education, health and public security; stimulate private investment; maintain basic infrastructure; restructure the public sector and increase its efficiency; and keep strict control over public expenditures. Overall expenditures will be 2.8% lower in real terms than in 1988 (equivalent to .7% of GDP), but expenditures (both current and investment) in regional development, health, nutrition, and education will be 3.9% higher in real terms. Parastatal expenditures will be reduced considerably, with the overall public sector fixed investment down 5.2% in real terms.

34. Financial Policies. The main objective is to strengthen domestic savings and the financial system. A balance will be sought between an adequate remuneration to savers and reasonable lending rates to investors and the public sector. More emphasis will be put on better credit allocation to the private sector and priority activities and regions. The banking system is expected to be given more autonomy and will be subject to a more flexible regulation. The authorities have indicated that they would undertake a reassessment of the role of the development banks and trust funds in order to avoid duplication between the two types of institutions and improve coordination among them. A complementary role between the banks and non-bank financial intermediaries will be sought.

35. Commercial and Industrial Policies. As mentioned above, the minimum import tariff rate will be raised to 10%. The authorities expect

that this will result in lower effective protection rates, lower dispersion in both nominal and effective protection rates, and increase somewhat government revenues. To offset any negative impact on exporting activities, the temporary import and duty drawback regimes will be improved and expanded. The sectoral programs ("Programas de rama"), which have caused considerable distortions in some sectors, will be renegotiated and phased out in the context of bilateral negotiations with the US. It is expected that the fiscal incentives (CEPROFIs) will be abolished. Regulations governing direct foreign investments will be made more liberal, simplified and transparent. As mentioned above (para. 9), SECOFI is undergoing a profound change: as part of the new Pacto (para. 29) it will introduce a major deregulation and administrative simplification program in the industrial and trade sectors. SECOFI also plans to lift price controls for items whose prices are above the international levels. Also, a new look at the methodology, justifying price controls, will be undertaken.

5. External Debt Solution: How Soon and How Much?

36. No other economic issue has received more attention in the congressional and other public debates in Mexico in the recent period than the problem of the country's foreign debt. In his inaugural speech, Mr. Salinas was careful to strike a delicate balance between putting the interests of the nation before the continuous transfer of funds abroad and a conciliatory message to Mexico's creditors and commercial partners. But the message was clear and unequivocal: Mexico has above all to grow again and will remove all obstacles to do so. He then outlined four basic principles which will guide his government's strategy in resolving the debt issue: (a) the transfer of funds abroad has to be reduced so that the economy can resume growth; (b) the value of old debt needs to be reduced too; (c) new money that Mexico will contract has to be obtained for a sufficiently large time horizon to avoid uncertainty and annual renegotiations; and (d) during the sexenio, the real value of foreign debt, measured as a share of the country's GDP, will also have to decline.

37. In congressional hearings in late December on the 1989 Budget, the two ministers presenting and defending the Administration's economic policies for 1989 (Aspe and Zedillo) were emphatic in the government's strategy of negotiated settlement of the problem of debt. They stressed that a menu of options would be considered by the country to achieve the goals set out by President Salinas. Those options include capturing the market discount of the country's debt, differentiation among its commercial creditors with some opting to retire or reduce their exposure in Mexico, and others increasing it, and/or obtaining additional resources from multilateral and bilateral financiers. Secretary Aspe stated that Mexico would be seeking in the 1989 debt renegotiations a reduction of transfers abroad from some 6% to 3% of the country's GDP. The opposition (both left and right) attacked the government for being too conciliatory towards Mexico's external creditors, incurring new debt, thus mortgaging and sacrificing the country's future development. Nevertheless, and somewhat surprising, when the revenue law of the Budget was voted upon in the Chamber of Deputies on December 22, the additional net foreign debt for 1989 proposed by the Executive Branch was approved by a vast majority. (Of the 500 deputies, 387 were present. Out of 387, 382 voted in favor of the government proposal, 3 against, and 2 abstained. This implies that, with the PRI having 260 seats--not all of them were present--some two-thirds of

the opposition representatives voted in favor of the 1989 revenue law. However, when the spending law was approved on December 29, all 170 members of the opposition parties who attended the session voted against the bill protesting that too much is allotted for foreign debt payments and that the spending program was "imposed" by the Administration.)

38. The Congressional approval of the country's new indebtedness does include an important novelty, however. US$7 billion of new debt was authorized, with an option of contracting an additional US$3.5 billion. However, should more than US$7 billion be needed in 1989, the President would have to go back to the Congress and seek its approval for this extra debt (not more than US$3.5 billion), providing explanation why more foreign money is needed. This is the first time in Mexico's recent history that the Legislative branch is limiting the Executive in contracting foreign loans. One other change voted by Congress is one requiring the President to seek the Chamber's opinion before selling or closing state-owned enterprises.

39. With the Congressional approval completed, the government (led by the SHCP) will now be embarking upon debt renegotiation. In fact, Mr. Aspe's brief visit to Washington last week is the first official step in this direction. The pressure on Mr. Salinas and his collaborators to come up with an acceptable solution soon will be enormous. Everybody knows that the success or failure of the PECE and the expected and promised recovery in the second half of the year hinges critically upon the resolution of the foreign debt problem. But for Mr. Salinas and his party there is obviously more than just the success of the 1989 economic program at stake. Most of the key officials on Salinas's team admit that the resolution of external debt issues is not a panacea and that Mexico has to continue on its fiscal austerity and internal structural adjustment path if it is to resume sustainable growth. Nevertheless, the longer the debt overhang lingers on with no tangible solution in sight, the more uncontrollable the handling of the economic and political situation will become for the Government of Mexico.

December 1988

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting to Consider MEXICO - Finance and Trade Sector Loan (FTSL), Industrial Sector Policy Loan (ISPL), and Public Enterprise Reform Loan (PERL)

Held on Wednesday, December 21, 1988 in Room E-1243

A. Present

Committee	Others
Messrs. M. Qureshi, Chairman	Messrs. V. Dubey, EAS
R. Steckhan, LACVP	U. Thumm, EAS
C. Michalopoulos, EMNVP	E. Segura, LACVP
J. Wood, FPRVP	K. W. Lee, LA2DR
J. Holsen, CECDR	M. Martinez, LA2CO
H. Scott, LEGVP	S. van Wijnbergen, LA2CO
H. Vergin, OPNSV	P. Knotter, LA2TF
	J. Varallyay, LA2CO
	D. Bock, DFS
	V. Corbo, CECMG
	A. Steer, FRS
	D. C. Rao, FRS
	T. Hutcheson, SPRPA
	R. Cucullu, LEGLA
	E. Mendez, LATTF
	C. Quijano, LACVP
	C. Loser, IMF
	V. Freeman, CL1D1
	F. Kahnert, ASIVP
	C. Robless, OPNSV
	R. Harris, CODOP
	S. Burmester, SECGE

B. Issues

1. After meeting on October 14 and November 9 to consider the proposed package at preliminary stages, the OC met on December 21, 1988 to discuss the green-cover President's Reports and a request by the Region for authorization to negotiate the three adjustment operations. Introducing the package, the Region explained that since appraisal in October, the policy content of the three proposed operations evolved in an iterative process with respect to both the Mexican authorities and other departments in the Bank. The IMF and the Bank were in general agreement with regard to the assessment of Mexico's economic situation and the adjustment policies that should be pursued.

2. Macroeconomic Framework and Financing Plan. The meeting first focused on the macroeconomic framework and the feasibility of the financing plan. The Chairman stressed the importance of an adequate macroeconomic

framework for undertaking the multitude of structural reforms that were planned. He expressed the hope that the IMF would be involved to facilitate the consolidation of the stabilization process and to help ensure that the external financing requirements of Mexico over the next few years were fully met. The Region pointed out that the main features of a new program (PECE) announced by President Salinas on December 12 pointed in the right direction, but that it was too soon as yet to make a judgment on the adequacy of the 1989 program.

3. In response to questions raised by some OC members, the Region explained that while it would have been more effective and less risky to undertake an upfront devaluation rather than the modest crawling adjustment that had been announced in the PECE, it was difficult to argue that the proposed crawling adjustment was inconsistent with the macro-objectives that had been set out. The operational deficit contained in the 1989 budget submitted to the Congress, on the other hand, was well within the proposed parameters set out in the Bank documents. However, it was noted that there was not yet enough information to judge whether the tax and expenditure measures proposed in the budget were consistent with the target for the operational deficit. The Region noted that, aside from the measures proposed in the budget, the authorities will need to maintain the flexibility to adjust quickly, as needed, if external factors such as oil prices or interest rates moved unfavorably. The representative of the IMF agreed with this assessment and stressed that while the course taken under PECE--and in particular the approach to exchange rate adjustment--provides flexibility, it also involved some risks. For example, high domestic interest rates might make it difficult to reduce the deficit and could compromise investment and growth targets. In response to queries about the expected marginal savings rate and the appreciation of the real exchange rate, the Region explained that after spectacular fiscal adjustments, Mexico is facing good fiscal prospects over the medium term and that the real exchange rate even after some appreciation is still lower than in 1985.

4. Certain Committee members voiced concern that macroeconomic performance had to be closely monitored, but cautioned that some of the tranche release conditions as stated in the Finance and Trade Sector Loan were not specific enough to lend themselves to adequate monitoring. The Region pointed out that the Bank has been monitoring Mexico's macroeconomic performance at six-month intervals in the context of previous adjustment operations but agreed that the presence of the Fund would be very helpful and would lessen the burden of monitoring the macro-performance on the Bank. In addition, a Fund arrangement involving significant use of resources would improve the financing picture over the next six years and strengthen Mexico's prospects for securing external financing from commercial banks and other sources.

5. Mexico's financing needs at an average of about US$6 billion per year or so (depending on such external factors as oil prices and interest rates) are very large and the success of the growth-oriented program would depend importantly on the availability of adequate external resources. In reviewing Mexico's financing requirements, the Chairman emphasized that

while the three proposed operations had to be supported by a credible financing strategy capable of securing the external financing needed, it would be unrealistic to delay processing of the three Bank loans until firm multi-year commitments for financing were available, as suggested by some OC members. There was no precedent for putting together in advance such a multi-year financing package over a 5-6 year period. The success of a realistic financing strategy will hinge on progress in Mexico's adjustment program, the presence of the Fund, and a suitable strategy vis-a-vis the commercial banks, which should be in place by mid-1989. The Chairman agreed with the Region's proposal that agreement in principle on matching Japanese cofinancing and development of a credible medium-term financing strategy should be conditions of Board presentation for the three loans. He also concurred with the proposed second-tranche condition, i.e. firm financing commitments for 1989-90 and agreement in principle with major creditors on a medium-term financing plan. There was also agreement that direct foreign investment would be expected to contribute a significant portion of Mexico's external financing needs in the coming years.

6. In a different context, a Committee Member raised the question whether the proposed approach based on the three adjustment loans for a total of $1.5 billion was the most effective use of the Bank's capacity to help Mexico secure the needed foreign financing. He wondered whether other approaches, e.g. the use of specific financial techniques in support of public enterprise restructuring, would not be preferable. The Region pointed out that the currently proposed approach envisaged policy reforms of unprecedented importance in Mexico and the total amount was well within the current year's lending program. Moreover, it had to be seen as one element in a $10 billion five-year lending program in support of Mexico's multi-year external financing needs. It was stressed that the current approach does not preclude other solutions, including more innovative financial techniques in the debt restructuring area. It was also noted that the task force to consider Mexico's external financing needs had recently been reactivated to explore additional approaches to resource mobilization.

7. Specifics of the Finance and Trade Sector Loan. In response to the Chairman's question regarding the key elements of the proposed sector reforms, the Region highlighted important areas such as improvements in the functioning of commercial banks through a reduction in forced lending, better regulation; greater competition from the streamlining of rules and regulations applied to brokerage houses, as well as more consistent policies with regard to development banks and trust funds including a reduction in subsidies and a marked improvement in their balance sheets. The Chairman stressed that in the financial and trade sectors, the conditionality should be formulated in terms of specific and monitorable actions in addition to broad policy objectives, in order to ensure efficient financial intermediation, including credit to the private sector. He also noted that the proposed loan dealt with macro-economic and trade policies in addition to certain reforms in the financial system. Since it was not a financial sector loan per se, expectations with respect to proposed changes in the financial system have to be realistic and reasonable.

8. In summing up the discussion on the macroeconomic framework and the specifics of the Finance and Trade Sector Loan, the Chairman reemphasized the importance of the macro conditions spelled out on p. 27 of the draft President's Report, the need to specify fiscal measures, and the need for a competitive real exchange rate to minimize risks. He also stressed the desirability of IMF involvement and reiterated that the negotiations should aim at securing specific action commitments in the different areas spelled out in the President's Report in which action was sought.

9. Industrial Sector Policy Loan. The Region described the thrust of the policy content of the ISPL as being deregulation, greater transparency, and less bureaucratic discretion in key areas such as direct foreign investment and technology transfer. The vehicles would be phasing out of subsidy programs, including effective reductions in protection and subsidies, deregulation of transport and telecommunication services, and improvements in public sector procurement. The Chairman agreed that while significant progress should be made in the various sector programs ("Programas de Rama"), far-reaching deregulation of the transportation sector may be more difficult. He stressed the need for specificity in the proposed actions and directed that the Region concentrate on certain key areas such as the liberalization of legislation including the removal of discrimination relating to direct foreign investment which is central to encouraging the inflow of private investment and the recovery of growth. It was important that the case-by-case approach to foreign private investment be phased out and the withholding tax be lowered.

10. Public Enterprise Reform Loan. The Region indicated that the main objective of the operation was to improve the efficiency of public enterprises through measures to improve the competitive environment and, insofar as individual enterprises are concerned, through restructuring and divestiture--including privatizations--and to provide managerial and financial autonomy, and improved management, to enterprises. The Chairman noted that in the area of privatization, the Bank should try to reach agreement with the Mexican government on as concrete a privatization program as possible to be undertaken in the future. A Committee Member noted that the proposed program of price increases for public enterprises was important for the Government's fiscal performance and asked for further explanation. The Region responded that a small number of public enterprises absorbed the bulk of government transfers and had the largest distortions in prices. During negotiations, the Bank will seek agreement with the Mexican government on a program of price increases and reduction in government transfers to these selected public enterprises.

C. Decisions

11. The Chairman summed up the discussions, as follows:

(a) There has been concern by some OC members about proceeding to negotiate the three proposed loans at this stage. But the Region made a good case that the environment and timing were now propitious for the new administration in Mexico to take the required decisions. The policy issues were, however, both complex and highly sensitive and the negotiations would most likely be long and difficult. Moreover, the Mexican authorities were the ones who were orchestrating the timing of the reforms as a basis for seeking World Bank support. The Region should report back to the SVPOP before negotiations are concluded, thus offering another opportunity to review the specific policy content of the three operations.

(b) The presence of the Fund would facilitate the implementation of Mexico's adjustment program and help secure external financing in the amounts required. The specifics of IMF involvement will be revisited before the conclusion of negotiations to ensure that adequate arrangements existed to monitor the macro-economic situation and secure external support.

(c) It will be necessary to have a credible financing strategy that gives some confidence that the required external finance will be available.

(d) The Region is authorized to initiate negotiations in January 1989.

(e) Because of the complexity and importance of the issues involved in these three operations, the loan package together with the minutes of the OC meeting should be sent to Mr. Conable for his review and approval of the course outlined.

JVARALLYAY/UTHUMM:vlw
December 29, 1988

MEXICO - FTSL

Proposed Conditionality

A. Policy Actions for Macroeconomic Management and Public Sector Planning

Problem Area	Objectives	Loan Conditions: By Board Presentation	Loan Conditions: By Second Tranche	Dated Covenants
1. Macroeconomic Consistency				
- In order to ensure a stable macroeconomic environment in 1989, the projected operational deficit and the sources of domestic pulic sector financing should be consistent with the expected inflation, GDP growth and possible foreign borrowing.	- a macroeconomic environment for 1989 with low inflation and minimum uncertainty about the main thrust of the economic policy.	- Approval by Congress of the 1989 Budget with an operational deficit not higher than 2% of GDP and agreement on the management of domestic credit to the public sector and on issuing of new domestic debt consistent with the macroeconomic gtargets for 1989.	- Satisfactory assessment of the macroeconomic framework and agreement on the necessary policy actions to ensure the achievement of the macroeconomic program.	
- Future of the "Pacto"; pressures on the nominal anchors.		- Strategy for gradual decontrol of nominal anchors without compromising the success of the stabilization effort.		
2. Public Sector Planning and Budgeting				
- Within the overall objective of recovering economic growth via revived investments, the Government needs to achieve greater efficiency in planning, preparing and implementing public investments.	- Improvements in investment efficiency are hampered by weak planning and budgeting systems.			- Action Program for the: (a) strengthening of investment planning and evaluation by issuing guidelines for economic evaluation for public investment projects; (b) strengthening budgeting procedures by introducing multi-year budgeting; and (c) improvement of externally funded investment implementation by introducing budgeting incentives and by establishing a central monitoring unit.

Problem Area	Objectives	Loan Conditions: By Board Presentation	Loan Conditions: By Second Tranche	Loan Conditions: Dated Covenants
3. Public Sector Revenues				
- Erosion in tax base cumbersome tax administration.	- Increases in tax revenues through tax reform and improved tax administration.	- Action Program for increasing tax revenues through tax reform and improved tax administration.	- Satisfactory implementation of the Action Program.	
4. State and Local Finances				
- Fall in the state governments' own tax revenues, particularly property taxes.	- Improvement in own tax raising effects.	- Action Program for the gradual elimination of non-matching grants for investment and regional development in those states and municipalities able to service Banobras credits on non-subsidized terms.		-Revision to the revenue sharing formula to give added weight to efforts by states to increase own resources and to introduce similar incentives for their municipal governments.
- Very serious deterioration in user charges and property taxes in the Federal District, requiring mounting transfers to cover services.	- Reduce budget transfers to the Federal District.		- Action Program for increases in own revenues so as to reduce budget transfers in the 1990 budget.	

B. Financial Sector

Problem Area	Objectives	Loan Conditions: By Board Presentation	Loan Conditions: By Second Tranche	Loan Conditions: Dated Covenants
1. Forced Lending to Public Sector				
- Private Sector has extremely limited access to banking sector funds.	- Support the government's objective of having the commercial banks respond only to market forces. Commercial banks should not be compelled to lend to the government or to any sector.	- Action Program for the gradual elimination of forced lending to the government and the lending allocations to given sectors.	- Satisfactory implementation of the Action Program.	
2. Competitive Environment				
- Reduced bank competition and deposit mobilization.	- To foster greater competition between banks thereby raising efficiency, and to mobilize more deposits.	- Action Program for allowing banks to set their own deposit interest rates. - Action Program for increasing the scope of brokers' activities.	- Satisfactory implementation of the Action Program.	
3. Development Banks				
- Role of development banks and trust funds unclear. Subsidies inadequately controlled.	- To improve administrative efficiency and ensure that subsidies are well targeted and controlled.	- Action Program for further progress in the elimination of interest rate subsidies.	- Action Program for the redefinition of the role of each Trust Fund and development Bank, including in particular a review of the finances of NAFIN, BANCOMEXT and BANOBRAS, and restructuring of BanRural and ANAGSA, so that transfers in 1990 could be substantially reduced as compared with 1988.	- Centralize the monitoring of interest rate subsidies.

Problem Area	Objectives	Loan Conditions: By Board Presentation	Loan Conditions: By Second Tranche	Loan Conditions: Dated Covenants
4. Bank Regulations and Supervision				
- Inadequate supervision and prudential regulations.	- To safeguard the solvency of the banking system and brokers.	- Action Program for the strengthening of supervision by actions in the following main areas: (a) classify banks' loan portfolios according to default risk; (b) more stringent provisioning for loan losses and interest accruals; (c) disclose the state of each bank's financial state in detail to the public; and (d) improve and enforce the supervision of brokers.	- Satisfactory implementation of the Action Program.	

C. Trade

Problem Area	Objectives	Loan Conditions: By Board Presentation	Loan Conditions: By Second Tranche	Dated Covenants
1. Policy Objectives				
- Need for clear indication of Government commitment to the trade liberalization process.	- Enhance credibility and sustainability of reform.	- Announce and publish Trade Policy Statement with a clear indication that there will be no rollback.		
2. Quantitative Restrictions (NTB)				
- Current coverage of NTB is about 23% of tradeable production.	- Further reduction of NTBs to lower protection, increase transparency and limit discretion.	- Action Program for further reductions in NTB.	- Satisfactory implementation of Action Program.	
3. Export Controls (EC)				
- Current coverage is about 25% of tradeable production.	- Promote exports.	- Action Program for further reductions in EC.	- Satisfactory implementation of Action Program.	
4. Anti-dumping				
- Use of the regulations to increase protection.	- The system should be consistent with the trade liberalization process.	- Action Program for improvements in the system, including the creation of an independent Commission in charge of final ruling located in a department with economy wide responsibilities.		

Annex V

MEXICO

INDUSTRIAL SECTOR POLICY LOAN
Suggested Agenda for Policy Reform

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
I. Improve Factor Quality and Mobility			
a) Direct Foreign Investment	In 1988 a reference system was established which provides information on the basis for previous foreign investment decisions. Withholding tax on dividends remitted was reduced from 55% to 50%.	Reduce withholding tax rates on dividends remitted to foreign companies from 50% to 40%.	Condition of Board Presentation.
	The National Commission on Foreign Investment (NCFI) announced in 1984 that Mexico's policy would favor DFI. In 1986 small foreign companies were exempted from the approval process if they met certain conditions. In 1987 rules for implementing the foreign investment law were simplified, permitting increases in foreign ownership up to the respective maximum percentage for existing firms. In 1988 the NCFI published clearer criteria for approving majority foreign owned project.	Prepare and announce a satisfactory plan of action to: i) further liberalize existing regulations and procedures governing foreign investment; ii) introduce more transparency and automaticity into system; iii) eliminate the requirement of case by case approval except for a small negative list of sectors; and iv) strengthen promotional efforts to attract foreign investors.	Condition of Board Presentation.
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
		Agreement on Terms of Reference for a study for reducing sectors from which DFI is excluded or limited and identifying other areas for further liberalization, and	Condition of Board Presentation.
		initiate such a study.	By April 30, 1989.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
		Complete study and agree on recommendations for implementation.	Condition of Second Tranche Release.
b) Technology			
1) Improve access to foreign technology.	In 1987 patent protection was increased from 10 to 14 years, infringement penalties were strengthened, and protection extended to chemical and pharmaceutical processes; production protection in this sector to be implemented in 1997.	Prepare and announce a satisfactory plan of action to (i) change the orientation of technology policy to active promotion and support for the acquisition of foreign technology; (ii) reorient the public R&D infrastructure to provide technical services and contract research to the industrial sector.	Condition of Board Presentation.
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
2) Promote research and development (R&D) activities.	Programs (Bank supported) and institutions to finance technological development in industry are in place.	Announce that patent protection to chemical and pharmaceutical products will be granted in 1992 rather than 1997.	Condition of Second Tranche Release.
		Agree on Terms of Reference for a study of major problems and constraints on technology development (legal, economic, financial, administrative and institutional), and initiate such a study.	Condition of Board Presentation. By April 30, 1989.
		Develop a strategy and make satisfactory progress in implementation of study recommendations.	Condition of Second Tranche Release.
c) Labor			
1) Increase interindustrial mobility of labor.	Pilot programs for labor retraining (Bank-supported is in place. Preliminary diagnosis on factors impairing mobility has been prepared.	Agree on Terms of Reference for a study of factors impairing interindustry labor mobility, and initiate such a study.	Condition of Board Presentation. By April 30, 1989.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
	State employment service has been established. Catalog of occupations and training needs is in preparation.	Complete study and agree on recommendations for implementation.	Condition of Second Tranche Release.
		Prepare a program to strengthen worker training programs and develop proposals for private firm financing for such programs.	Condition of Second Tranche Release.
		Carry out a study of possible ways to enable export firms to enter into more flexible labor contracts.	Condition of Second Tranche Release.
II. Phrase out Sectoral Programs			
Phase out sectoral programs as instruments of industrial promotion to improve efficiency of resource allocation.		Prepare and announce action plans to phase out sectoral programs in automotive, petrochemical, pharmaceutical, microcomputer and textile sectors, by eliminating QR's, DCRs, entry barriers, tax and credit incentives, foreign exchange balances, price controls and preferential DFI treatment, taking into consideration existing contractual agreements.	Condition of Second Tranche Release.
		Automotive (including parts) and trucks	
	DCRs for exported automobiles lowered; relaxation of regulations on number of automobile product lines.	Prepare and announce satisfactory plan of action to phase out: (i) remaining QRs and DCRs for autoparts; (ii) QRs, DCRs, foreign exchange balance requirements and regulations for car production; (iii) QRs and DCRs for trucks and trucks' components;	Condition of Board Presentation.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
		(iv) restrictions on production of gasoline powered trucks; and (v) to make the indirect consumption tax (ISAN) more progressive for luxury cars.	
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
		-Petrochemicals:	
	Government allowed imports of basic petrochemicals by the private sector; QRs on secondary products were replaced by 10-15% tariff; 30% subsidy on energy inputs and basic petrochemicals prices was eliminated. Government reclassified petrochemical products opening up production for private and foreign participation.	Prepare and announce a satisfactory action plan to: (i) transfer products from basic to secondary (to reduce basic products to a minimum "core-group") and from secondary to tertiary petrochemicals products; (ii) allow private sector to enter into long-term import contracts for basic petrochemicals; (iii) eliminate licensing requirements for basic petrochemical imports; and (iv) develop sales contracts of basic petrochemicals between PEMEX and secondary producers, which are in line with industry practices worldwide.	Condition of Board Presentation.
		Satisfactory progress in implementation of action plan.	Condition of Second Tranche Release.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
		-Pharmaceuticals:	
	NCFI gives blanket approval (and not product or project specific) for existing firms.	Announce expiration of program.	Condition of Board presentation.
		Prepare and announce a satisfactory action plan to eliminate (i) QRs and DCRs in accordance with contractual arrangements; (ii) compulsory R&D spending; and (iii) price controls.	Condition of Board Presentation.
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
		Agree on Terms of Reference for a study to establish appropriate health standards, and procedures for the pharmaceuticals industry;	Condition of Board Presentation.
		and initiate such a study.	By April 30, 1989.
		Satisfactory progress in carrying out study.	Condition of Second Tranche Release.
		-Microcomputers:	
	QRs on components were eliminated.	Prepare and announce a satisfactory plan of action to eliminate (i) remaining QRs, DCRs, and foreign exchange balance requirements; and (ii) compulsory R&D spending.	Condition of Board Presentation.
		Satisfactory progress in implementation of plan of action.	Conditon of Second Tranche Release.
		Textiles	
	100% DFI was allowed on an exceptional basis.	Introduce auction system for export quotas.	Condition of Second Tranche Release.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
III. Promote Non-Distorted Goods Markets			
Remove entry barriers and simplify administrative and legal procedures affecting businesses.	Introduction of simplified registration procedures for microenterprises in 1988 and of administrative procedures (e.g. construction permits, tax administration) in 1986-88.	Create an inter-ministerial task force (with private sector participation) to make proposals for administrative simplification.	Condition of Board Presentation.
		Prepare a satisfactory program of measures to simplify bureaucratic procedures, affecting entry, exit and operation of enterprises and a satisfactory plan of action to implement such measures.	Condition of Board Presentation.
IV. Promote Competitive Factor Pricing.			
a) Eliminate tax incentives.	Temporary suspension in issuing new tax incentives certificates (CEPROFIs) in line with ESP except for SMI, rental housing, and eligible agriculture.	Announce that CEPROFIs are permanently eliminated.	Condition of Board Presentation.
b) Eliminate industrial credit subsidies.	Industrial credit subsidies have been reduced.	Eliminate remaining industrial credit subsidies by permitting commercial banks to onlend at market rates.	Condition of Board Presentation.
V. Deregulate and Improve Provision of Services			
		Establish a commission to prepare a coherent reform package.	Condition of Board Presentation.
a) Transportation 1. Increase freedom for users to select providers of trucking services.		Prepare and announce a satisfactory plan of action to (i) eliminate	Condition of Board Presentation.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
2. Remove obstacles to movement of existing carriers and the range of cargoes which can be transported in order to improve the use of transport capacity. 3. Remove barriers to entry into trucking. 4. Use full potential for containerized road transport. 5. Improve international trucking arrangements with the U.S.	A second firm has been authorized to operate as a multi-modal (container) transport agent. Consolidation of containers is now taking place in onlend depots. Negotiations have taken place with U.S. Department of Commerce to facilitate international trucking movements. Movements of truck trailers across the border is now allowed.	monopolistic practices of cargo terminals as allocators of trucking (addressing requirements for issuing shipping documents and trucking service contracts); (ii) Set only upper and lower limits on trucking rates and leave rate negotiation to users and carriers; (iii) Permit nationwide services for small cargo movements; (iv) Allow truckers who ship traffic across route corridors to pick up return cargo; (v) Permit unrestricted truck operation within 100 kms of origin and destination of cargo; (vi) Allow all federal concessionaires to transport international cargo; (vii) Extend concept of specialized cargo to all cargo shipped under long term contracts; (viii) Permit any experienced carrier to be a multimodel (container) operator without route restrictions and allow the movement of national cargo in international containers; (ix) Define containers as specialized cargo: (x) Develop the institutional arrangements for establishing international freight terminals in Mexico City and other key centers; and (xi) Develop proposals for facilitating international movements as a basis for negotiations with the U.S.	

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
b) Telecommunications			
1) Establish a program for telecommunication sector reform.		Establish a commission to prepare a coherent reform package.	Condition of Board Presentation.
		Prepare and announce a satisfactory plan of action including the items listed below.	Condition of Board Presentation.
2) Reform tariff and tax system to reduce existing price distortions.		Define pricing and tax policy and strategy for adjustment.	
		Initiate tariff adjustments by: (i) raising rental and local call charges; and (ii) lowering international call charges closer to international market rates levels.	
		Study the possibility of charging calls by time and reducing the number of free local calls.	
		Reduce the specific tax on telephone bills.	
3) Accumulate investment capital for infrastructure development.	Interminsterial commission established.	Increase and maintain average tariff levels in real terms.	
		Explore and implement, as feasible, alternatives for cooperative financing and joint venture schemes.	
4) Create a coherent and consistent regulatory structure and system of regulations.	Regulatory and operational functions separated in different DG's within SCT. SERTEL given partial managerial autonomy.	Fully separate regulatory and operational functions by: (i) strengthening SCT's regulatory role. (ii) separating SCT's operational functions into	

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
	TELEGRAFOS and CORREOS given greater autonomy but remain under SCT control.	independent public or private businesses. (iii) shifting marketing of Morelos satelite services to independent public or private entity.	
		Increase transparency of regulatory process and encourage user input.	
5. Increase efficiency and responsiveness of public providers of telecom services.	TELMEX has been reorganized to increase its responsiveness and competitiveness.	Complete reorganization of TELMEX, taking into consideration possible future privatization.	
6. Increase competition in the provision of telecommuniction services.		Implement a package of initial liberalizing measures, including:	
		(i) eliminating licensing requirements for data-based and information-processing services; (ii) permitting Telmex to offer data services and a full range of private net-work services; (iii) permitting the interconnection of private telephone networks and some resale of voice and data services; and (iv) open telereservation service to competition.	
		Satisfactory progress in implementation of plan of action.	Condition of Second Tranche Release.
VI. Reduce Industrial Pollution			
Reduce Industrial Pollution in the Mexico City Metropolitan Area (MCMA).	A new environment law, the Ley General de Equilibrio Ecologico y la Proteccion al Ambiente, was enacted on March 31, 1988.	Establish a high level inter-secretarial committee to coordinate environmental policy measures.	Condition of Board Presentation.

OBJECTIVES	ACTIONS ALREADY TAKEN	SUGGESTED MEASURES	TIMING
	SEDUE has established environmental quality standards. SEDUE has prepared a partial inventory of industrial polluters (mostly air and water).	Develop a strategic plan to reduce industrial pollution in the MCMA, to include: (i) Publishing air and water quality standards and establishing appropriate enforcement mechanisms. (ii) ensuring that corresponding emission/effluent level parameters, and solid and hazardous waste disposal requirements are in place and enforced. (iii) strengthening existing and establishing new environmental quality monitoring networks. (iv) developing a price model for establishing a system of industrial user and treatment fees (water), and collection, tipping and confinement fees (solid and hazardous wastes). (v) completing the inventory of major industrial air, water, solid and hazardous waste polluters.	Condition of Second Tranche Release.
VII. Inter-ministerial Coordination		Establish a Policy Coordinating Committee composed of all government entities involved in the implementation of the project.	Condition of Board Presentation.

MEXICO - RPEL: Loan Conditionality

Board presentation	Second Tranche (06/90)
1. Agreement on a foreign financing plan (FFP) consistent with the macro program, including cofinancing tied to this loan.	Satisfactory progress in implementation.
2. Agreement on reducing budgetary transfers to PEs in accordance with the attached Table 2, which would yield an estimated: (a) 1989 aggregate budgeted transfer to PEs of 1.8%, and (b) 1990 aggregate budgetary transfer to PEs of 1.3% of GDP.	(a) Transfers in line with agreement; (b) Actual transfers during 1990 being in line with agreement.
3. Agreement on a real price increase plan (RPIP) for PEs along the lines of Table 2.	Compliance with the agreed-upon RRIP.
4. Select at least 10 PEs for the RPEL, accounting for 35% or more of total value of assets of itemized PEs in the budget--excluding Pemex and CFE. Agree on a minimum proportion of these PEs, both in number and value of assets, to be prepared for privatization.	For the selected PEs for privatization, have completed all the necessary steps to get in saleable form and offer for sale. For the rest of the selected PEs, have them operating under the P.A. system for at least 3 months.
5. Publish a statement on Government role and policy in the production of goods and services, defining clearly the concept of "priority" area. The concept must state that the Government will <u>not</u> establish new PEs (or PEs' subsidiaries) or acquire existing private sector enterprises which operate in areas of a <u>commercial</u> nature and/or which produce <u>tradeable</u> goods, except in cases of major market failure involving the production of goods/services of social interest.	
6. Final approval of the P.O. under a charter acceptable to the Bank and appointment of General Manager.	Fully staffed and operating according to charter.
7. Establishment of the DEP under a charter acceptable to the Bank and issuance of TOR to consultants to assist in the development of PAs.	Fully staffed and operating according to charter.
8. Issue regulations to the PE Law defining: (a) supervisory role of Govt. agencies dealing with PEs; (b) role and composition of BOD of PEs; (c) charter of PEs enlarging powers of managers; (d) stringent requirements for the creation of PEs, their subsidiaries and acquisition of companies by public sector entities, including case-by-case approval by CGF.	
9. Agreement on reform in the budgeting system for PEs: 1990 budget should have only three aggregate transfer items per PE (except for Pemex, CFE, Conasupo) and reflect investment funding priority among the PEs.	The 1990 PEs' budget had been prepared under new system.
10. Establish task force and assign responsible office to design and implement: (a) a multi-year investment planning system for the budget; (b) a multi-year PE debt-relief program; (c) a program to delink credit risk of PEs from Govt. guarantees and to increase PEs' reliance on domestic market borrowing, subject to single aggregate domestic credit ceiling for all PEs.	(a) Preparation of 1990 PEs' budget to have incorporated multi-year investment plan; (b) Satisfactory progress in plan implementation; (c) Satisfactory progress in plan implementation.
11. Implementation of the Loan's Plan of Action described below.	Satisfactory progress in the implementation of the loan's Plan of Action.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 15, 1988

TO: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: MEXICO: US$500 million Finance and Trade Sector Loan (FTSL)
US$500 million Industrial Sector Policy Loan (ISPL)
US$500 million Public Enterprise Reform Loan (PERL)

1. I attach for your approval and subsequent distribution to the Operations Committee the draft green cover President's Reports and the Notice of Invitation to Negotiate for the US$500 million Finance and Trade Sector Loan (FTSL), US$500 million Industrial Sector Policy Loan (ISPL) and US$500 million Public Enterprise Reform Loan (PERL). Attached you will also find the minutes of the Operations Committee meeting that reviewed the Region's preliminary proposal for these three operations, a copy of the five-year lending program and a green cover sector report "Towards Growth, Structural Reform and Macroeconomic Stability in Mexico" (Volume I and II, dated December 6, 1988), which provided the intellectual underpinning of the adjustment program. Loan and Guarantee Agreements for the three operations are being revised to reflect changes in conditionality noted in para. 3 below and will be provided shortly.

Loan Processing, Conditions of Negotiations and Board Presentation

2. Subsequent to several high level meetings with Government officials during appraisal in October, the Region had an opportunity on November 16 to review the policy content of the three proposed operations with members of President Salinas' transition team, who have since been assigned to key positions in the new Cabinet. While the Mexican party was in agreement in principle with the broad thrust and direction of the measures proposed in the respective policy matrices, it was uncertain as to how fast the end objectives could be accomplished. Indeed, the detailed program of the Salinas Government still remains to be determined. In view of this, we expect that negotiations -- now expected to start in January 1989 -- may take some time.

3. We are proposing one further change in the attached documents. In order to ensure that the proceeds of the First Tranche of the three operations will be available after Board action without delay, we now propose that the Mexicans should, before the loans are presented to the Executive Directors, satisfy all First Tranche release conditions as set forth in para. 110 of the President's Report of the FTSL, para. 125 of the ISPL, and para. 90 of the PERL. These changes will be reflected in the final version of the documents. In this connection, I want to note that wherever the various documents refer to the "adoption" of action programs, such programs will include a specific timetable for implementation and the Government will give assurances that it will make all legal and administrative arrangements which are required for the implementation of the agreed actions. This, of course, also applies to the second tranche release conditions under all three loans.

4. You will note that there are several tranche release conditions that are still stated in general terms in the documents. They will be firmed up during negotiations. Proposed Plans of Action will be defined with specific timebound conditions and targets linked to tranche release. Also, "satisfactory progress" under the Plans of Actions, as conditions of tranche release will be defined during negotiation. Before we conclude negotiations, we intend to come back to you to seek your approval of the negotiated conditionality package.

Recent Economic Developments

5. On December 12, President Salinas announced a new Pact for Economic Stability and Growth in an effort to consolidate the success of earlier stabilization measures, while stemming a worsening trend in external accounts and eliminating distortions due to a year-old freeze on key nominal variables.

6. Under the announced package, an 8% increase in minimum wage will be granted on January 1, 1989. Contractual wages will continue without a ceiling. The nominal exchange rate will, on average, slide at one peso a day between January 1-July 31, 1989, depreciating 9.2% in the seven month period, which is equivalent to 17% on an annual basis. To protect consumers, the freeze on the price of gasoline, natural gas, and electricity will not be lifted, but adjustments -- yet to be determined -- will be allowed to correct obvious and extreme price distortions. The structure and level of import tariffs will be changed, with a view to eliminating distortions and curbing imports; but it has not been stated how these changes would take place. Farmers' guarantee prices will be revised for the autumn-winter cycle, and in the meanwhile the price of fertilizers and diesel-oil and electricity for irrigation will not change. In addition, prompt implementation of economic deregulatory measures has been promised.

7. The new Pact, which is a cautiously, if vaguely worded, statement, is a step in the right direction towards greater price flexibility. It establishes a broad framework and a few specific targets for January 1-July 31, 1989, in an effort to consolidate the stabilization process. More has to be learned about the details and implementation of the Government's proposals before the Bank can make a full judgement on whether the new Pact constitutes an adequate framework for accomplishing that objective. Therefore, the draft President's Reports have not been updated to reflect the December 12 measures. That would be done at the grey cover stage.

Finance and Trade Sector Loan (FTSL)

8. Under the FTSL, a Letter of Development Policy would be issued by the Government, setting out the broad parameters of the medium term adjustment program. The centerpiece of macroeconomic policy conditionality under the FTSL is the Government's fiscal package. Approval of the 1989 budget with an operational deficit of no more than 2% of GDP (down from 3.1% of GDP in 1988) would be a first tranche release condition.

9. Following the recent measures announced on December 12, 1988, the Bank will conduct a thorough evaluation of the full range of measures

planned by the Government to achieve satisfactory realignment of prices and to assure continued growth in non-oil exports. Adoption of a broader program for 1989 to consolidate the stabilization would be a condition of first tranche release and evidence of a macroeconomic framework consistent with the objectives of the Government's Letter of Development Policy would be a condition of second tranche release. The measures should also assure satisfactory resolution of the pending price and related policy conditionality under three ongoing adjustment operations (Fertilizer, Steel and Agriculture Projects). Such specific measures, satisfactory to the Bank, would be a condition of Board presentation of the FTSL.

Public Enterprises Reform Loan (PERL)

10. The main objective of the proposed PERL operation is to assist the Government in improving the efficiency of public enterprises, reducing the burden they impose on the economy. The proposed program includes: (i) a "disengagement" component to continue with the privatization, liquidation, merger and transfer of public enterprises; and (ii) a program of reforms in the policy and institutional environment to improve the efficiency of enterprises to be retained by the Government. These measures will improve the competitive environment and will provide greater managerial and financial autonomy and accountability to public enterprises. They will increase market forces, change the role of Government agencies, decentralize decision-making to the Boards of Directors of the enterprises, establish a performance setting and monitoring system, and strengthen managerial capabilities and incentives to improve enterprise efficiency.

Industrial Sector Policy Loan (ISPL)

11. ISPL supports a program of reform geared to deregulate the Mexican industrial sector, including the phasing out of the sectoral approach to industrial development, in particular in the automotive, petrochemical, pharmaceutical and microcomputer subsectors, the easing of bureaucratic procedures and barriers to entry for business enterprises, increasing factor mobility (especially direct foreign investment, technology transfer and labor mobility) and supporting R & D, improving key services to industry (transportation and telecommunications). It would also finance studies to identify further policy changes or amendments to existing legislation needed to improve the regulatory framework and help initiate a program to control industrial pollution in the Mexico City Metropolitan Area.

Financing Requirements

12. Mexico's financing needs under the assumptions of the most likely economic scenario show a gap of about US$36.5 billion over 1989-94:

Net Financing Needs/Flows 1989-94
(US$ billions)

Needs			Sources	
Current Account Deficit 1/		27.7	Direct Foreign Investment	11.9
Net Amortization		22.8	IBRD	4.7
Bonds	1.5		Bilaterals	2.5
Banks	13.5		IMF (CFF)	0.6
Private n-g debt	7.5		Subtotal	19.7
Suppliers	0.3			
IMF		5.7	Financing Gap	36.5
Total		56.2	Total	56.2

To the extent that the current account deficit is sensitive to external factors, such as international oil prices, the financing gap too is sensitive, dollar for dollar.

13. Mexico's adjustment program is faced with a risk that external finance might not be available as, and when, required to fill the gap. If this risk were to materialize, economic growth would have to slow down, remaining within 2% p.a. over the whole next "sexenio". This is not a viable scenario. On the other hand, if Mexico were to have access to the international market up to an amount necessary to cover the full gap, the economy would return to grow at rates close to 5% p.a. by the end of the "sexenio" (1994). Under this likely outcome the debt to output ratio would decline from 59% in 1988 to 51.9% by 1994, while debt service would taper off from 58.2% to 29.7%. In other words, Mexico's repayment capacity and creditworthiness would improve, as growth is recovered.

14. While the three proposed operations would provide critically needed seed money for the adjustment program of the new Salinas Administration, it would clearly not be enough. Therefore, as a condition of Board presentation of the three loans, the Government would furnish satisfactory evidence to the Bank that (a) it has reached agreement in principle with the Japanese Government on a matching cofinancing of the three proposed operations, and (b) it has developed a medium term financing plan consistent with the requirements of the adjustment program and the growth targets.

1/ Plus the build-up in gross reserves.

15. As a condition of second tranche release, the Government would have to show that (a) commitments have actually been obtained for the required financing for 1989-90, and (b) it has reached agreement in principle with its major external creditors on a viable medium term financing plan.

16. The Bank -- in its capacity of Mexico's principal creditor -- should consult further with the international financial community, to assist the Government in obtaining the necessary financing, and ensure the success of the adjustment program and recovery of growth. The consultations should: (a) make a strong case vis-a-vis Mexico's creditors about the depth and appropriateness of the country's adjustment efforts; (b) indicate the financing requirements over 1989-94; (c) promote cofinancing of the three proposed operations, as well as other Bank loans; and (d) indicate that the Bank would welcome market related debt reduction schemes which enjoy broad acceptance in the international community.

17. In his inauguration speech, President Salinas recently established the need for reduction in the stock of old debt and net transfers abroad, and stressed that Mexico's financing package should be multi-annual to reduce uncertainties. To achieve these objectives it will be necessary to take a fresh look at the foreign debt problem and the apparently conflicting objectives of simultaneous debt reduction and new financing, especially a multi-year financing package as required for the success of the Government's adjustment program. The Government has restated its intention to approach these issues in a non-confrontational manner. However, this posture could come under strain, especially if delays in reaching agreement with creditors would constrain economic growth and would withhold Bank disbursements under the three proposed operations.

Attachments

Cleared with & cc: Mr. Sugar, LOA; Ms. Manley, LEG

cc: Messrs. Jaycox (AFRVP), Karaosmanoglu (ASIVP), Thalwitz (EMNVP), Inakage (VPCOF), Wood (VPFPR), Shihata (VPLEG), Rajagopalan (VPPRE), Lee (CODDR), Dubey (EASDR), Bock (VPFIS/DFS), Hopper (SVPPR), Shakow (SPRDR), Fischer (VPDEC), Vergin (SVPOP), Holsen (CECDR), Baneth (IECDR), Gelb (CECFP), Cucullu (LEG), Stern (SVPFI), Rao (FRSDR), Frank (CFPVP), Parmar (CIOVP), Burmester/Thahane (SEC)

LAC Information Center

FCL

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee Meeting to Consider
MEXICO - Industrial ~~Sector Adjustment Loan~~, Public Enterprise
Adjustment Loan, and Structural Adjustment Loan

Held on Friday, October 14, 1988 in Room E-1243

A. Present

Committee	Others
Messrs. M. Qureshi (Chairman)	Messrs. V. Dubey (EAS)
S. Husain (LACVP)	A. Ray (EAS)
E. Jaycox (AFRVP)	M. Martinez (LA2CO)
W. Thalwitz (EMNVP)	P. Knotter (LA2TF)
J. Wood (VPFPR)	E. Segura (LACVP)
V. Corbo (VPPPR)	J. Varallyay (LA2CO)
H. Scott (VPLEG)	

B. Issues

1. The OC met on October 14, 1988 to discuss the papers circulated by the Region for the above-mentioned adjustment operations. At the Chairman's request, Mr. Husain explained the background to the three proposed operations. These proposals respond to the strong request made by the Mexican Government during the Annual Meetings for help in insuring a smooth transition from the Pacto and in laying the basis for growth. The GOM approached the Bank because it regarded it as the only institution capable of designing an internally consistent program that gives emphasis to the resumption of sustainable growth. The proposed operations, on which a great deal of work has already been done, still require more definition. The papers submitted reflected the Region's preliminary views at this point; more specific proposals would be presented to the Committee after the missions' return.

2. The Chairman added that when the GOM made the request, they made it clear that a very quick response was needed because the outgoing President wanted to bring the process of reform as near to completion as possible before the new administration took over. We have promised to explore all the possibilities, but without making any commitment since much will depend on the extent of work the GOM itself has been able to do. The new administration must also fully agree with the operations as it will be in charge of implementing the reforms. The incoming administration has already appointed a high-level official to liaise with us; furthermore Mr. Husain will personally discuss these matters with Mr. Salinas, the incoming President.

3. The Chairman also said that we have urged the GOM to get the IMF, which only has responsibility for Enhanced Surveillance at this time, more involved in the process. The GOM has indicated its willingness to explore

use of the compensatory financing facility because of the oil price drop; however, it is unlikely that the GOM will seek a stand-by right now because of the political sensitivity of the issue. The GOM has also indicated to the G-7 ministers in Berlin that the basic issue in Mexico at the present juncture was not macro-stabilization but growth-oriented adjustment programs of the type being envisaged in the proposed operations. This is why they had approached the Bank to put together a growth-oriented program. The Chairman added that while the Bank will have to be satisfied with the macro-policy framework, it would need to be extremely sensitive to jurisdictional issues concerning the Bank and the IMF.

4. Two Committee members enquired about the financing situation. Who will provide the finance and would it be adequate for Mexico's debt situation? Can the financing gap be filled without debt-reductions? The Chairman said in response that the GOM wants to raise new money at this point leaving aside debt-reduction schemes. The Region added that it cannot be expected that all necessary finance will be firmly lined up by the time we proceed with these operations, although we hope that significant progress will be made.

5. Another Committee member enquired about the IMF's views on the macro-model being used, and about the specific things that we were expecting to achieve before December 1. The Region said that there was broad agreement about the macro model; a multi-year medium-term adjustment program and policy matrices for the three operations should be available by December.

6. A speaker emphasized the need for a four or five-year planning horizon and for settling the whole financing package over that horizon. The Region said that there is no possibility of such a "jumbo" approach succeeding. If, however, both the Bank and the IMF support the government, we should be able to maintain and enhance its credibility and induce more commercial money.

C. Decision

7. The Chairman agreed that the Regional proposals provided an adequate response to the Mexican request.

ARay:vlw
October 17, 1988

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: MEXICO
FIVE YEAR LENDING PROGRAM: FY89-93
AS OF END NOVEMBER 88

SECTOR			FY89	FY90	FY91	FY92	FY93	FY89_93
AGRICULTURE	PA090-NORTHERN IRRI	L	40.0	.0	.0	.0	.0	40.0
	PA144-FORESTRY DEV	L	45.6	.0	.0	.0	.0	45.6
	PA165-AG SCTR/FOOD SECURTY	L	.0	.0	250.0	.0	.0	250.0
	PA171-IRRIG SCTR	L	.0	.0	300.0	.0	.0	300.0
	PA182-AG CREDIT X	L	.0	.0	400.0	.0	.0	400.0
	PA102-AG MRKTNG II	S	.0	.0	150.0	.0	.0	150.0
	PA193-RURAL DEV PROG	L	.0	.0	.0	300.0	.0	300.0
	PA183-FISHERIES DEVT	S	.0	.0	.0	150.0	.0	150.0
	PA184-GRAIN STORAGE	S	.0	.0	.0	150.0	.0	150.0
	PA111-TROPICAL AG III	L	.0	.0	.0	.0	300.0	300.0
	PA186-AG SERVICES	L	.0	.0	.0	.0	300.0	300.0
	PA185-RURAL DEVT	S	.0	.0	.0	.0	150.0	150.0
	*SUB-TOTAL AGRICULTURE		85.6	.0	1100.0	600.0	750.0	2535.6
EDUC + PHN	PA159-HLTH PROJ	L	.0	100.0	.0	.0	.0	100.0
	PA194-HLTH II	L	.0	.0	.0	.0	150.0	150.0
	PA195-EDUCATN	L	.0	.0	.0	.0	100.0	100.0
	*SUB-TOTAL EDUC + PHN		.0	100.0	.0	.0	250.0	350.0
ENERGY + POWER	PA113-HYDROELEC DEV	L	.0	460.0	.0	.0	.0	460.0
	PA166-PWR DISTRIB PRJ	S	.0	.0	400.0	.0	.0	400.0
	PA168-ELEC PWR III	L	.0	.0	.0	.0	300.0	300.0
	*SUB-TOTAL ENERGY + POWER		.0	460.0	400.0	.0	300.0	1160.0
INDUSTRY + IDF	PA163-IND SCTR RSTRUC	L	250.0	.0	.0	.0	.0	250.0
	PA198-IND SCT POLICY	L	500.0	.0	.0	.0	.0	500.0
	PA153-EDP III	L	.0	300.0	.0	.0	.0	300.0
	PA176-MINING SCTR	L	.0	300.0	.0	.0	.0	300.0
	PA180-IND TECH II	L	.0	.0	60.0	.0	.0	60.0
	PA178-IND SCTR	L	.0	.0	.0	300.0	.0	300.0
	PA189-FRTLZR SCTR ADJ II	L	.0	.0	.0	250.0	.0	250.0
	PA104-S&M IND V	S	.0	.0	.0	150.0	.0	150.0
	PA112-STEEL/CAP. GOODS	L	.0	.0	.0	.0	150.0	150.0
	PA179-EDP/TPL IV	L	.0	.0	.0	.0	400.0	400.0
	PA188-IND. UNID	L	.0	.0	.0	.0	250.0	250.0
	*SUB-TOTAL INDUSTRY + IDF		750.0	600.0	60.0	700.0	800.0	2910.0
INFRASTRUCTURE	PA173-LOW-INC HSNG II	L	.0	400.0	.0	.0	.0	400.0
	PA191-EARTHQ SUPPLM	L	.0	60.0	.0	.0	.0	60.0
	PA174-WTR, WOMEN&DEV	S	.0	18.0	.0	.0	.0	18.0
	PA151-WTR&SANIT SCTR	L	.0	.0	200.0	.0	.0	200.0
	PA157-STATE HWYS	L	.0	.0	60.0	.0	.0	60.0
	PA152-URBN TRNSPRT II	S	.0	.0	.0	200.0	.0	200.0
	PA175-TOLL RDS	S	.0	.0	.0	100.0	.0	100.0
	PA106-HWY SCTR III	L	.0	.0	.0	.0	150.0	150.0
	PA114-URBAN DEVT VI	L	.0	.0	.0	.0	150.0	150.0
	PA136-PORTS SCTR V	L	.0	.0	.0	.0	150.0	150.0
	PA149-RAILWY SCTR	L	.0	.0	.0	.0	250.0	250.0
	PA160-FED DIST WTR/SWRG	L	.0	.0	.0	.0	60.0	60.0
	PA115-WTR POLLUTN II	S	.0	.0	.0	.0	75.0	75.0
	PA116-SOLID WASTE	S	.0	.0	.0	.0	100.0	100.0
	*SUB-TOTAL INFRASTRUCTURE		.0	478.0	260.0	300.0	935.0	1973.0
NON-PROJECT	PA196-SAL I	L	500.0	.0	.0	.0	.0	500.0
	PA197-REF OF PUB ENTERP	L	500.0	.0	.0	.0	.0	500.0
	PA181-IND PARAST	L	.0	.0	.0	300.0	.0	300.0
	PA192-FIN SCTR	L	.0	.0	.0	.0	400.0	400.0
	PA177-IND POLL.	S	.0	.0	.0	.0	160.0	160.0
	*SUB-TOTAL NON-PROJECT		1000.0	.0	.0	300.0	560.0	1860.0
	*TOTAL MEXICO		1835.6	1638.0	1820.0	1900.0	3595.0	10788.6

MMcCarthy, LACCA
12/09/88

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY:
FIVE YEAR LENDING PROGRAM:

SECTOR	FY89	FY90	FY91	FY92	FY93	FY89_93
TOTAL	1835.6	1638.0	1820.0	1900.0	3595.0	10788.6

MMcCarthy, LACCA
12/09/88

FROM: Vice President and Secretary December , 1988

NOTICE OF INVITATION TO NEGOTIATE

MEXICO

INDUSTRIAL SECTOR POLICY LOAN

The Bank is inviting the Government of Mexico to send representatives to Washington, D.C. to negotiate a proposed loan of $500 million equivalent to help finance an Industrial Sector Policy Loan.

The loan would support a program of reforms designed to help deregulate Mexico's industrial sector, and to transform it from a protected inward-oriented sector, to one based on open competition among factors, markets and services, which would be more responsive to the need for technological change and modernization.

Distribution

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Directors and Department Heads, Bank and IFC.

From: Vice President and Secretary

NOTICE OF INVITATION TO NEGOTIATE

MEXICO

FINANCE AND TRADE SECTOR LOAN

The Bank is inviting the Government of the United Mexican States and Banco Nacional de Comercio Exterior, S.N.C., to send representatives to Washington, D.C., to negotiate a proposed loan of US$500 million equivalent to help finance a Finance and Trade Sector Adjustment Program.

The loan would finance eligible general imports in support of the Government's program designed to ensure macroeconomic, finance and trade policies consistent with the objectives of stabilizations and growth. Proposed measures would help (a) consolidate the stabilization effort; (b) reduce further import and export restrictions; (c) reform the financial sector assuring more efficient intermediation of resources; and (d) put in place a strategy for improving social sector programs designed to alleviate poverty by strengthening basic needs programs.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Directors and Department Heads, Bank and IFC

FROM: Vice President and Secretary

NOTICE OF INVITATION TO NEGOTIATE

MEXICO

REFORM OF PUBLIC ENTERPRISES LOAN

The Bank is inviting the Government of Mexico to send representatives to Washington, D.C. to negotiate a proposed loan of $500 million equivalent to help finance an Industrial Sector Policy Loan.

The loan would support a program of reforms designed to improve the efficiency of the public enterprises (PEs), reducing the heavy burden they impose on the economy.

The program includes: (i) a "disengagement" component to continue with privatization, liquidation, mergers, and transfers of PEs to local Government, and (ii) a program of reforms in the policy and institutional environment to improve the efficiency of PEs retained by the Government.

Distribution

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Directors and Department Heads, Bank and IFC

MH

DECLASSIFIED
CONFIDENTIAL
AUG 27 2013
WBG ARCHIVES
December 30, 1988

Messrs. Conable
Qureshi

Subject: Mexico

Following our meeting with Paul Volcker, I thought it might be useful to sketch out some of the main implications of a major debt-reduction effort for Mexico so that we can have a better understanding of the issues and magnitudes involved. The attached analysis was done in FRS (Mr. Steer) based on the question of what it might take by way of debt reduction to get Mexico back soon to a level of creditworthiness where it would no longer have to rely on concerted lending. The note shows that while this would require an ambitious debt-reduction scheme, the amounts involved might be feasible. If possible, it would dramatically change Mexico's prospects and debt politics, and provide a major incentive to other highly-indebted countries to initiate and/or sustain effective adjustment programs. It would, for the first time, permit a significant distinction based on a performance in the debt strategy.

The purpose of the note is not to define a specific proposal but to illuminate an approach. There is no dearth of financial engineering proposals and there is nothing novel in this note. The specifics are less important than the general implications, and will, in any event, be molded in the negotiations.

The reason I suggest that we discuss this as a follow-up to our discussion with Paul is that I remain convinced that we can only be an effective participant in the shaping of any such approach if it is done before we have committed our $1.5 billion in adjustment lending. The resulting increase in our net disbursements represents a large portion of total new money required in 1989. Future years will require more effort from the commercial banks, if present estimates hold, and we will have relatively less clout.

The approach in the note is based on my strong preference for a private sector solution to the commercial component of the debt. I believe this is feasible and that our support need not involve any direct taking of the commercial risk. However, there is much talk about the "need" for credit enhancement and this could be a feature of the approach outlined without changing the principal conclusions.

Ernest Stern

Attachments

MEXICO

Summary

If serious debt reduction is to be undertaken in the context of performance objectives, Mexico is a prime candidate. Its adjustment program is far-reaching and has been implemented with reasonable consistency. Nevertheless, the existing debt, plus new capital requirements, would mean a debt service ratio which would not permit Mexico to return to the voluntary market for many years. An objective to return Mexico to the market over the next 3-5 years would be an appropriate recognition of its performance.

To demonstrate what this might involve, this note presents some simple calculations on the potential magnitudes of four alternative debt reduction scenarios. The rough and ready results (shown in the attached diagrams and tables) suggest that a substantial conversion scheme could make a significant contribution to the restoration of creditworthiness over, say, the next 3-5 years.

A conversion involving half of all commercial bank debt at 60% of face value (Option A below) would result in interest savings equivalent to 1% of GDP each year; the cumulative current account deficit over the next three years, 1989-91, would fall by almost 40%, in comparison with a "without debt reduction" case. Over the Sexennio as a whole (1989-94), net new money requirements from the commercial banks would fall from an estimated $15.5 billion (without debt reduction) to $5.9 billion. Even without a debt reduction, the ratio of interest payments to exports is projected to fall (perhaps optimistically) from 28% in 1988 to 23% in 1991 and 18.3% in 1994. The suggested debt reduction scheme would immediately take an additional 4 percentage points off this, so that by 1991-94, Mexico would have entered the 14%-18% range, which seems to be the range at which voluntary market access once again becomes at least a possibility, as seen by the following:

Interest-to-Exports Ratio (1987-89)
(in percentages)

India	9	Colombia	20
Tunisia	10	Philippines	21
Pakistan	11	Venezuela	22
Turkey	13	Nigeria	26
Cameroon	14	Chile	27
Indonesia	16	Brazil	28
Hungary	17	Argentina	41

Coupled with the reduced and sustainable current account deficit and moderate new money requirements from commercial banks during that period, Mexico could have a serious chance of voluntary or quasi-voluntary new borrowing from 1991 onwards.

Background and Alternative Scenarios

Mexican debt is currently selling at about 42-45% of face value. The price obtained in any major conversion scheme would obviously depend upon:

(i) the size of the scheme;

(ii) the attractiveness of the new paper--i.e., degree of security and associated features, e.g., debt-equity swap privileges, immunity from new money obligations;

(iii) the unattractiveness of non-participation in the scheme--i.e., new money requirements (currently and projected) from remaining banks, scope for free riding, etc.

The four possible scenarios correspond to alternative assumptions concerning size and enhancement. Their impacts on key indicators are shown in Figure 1 and Tables 1 and 2. More detail is given in Annex Tables A-E.

The Base Case--Without Debt Reduction. Based on a modified version of the Region's base case projections, the picture that emerges is as follows:

- filling the financing gap in 1989 will be relatively easy, partly due to the tripling of IBRD net disbursements to $1.5 billion. The commercial banks will need to put in $1.3-$1.5 billion in concerted new money.

- thereafter, the financing picture becomes more difficult, with over $2.5 billion in new concerted commercial money (in addition to total rollover of existing debt) being required annually on an indefinite basis. This is equivalent to almost 50% effective interest capitalization for the 1990-94 period.[1]

- public and publicly-guaranteed MLT debt rises from $88 billion to $109 billion between 1988 and 1994. Overall, debt rises more gradually (due to an assumed reduction in non-guaranteed debt) from $105 billion to $118 billion.

Debt Conversion Scheme: Option A. A realistic scheme might involve, for example, the conversion of 50% of commercial bank debt (which currently stands at $65 billion) at 60% of face value. In this example, $19.5 billion of new bonds would be issued as an exit bond replacing debt of $32.5 billion. Interest savings would immediately amount to $1.3 billion per year, rising to $1.8 billion by 1994.

1/ The Region's base case calls for new money equivalent to 85% of interest payments due to them for the 1990-94 period.

To achieve this price, the new bonds would need not only the principal secured but, in addition, at least a portion of interest payments.[2] Full coverage of principal payments would require $3.0 billion today, assuming a defeasance scheme with 20-year bonds. If 25 or even 30 year bonds might be feasible, the cost of the zero coupons would be about half. A trust fund equal to one-year interest would require an additional $1.7 billion. A trust fund, or escrow account, to provide a rolling one year protection for interest payments can be created in any number of ways. For example, it could be provided from Mexico's reserves (which, however, could still be counted for IMF reserve purposes), a part of the IMF resources and be open to bilateral contributions. This would provide precisely the kind of link the Miyazawa plan envisaged and Japan might be interested in utilizing some of its funds for this purpose. Some funds could be provided on a short-term basis if Mexico pledged to deposit part of its reservers from oil if the price is above $[16] bbl. Such a commitment could be matched by our undertaking to support another "growth facility", i.e., agree to lend another $500 million for infrastructure maintenance and other rapidly disbursing investments if oil dropped below $[13]. Again, the specific mechanism is not as important as the fact that a one or even two-year interest payment cover could be created in a number of ways without too much difficulty.

The attractive features of this scheme are:

- o it brings the current account down by about one percentage point of GDP, to a level (2% of GDP), which is sustainable--the sort of current account that will promote confidence;

- o incentives for the commercial banks are about right. Those banks which do not participate in the conversion scheme (i.e., the shrunken base for concerted new money), will be expected to continue to put up substantial new money flows (making participation in the conversion scheme relatively attractive), but new money requirements would be less onerous than in the absence of a conversion scheme. It would, therefore, be in all parties' interests to release pro rata sharing clauses to permit such a scheme. New money requirements for the banks staying in for the long haul would amount to 26% of interest payments over the 1989-91 period, in comparison with 37% in the base case. For the 1992-94 period, the implicit capitalization would be 37% with debt reduction and 47% without. (In addition to the lower ratios, the <u>amounts</u> are less, since total interest due will have been reduced.) Hopefully, requirements would be less than this, as quasi voluntary flows would gradually begin to replace concerted flows in the early 1990s.

2/ When adjusting for interest rate differentials on the old debt and the new bonds, the Morgan scheme provided Mexico a discount of not much more than 10% (i.e., 90% of face value). A slightly larger discount could be expected anyway if linked with a new money package (i.e., the alternative to participating in the conversion would be less attractive than last time). But the major reason for achieving a larger discount would be enhancement of interest.

Since some new money is also required, and since a debt conversion like this has capital implications which may not suit all banks, the total package should contain other options as well. One which might be constructed as an equivalent to the conversion scheme is a permanent reduction in the interest rate, to a fixed rate well below market. An equivalent to new money could be interest capitalization.

One risk of such a conversion is the dramatic increase in preferred-creditor debt. The new bonds (which would have at least as high a status as IBRD debt) would more than double the stock of preferred creditor debt (to over $30 billion). The increase in <u>debt service</u> to preferred creditors would, however, be much less than this, due to the absence of amortization of the new bonds until year 20 (or 25 or 30). The net effect would be to raise the share of preferred creditors in total debt service to the 30-35% range. However, this dilution of the Bank's preferred-creditor status is likely to be more than offset by the improvement in overall creditowrthiness. Another risk is the loss of flexibility in raising concerted new funds from a substantially reduced new money base. This will require more detailed assessment.

<u>Options B, C and D</u>. Option B assumes an even more successful debt conversion--50% of commercial bank debt at 50% discount. This is included in the attached tables principally to illustrate the sensitivity to changes in the conversion price. It is unlikely that half of all commercial debt would be offered at this discount even with full guarantees of interest and principal.

Options C and D are less sanguine than Option A. They assume, respectively, a conversion of 50% of commercial bank debt at a price of 70 cents on the dollar and 30% of commercial bank debt at 50 cents on the dollar. The impact of the two schemes (C and D) are identical in a cash flow sense, but they differ in two important respects--the implicit interest capitalization requirement of the non-participating banks, and the impact upon preferred creditor debt. To the extent, therefore, that there were to be a choice between converting 50% of the debt at 70 cents or 30% at 50 cents, the latter would be preferable in that it retains more scope for flexibility in the event that financing requirements have been underestimated.

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

Jea. hold for upcoming Volcker mtg. done

MH has copy

1/18

Mexico

CORRESPONDENCE DATE : 88/12/30 DUE DATE : 00/00/00
LOG NUMBER : 890103005 FROM : Mr. Stern
SUBJECT : Note - Subject: Mexico

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- ______ APPROVED
- ______ PLEASE HANDLE
- ______ FOR YOUR INFORMATION
- ✓ FOR YOUR REVIEW ~~AND RECOMMENDATION~~
- ______ FOR THE FILES
- ______ PLEASE DISCUSS WITH ______
- ______ PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
- ______ AS WE DISCUSSED
- ______ RETURN TO ______

COMMENTS :

Implementation

~~CONFIDENTIAL~~

December 30, 1988

Messrs. Conable
Qureshi

Subject: Mexico

Following our meeting with Paul Volcker, I thought it might be useful to sketch out some of the main implications of a major debt-reduction effort for Mexico so that we can have a better understanding of the issues and magnitudes involved. The attached analysis was done in FRS (Mr. Steer) based on the question of what it might take by way of debt reduction to get Mexico back soon to a level of creditworthiness where it would no longer have to rely on concerted lending. The note shows that while this would require an ambitious debt-reduction scheme, the amounts involved might be feasible. If possible, it would dramatically change Mexico's prospects and debt politics, and provide a major incentive to other highly-indebted countries to initiate and/or sustain effective adjustment programs. It would, for the first time, permit a significant distinction based on a performance in the debt strategy.

The purpose of the note is not to define a specific proposal but to illuminate an approach. There is no dearth of financial engineering proposals and there is nothing novel in this note. The specifics are less important than the general implications, and will, in any event, be molded in the negotiations.

The reason I suggest that we discuss this as a follow-up to our discussion with Paul is that I remain convinced that we can only be an effective participant in the shaping of any such approach if it is done before we have committed our $1.5 billion in adjustment lending. The resulting increase in our net disbursements represents a large portion of total new money required in 1989. Future years will require more effort from the commercial banks, if present estimates hold, and we will have relatively less clout.

The approach in the note is based on my strong preference for a private sector solution to the commercial component of the debt. I believe this is feasible and that our support need not involve any direct taking of the commercial risk. However, there is much talk about the "need" for credit enhancement and this could be a feature of the approach outlined without changing the principal conclusions.

Ernest Stern

Attachments

MEXICO

Summary

If serious debt reduction is to be undertaken in the context of performance objectives, Mexico is a prime candidate. Its adjustment program is far-reaching and has been implemented with reasonable consistency. Nevertheless, the existing debt, plus new capital requirements, would mean a debt service ratio which would not permit Mexico to return to the voluntary market for many years. An objective to return Mexico to the market over the next 3-5 years would be an appropriate recognition of its performance.

To demonstrate what this might involve, this note presents some simple calculations on the potential magnitudes of four alternative debt reduction scenarios. The rough and ready results (shown in the attached diagrams and tables) suggest that a substantial conversion scheme could make a significant contribution to the restoration of creditworthiness over, say, the next 3-5 years.

A conversion involving half of all commercial bank debt at 60% of face value (Option A below) would result in interest savings equivalent to 1% of GDP each year; the cumulative current account deficit over the next three years, 1989-91, would fall by almost 40%, in comparison with a "without debt reduction" case. Over the Sexennio as a whole (1989-94), net new money requirements from the commercial banks would fall from an estimated $15.5 billion (without debt reduction) to $5.9 billion. Even without a debt reduction, the ratio of interest payments to exports is projected to fall (perhaps optimistically) from 28% in 1988 to 23% in 1991 and 18.3% in 1994. The suggested debt reduction scheme would immediately take an additional 4 percentage points off this, so that by 1991-94, Mexico would have entered the 14%-18% range, which seems to be the range at which voluntary market access once again becomes at least a possibility, as seen by the following:

Interest-to-Exports Ratio (1987-89)
(in percentages)

India	9	Colombia	20
Tunisia	10	Philippines	21
Pakistan	11	Venezuela	22
Turkey	13	Nigeria	26
Cameroon	14	Chile	27
Indonesia	16	Brazil	28
Hungary	17	Argentina	41

Coupled with the reduced and sustainable current account deficit and moderate new money requirements from commercial banks during that period, Mexico could have a serious chance of voluntary or quasi-voluntary new borrowing from 1991 onwards.

Background and Alternative Scenarios

Mexican debt is currently selling at about 42-45% of face value. The price obtained in any major conversion scheme would obviously depend upon:

(i) the size of the scheme;

(ii) the attractiveness of the new paper--i.e., degree of security and associated features, e.g., debt-equity swap privileges, immunity from new money obligations;

(iii) the unattractiveness of non-participation in the scheme--i.e., new money requirements (currently and projected) from remaining banks, scope for free riding, etc.

The four possible scenarios correspond to alternative assumptions concerning size and enhancement. Their impacts on key indicators are shown in Figure 1 and Tables 1 and 2. More detail is given in Annex Tables A-E.

The Base Case--Without Debt Reduction. Based on a modified version of the Region's base case projections, the picture that emerges is as follows:

- filling the financing gap in 1989 will be relatively easy, partly due to the tripling of IBRD net disbursements to $1.5 billion. The commercial banks will need to put in $1.3-$1.5 billion in concerted new money.

- thereafter, the financing picture becomes more difficult, with over $2.5 billion in new concerted commercial money (in addition to total rollover of existing debt) being required annually on an indefinite basis. This is equivalent to almost 50% effective interest capitalization for the 1990-94 period.[1]

- public and publicly-guaranteed MLT debt rises from $88 billion to $109 billion between 1988 and 1994. Overall, debt rises more gradually (due to an assumed reduction in non-guaranteed debt) from $105 billion to $118 billion.

Debt Conversion Scheme: Option A. A realistic scheme might involve, for example, the conversion of 50% of commercial bank debt (which currently stands at $65 billion) at 60% of face value. In this example, $19.5 billion of new bonds would be issued as an exit bond replacing debt of $32.5 billion. Interest savings would immediately amount to $1.3 billion per year, rising to $1.8 billion by 1994.

1/ The Region's base case calls for new money equivalent to 85% of interest payments due to them for the 1990-94 period.

To achieve this price, the new bonds would need not only the principal secured but, in addition, at least a portion of interest payments.[2] Full coverage of principal payments would require $3.0 billion today, assuming a defeasance scheme with 20-year bonds. If 25 or even 30 year bonds might be feasible, the cost of the zero coupons would be about half. A trust fund equal to one-year interest would require an additional $1.7 billion. A trust fund, or escrow account, to provide a rolling one year protection for interest payments can be created in any number of ways. For example, it could be provided from Mexico's reserves (which, however, could still be counted for IMF reserve purposes), a part of the IMF resources and be open to bilateral contributions. This would provide precisely the kind of link the Miyazawa plan envisaged and Japan might be interested in utilizing some of its funds for this purpose. Some funds could be provided on a short-term basis if Mexico pledged to deposit part of its reservers from oil if the price is above $[16] bbl. Such a commitment could be matched by our undertaking to support another "growth facility", i.e., agree to lend another $500 million for infrastructure maintenance and other rapidly disbursing investments if oil dropped below $[13]. Again, the specific mechanism is not as important as the fact that a one or even two-year interest payment cover could be created in a number of ways without too much difficulty.

The attractive features of this scheme are:

- it brings the current account down by about one percentage point of GDP, to a level (2% of GDP), which is sustainable--the sort of current account that will promote confidence;

- incentives for the commercial banks are about right. Those banks which do not participate in the conversion scheme (i.e., the shrunken base for concerted new money), will be expected to continue to put up substantial new money flows (making participation in the conversion scheme relatively attractive), but new money requirements would be less onerous than in the absence of a conversion scheme. It would, therefore, be in all parties' interests to release pro rata sharing clauses to permit such a scheme. New money requirements for the banks staying in for the long haul would amount to 26% of interest payments over the 1989-91 period, in comparison with 37% in the base case. For the 1992-94 period, the implicit capitalization would be 37% with debt reduction and 47% without. (In addition to the lower ratios, the <u>amounts</u> are less, since total interest due will have been reduced.) Hopefully, requirements would be less than this, as quasi voluntary flows would gradually begin to replace concerted flows in the early 1990s.

2/ When adjusting for interest rate differentials on the old debt and the new bonds, the Morgan scheme provided Mexico a discount of not much more than 10% (i.e., 90% of face value). A slightly larger discount could be expected anyway if linked with a new money package (i.e., the alternative to participating in the conversion would be less attractive than last time). But the major reason for achieving a larger discount would be enhancement of interest.

Since some new money is also required, and since a debt conversion like this has capital implications which may not suit all banks, the total package should contain other options as well. One which might be constructed as an equivalent to the conversion scheme is a permanent reduction in the interest rate, to a fixed rate well below market. An equivalent to new money could be interest capitalization.

One risk of such a conversion is the dramatic increase in preferred-creditor debt. The new bonds (which would have at least as high a status as IBRD debt) would more than double the stock of preferred creditor debt (to over $30 billion). The increase in debt service to preferred creditors would, however, be much less than this, due to the absence of amortization of the new bonds until year 20 (or 25 or 30). The net effect would be to raise the share of preferred creditors in total debt service to the 30-35% range. However, this dilution of the Bank's preferred-creditor status is likely to be more than offset by the improvement in overall creditowrthiness. Another risk is the loss of flexibility in raising concerted new funds from a substantially reduced new money base. This will require more detailed assessment.

Options B, C and D. Option B assumes an even more successful debt conversion--50% of commercial bank debt at 50% discount. This is included in the attached tables principally to illustrate the sensitivity to changes in the conversion price. It is unlikely that half of all commercial debt would be offered at this discount even with full guarantees of interest and principal.

Options C and D are less sanguine than Option A. They assume, respectively, a conversion of 50% of commercial bank debt at a price of 70 cents on the dollar and 30% of commercial bank debt at 50 cents on the dollar. The impact of the two schemes (C and D) are identical in a cash flow sense, but they differ in two important respects--the implicit interest capitalization requirement of the non-participating banks, and the impact upon preferred creditor debt. To the extent, therefore, that there were to be a choice between converting 50% of the debt at 70 cents or 30% at 50 cents, the latter would be preferable in that it retains more scope for flexibility in the event that financing requirements have been underestimated.

Table 1. ILLUSTRATIVE IMPACT OF ALTERNATIVE DEBT REDUCTION SCHEMES

Size and Discount of Commercial Bank Debt Conversion /a	Debt Stock: Total 1989	Debt Stock: Total 1994	Debt Stock: Financial Markets 1989	Debt Stock: Financial Markets 1994	Current Account Deficit 1989	Current Account Deficit 1991	Current Account Deficit 1994	Interest Payments to Financial Markets 1989	Interest Payments to Financial Markets 1991	Interest Payments to Financial Markets 1994	Commercial Banks New Money 1989-91	Commercial Banks New Money 1992-94	Implicit Interest Rate Capitalization /b 1989-91	Implicit Interest Rate Capitalization /b 1991-94
	USD billion												Percent	
No debt reduction (Base Case)	106	118	66	81	-3.0	-5.0	-4.9	5.8	6.1	6.3	6.6	8.9	37	47
A. 50% of debt at 60% face value	92	95	52	58	-1.7	-3.4	-3.1	4.6	4.6	4.5	2.3	3.6	26	37
B. 50% of debt at 50% face value	89	90	49	53	-1.5	-3.1	-2.7	4.3	4.2	4.1	1.4	2.5	17	29
C. 50% of debt at 70% face value	96	101	56	63	-2.0	-3.7	-3.5	4.9	4.9	4.8	3.2	4.7	38	51
D. 30% of debt at 50% face value	96	101	56	63	-2.0	-3.7	-3.5	4.9	4.9	4.8	3.2	4.7	27	38

/a Percentages of debt converted refer to commercial bank debt to public and publicly guaranteed borrowers.

/b New money as a percentage of interest receipts on commercial debt not included in the debt conversion scheme.

FRSCR:12/23/88

Table 2: FINANCING REQUIREMENTS AND CREDITWORTHINESS INDICATORS

Size and Discount of Commercial Bank Debt Conversion /a	Amount of Debt Reduction	Exit Bond	Funds Required for Defeasance of Principal	One Year Interest Guarantee	Total Interest Payments as % of Exports 1989	Total Interest Payments as % of Exports 1994	DOD % Exports 1989	DOD % Exports 1994	Preferred Creditor /b Debt Service Ratio 1989	Preferred Creditor /b Debt Service Ratio 1994
	USD billion				in percent					
No debt reduction (Base Case)	0.0	0.0	0.0	0.0	27.0	18.3	308	229	9.5	9.3
A. 50% of debt at 60% face value	13.0	19.5	3.0	1.7	23.3	14.7	267	185	14.4	12.3
B. 50% of debt at 50% face value	16.5	16.3	2.5	1.4	22.5	14.0	257	175	13.6	11.8
C. 50% of debt at 70% face value	9.4	22.8	3.5	2.0	24.1	15.4	277	195	15.3	12.8
D. 30% of debt at 50% face value	9.4	9.8	1.5	0.9	24.1	15.4	277	195	11.9	10.8

/a Percentages of debt converted refer to commercial bank debt to public and publicly guaranteed borrowers.

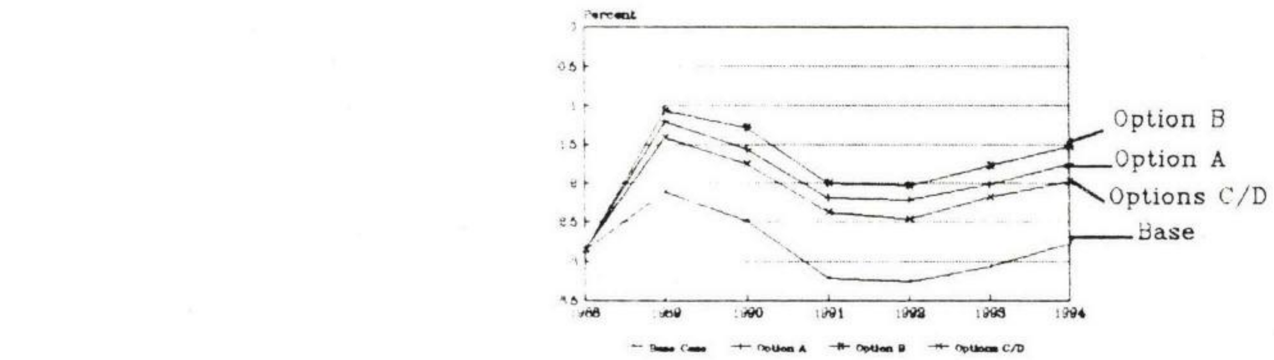
/b Ratio of total debt service to preferred creditors including interest on new bonds in conversion scheme as percent of total exports of goods and services.

FRSCR:12/23/88

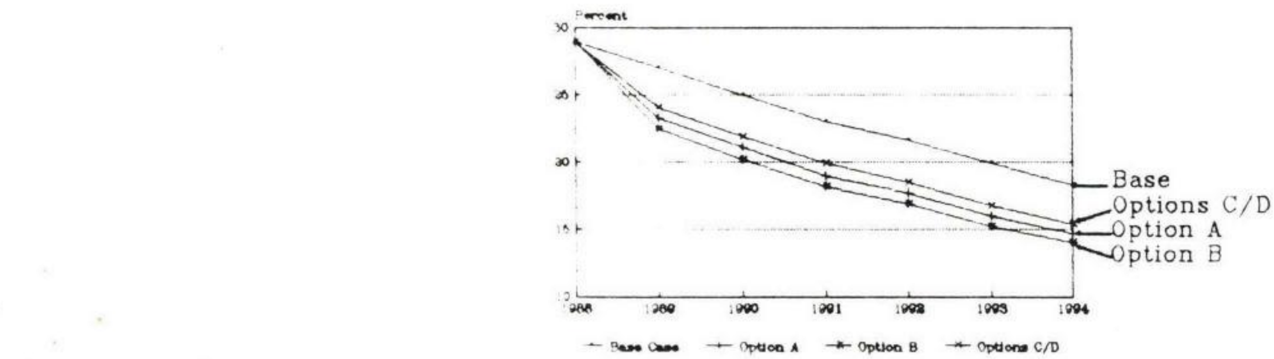
Figure 1

MEXICO
Comparison of Options

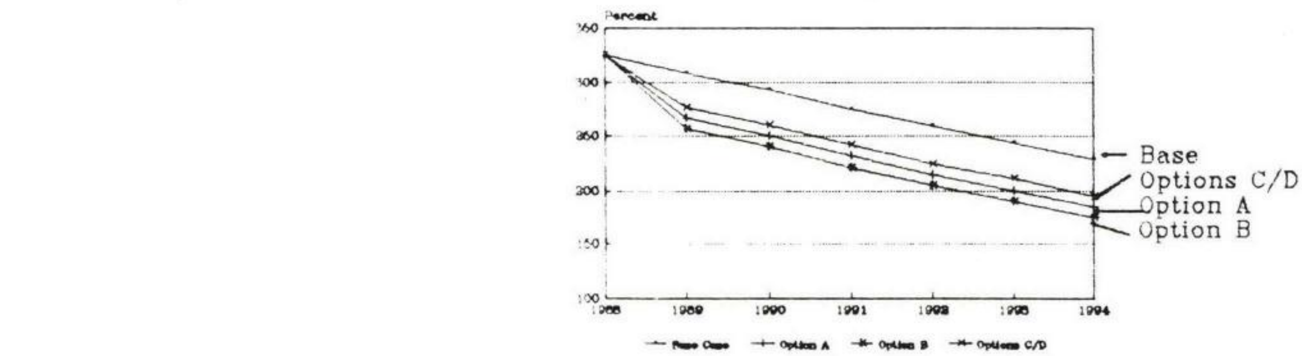
Current Account Deficit/GDP



Interest/Exports



DOD/Exports



FRS/CR
12/23/88

BASE : IMF STANDBY IN 1991		1989	1990	1991	1992	1993	1994	1989-91	1992-94
Exports gfs		34.5	36.8	40.0	43.5	47.2	51.5		
Current Account		-3.0	-3.7	-5.0	-5.3	-5.2	-4.9	-11.7	-15.4
Total Interest		9.3	9.2	9.2	9.4	9.4	9.4	27.7	28.2
o/w: Com. Bank Interest		5.8	5.9	6.1	6.3	6.4	6.3	17.9	18.9
Financing									
Net Borrowing		1.5	1.3	2.3	2.5	2.8	2.5	5.1	7.8
Net Foreign Investment		1.6	1.7	1.9	2.1	2.2	2.3	5.2	6.6
Other Non-Debt Flows		-0.1	0.7	0.8	0.7	0.2	0.1	1.4	1.0
Commercial bank									
New Money Required		1.3	2.5	2.8	2.7	3.6	2.6	6.6	8.9
Interest Cap Rate		22.33%	42.11%	45.78%	42.98%	56.43%	41.88%		
Memo Items:									
Interest as % of Exports g+s		27.0%	25.0%	23.0%	21.6%	19.9%	18.3%		
DOD as % of Exports		308%	293%	275%	259%	244%	229%		
Current Debt Structure 1988:		Projected Debt Stocks						Net Flows	
Preferred Creditors									
IBRD	8.3	9.8	11.0	11.6	12.2	12.6	13.0	3.3	2.0
IMF	5.1	4.8	3.5	3.5	3.5	3.5	3.5	-1.6	0.0
IDB	2.9	2.8	2.7	2.7	2.6	2.6	2.4	-0.2	-0.3
Bilaterals	6.7	7.9	8.7	9.3	9.3	9.3	9.3	2.6	0.6
Financial Markets	65.0	66.3	68.8	71.6	74.3	77.9	80.5	6.6	11.7
Private Non-Guaranteed	10.8	8.8	7.1	5.4	4.7	3.6	3.3	-5.4	-3.8
Suppliers Credits	0.3	0.2	0.1	0.1	0.1	0.0	0.0	-0.2	-0.1
Short-Term	5.8	5.8	5.8	5.8	5.8	5.8	5.8	0.0	0.0
TOTAL	104.9	106.4	107.7	110.0	112.5	115.3	117.8	5.1	10.1

OPTION A: Voluntary Commercial Bank Debt Relief
50% of Debt Reduced to 60% of Face Value

		1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Exports gfs		34.5	36.8	40.0	43.5	47.2	51.5			
Current Account		-1.7	-2.3	-3.4	-3.6	-3.4	-3.1	-7.4	-10.0	-17.5
Total Interest		8.0	7.8	7.6	7.7	7.6	7.6	23.4	22.8	46.3
o/w: Com. Bank Interest		4.6	4.5	4.5	4.6	4.5	4.5	13.6	13.6	27.2
Exit Bonds		1.7	1.7	1.7	1.6	1.6	1.5	5.1	4.8	9.8
New Base		2.9	2.8	2.9	2.9	2.9	2.9	8.5	8.8	17.3
Financing										
Net Borrowing		0.2	-0.1	0.7	0.8	1.0	0.7	0.8	2.5	3.3
Net Foreign Investment		1.6	1.7	1.9	2.1	2.2	2.3	5.2	6.6	11.8
Other Non-Debt Flows		-0.1	0.7	0.8	0.7	0.2	0.1	1.4	1.0	2.4
Memo Items:										
Commercial Bank										
New Money Required		0.0	1.1	1.2	1.0	1.8	0.8	2.3	3.6	5.9
Interest Cap Rate New Money as % New Base		1.6%	37.5%	42.5%	34.3%	59.7%	27.3%	27.2%	40.5%	33.9%
Total Interest as % of Exports g+s		23.3%	21.1%	19.0%	17.7%	16.0%	14.7%			
DOD as % of Exports		267%	250%	232%	215%	200%	185%			
Preferred Creditor DSR		14.4%	14.7%	14.5%	13.9%	13.1%	12.3%			
Current Debt Structure 1988:		Projected Debt Stocks						Net Flows		
Preferred Creditors										
IBRD	8.3	9.8	11.0	11.6	12.2	12.6	13.0	3.3	1.4	4.7
IMF	5.1	4.8	3.5	3.5	3.5	3.5	3.5	-1.6	0.0	-1.6
IDB	2.9	2.8	2.7	2.7	2.6	2.6	2.4	-0.2	-0.3	-0.5
Bilaterals	6.7	7.9	8.7	9.3	9.3	9.3	9.3	2.6	0.0	2.6
Financial Markets	65.0	52.0	53.1	54.3	55.3	57.1	57.9	2.3	3.6	5.9
Exit Bonds		19.5	19.5	19.5	19.5	19.5	19.5	0.0	0.0	0.0
New Money Group		32.5	33.6	34.8	35.8	37.6	38.4	2.3	3.6	5.9
Private Non-Guaranteed	10.8	8.8	7.1	5.4	4.7	3.6	3.3	-5.4	-2.1	-7.5
Suppliers Credits	0.3	0.2	0.1	0.1	0.1	0.0	0.0	-0.2	-0.1	-0.3
Short-Term	5.8	5.8	5.8	5.8	5.8	5.8	5.8	0.0	0.0	0.0
TOTAL	104.9	92.1	92.0	92.7	93.5	94.5	95.2	0.8	2.5	3.3

FRS/CR, 23-Dec-88

OPTION B: Voluntary Commercial Bank Debt Relief
50% of Debt Reduced to 50% of Face Value

	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Exports gfs	34.5	36.8	40.0	43.5	47.2	51.5			
Current Account	-1.5	-1.9	-3.1	-3.3	-3.0	-2.7	-6.5	-8.9	-15.4
Total Interest	7.8	7.4	7.3	7.4	7.2	7.2	22.5	21.7	44.2
o/w: Com. Bank Interest	4.3	4.2	4.2	4.2	4.2	4.1	12.7	12.5	25.1
Exit Bonds	1.4	1.4	1.4	1.4	1.3	1.3	4.2	4.0	8.2
New Base	2.9	2.8	2.8	2.9	2.8	2.8	8.5	8.5	17.0
Financing									
Net Borrowing	-0.0	-0.5	0.4	0.5	0.6	0.3	-0.1	1.4	1.3
Net Foreign Investment	1.6	1.7	1.9	2.1	2.2	2.3	5.2	6.6	11.8
Other Non-Debt Flows	-0.1	0.7	0.8	0.7	0.2	0.1	1.4	1.0	2.4

Memo Items: Commercial Bank	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
New Money Required	-0.2	0.7	0.9	0.7	1.4	0.4	1.4	2.5	3.9
Interest Cap Rate New Money as % New Base	-8.4%	26.9%	31.6%	23.0%	48.8%	15.0%	16.5%	28.9%	22.8%
Total Interest as % of Exports g+s	22.5%	20.2%	18.2%	16.9%	15.2%	14.0%			
DOD as % of Exports	257%	240%	221%	205%	190%	175%			
Preferred Creditor DSR	13.6%	13.9%	13.8%	13.2%	12.5%	11.8%			

Current Debt Structure 1988:		Projected Debt Stocks						Net Flows		
Preferred Creditors										
IBRD	8.3	9.8	11.0	11.6	12.2	12.6	13.0	3.3	1.4	4.7
IMF	5.1	4.8	3.5	3.5	3.5	3.5	3.5	-1.6	0.0	-1.6
IDB	2.9	2.8	2.7	2.7	2.6	2.6	2.4	-0.2	-0.3	-0.5
Bilaterals	6.7	7.9	8.7	9.3	9.3	9.3	9.3	2.6	0.0	2.6
Financial Markets	65.0	48.5	49.3	50.1	50.8	52.2	52.6	1.4	2.5	3.9
Exit Bonds		16.3	16.3	16.3	16.3	16.3	16.3	0.0	0.0	0.0
New Money Group		32.3	33.0	33.9	34.6	35.9	36.4	1.4	2.5	3.9
Private Non-Guaranteed	10.8	8.8	7.1	5.4	4.7	3.6	3.3	-5.4	-2.1	-7.5
Suppliers Credits	0.3	0.2	0.1	0.1	0.1	0.0	0.0	-0.2	-0.1	-0.3
Short-Term	5.8	5.8	5.8	5.8	5.8	5.8	5.8	0.0	0.0	0.0
TOTAL	104.9	88.6	88.2	88.5	89.0	89.6	89.9	-0.1	1.4	1.3

FRS/CR, 23-Dec-88

OPTION C: Voluntary Commercial Bank Debt Relief
50% of Debt Reduced to 70% of Face Value

	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Exports gfs	34.5	36.8	40.0	43.5	47.2	51.5			
Current Account	-2.0	-2.6	-3.7	-4.0	-3.7	-3.5	-8.3	-11.1	-19.5
Total Interest	8.3	8.1	7.9	8.1	7.9	8.0	24.3	23.9	48.3
o/w: Com. Bank Interest	4.9	4.8	4.9	4.9	4.9	4.8	14.5	14.7	29.2
Exit Bonds	2.0	2.0	1.9	1.9	1.9	1.8	5.9	5.6	11.5
New Base	2.9	2.8	2.9	3.0	3.0	3.1	8.6	9.1	17.7
Financing									
Net Borrowing	0.5	0.2	1.0	1.2	1.3	1.1	1.7	3.6	5.3
Net Foreign Investment	1.6	1.7	1.9	2.1	2.2	2.3	5.2	6.6	11.8
Other Non-Debt Flows	-0.1	0.7	0.8	0.7	0.2	0.1	1.4	1.0	2.4
Memo Items:									
Commercial Bank									
New Money Required	0.3	1.4	1.5	1.4	2.1	1.2	3.2	4.7	7.9
Interest Cap Rate New Money as % New Base	11.6%	48.0%	53.0%	45.1%	69.8%	38.7%	37.6%	51.2%	44.6%
Total Interest as % of Exports g+s	24.1%	21.9%	19.9%	18.5%	16.8%	15.4%			
DOD as % of Exports	277%	260%	242%	225%	211%	195%			
Preferred Creditor DSP	15.3%	15.5%	15.2%	14.5%	13.7%	12.8%			

Current Debt Structure 1988:		Projected Debt Stocks						Net Flows		
Preferred Creditors										
IBRD	8.3	9.8	11.0	11.6	12.2	12.6	13.0	3.3	1.4	4.7
IMF	5.1	4.8	3.5	3.5	3.5	3.5	3.5	-1.6	0.0	-1.6
IDB	2.9	2.8	2.7	2.7	2.6	2.6	2.4	-0.2	-0.3	-0.5
Bilaterals	6.7	7.9	8.7	9.3	9.3	9.3	9.3	2.6	0.0	2.6
Financial Markets	65.0	55.6	56.9	58.5	59.8	62.0	63.2	3.2	4.7	7.9
Exit Bonds		22.8	22.8	22.8	22.8	22.8	22.8	0.0	0.0	0.0
New Money Group		32.8	34.2	35.7	37.1	39.2	40.4	3.2	4.7	7.9
Private Non-Guaranteed	10.8	8.8	7.1	5.4	4.7	3.6	3.3	-5.4	-2.1	-7.5
Suppliers Credits	0.3	0.2	0.1	0.1	[illegible]	[illegible]	0.0	-0.2	-0.1	-0.3
Short-Term	5.8	5.8	5.8	5.8	5.8	5.8	5.8	0.0	0.0	0.0
TOTAL	104.9	95.7	95.8	96.9	98.[illegible]	99.4	100.5	1.7	3.6	5.3

FRS/CR, 23-Dec-88

OPTION D: Voluntary Commercial Bank Debt Relief
30% of Debt Reduced to 50% of Face Value

	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Exports gfs	34.5	36.8	40.0	43.5	47.2	51.5			
Current Account	-2.0	-2.6	-3.7	-4.0	-3.7	-3.5	-8.3	-11.1	-19.5
Total Interest	8.3	8.1	7.9	8.1	7.9	8.0	24.3	23.9	48.3
o/w: Com. Bank Interest	4.9	4.8	4.9	4.9	4.9	4.8	14.5	14.7	29.2
Exit Bonds	0.9	0.8	0.8	0.8	0.8	0.8	2.5	2.4	4.9
New Base	4.0	4.0	4.0	4.1	4.1	4.1	12.0	12.3	24.3
Financing									
Net Borrowing	0.5	0.2	1.0	1.2	1.3	1.1	1.7	3.6	5.3
Net Foreign Investment	1.6	1.7	1.9	2.1	2.2	2.3	5.2	6.6	11.8
Other Non-Debt Flows	-0.1	0.7	0.8	0.7	0.2	0.1	1.4	1.0	2.4
Memo Items:									
Commercial Bank									
New Money Required	0.3	1.4	1.5	1.4	2.1	1.2	3.2	4.7	7.9
Interest Cap Rate New Money as % New Base	8.3%	34.4%	38.4%	33.1%	51.7%	29.0%	27.0%	38.0%	32.6%
Total Interest as % of Exports g+s	24.1%	21.9%	19.9%	18.5%	16.8%	15.4%			
DOD as % of Exports	277%	260%	242%	225%	211%	195%			
Preferred Creditor DSR	11.9%	12.4%	12.4%	12.0%	11.4%	10.8%			

Current Debt Structure 1988:		Projected Debt Stocks						Net Flows		
Preferred Creditors										
IBRD	8.3	9.8	11.0	11.6	12.2	12.6	13.0	3.3	1.4	4.7
IMF	5.1	4.8	3.5	3.5	3.5	3.5	3.5	-1.6	0.0	-1.6
IDB	2.9	2.8	2.7	2.7	2.6	2.6	2.4	-0.2	-0.3	-0.5
Bilaterals	6.7	7.9	8.7	9.3	9.3	9.3	9.3	2.6	0.0	2.6
Financial Markets	65.0	55.6	56.9	58.5	59.8	62.0	63.2	3.2	4.7	7.9
Exit Bonds		9.8	9.8	9.8	9.8	9.8	9.8	0.0	0.0	0.0
New Money Group		45.8	47.2	48.7	50.1	52.2	53.4	3.2	4.7	7.9
Private Non-Guaranteed	10.8	8.8	7.1	5.4	4.7	3.6	3.3	-5.4	-2.1	-7.5
Suppliers Credits	0.3	0.2	0.1	0.1	0.1	0.0	0.0	-0.2	-0.1	-0.3
Short-Term	5.8	5.8	5.8	5.8	5.8	5.8	5.8	0.0	0.0	0.0
TOTAL	104.9	95.7	95.8	96.9	98.0	99.4	100.5	1.7	3.6	5.3

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 18, 1988

TO: Mr. Moeen A. Qureshi

THROUGH: Mr. S. Shahid Husain

FROM: Rainer B. Steckhan, Director, LA2 Steckhan

EXTENSION: 38074

SUBJECT: Mexico

1. We had a very productive, open and friendly discussion of the three possible adjustment loans with a core team of senior Mexicans (including such ministerial "hopefuls" as Jaime Serra, Maria Elena Vasquez, and Paco Gil, as well as Viceminister Cedillo, and Gurria) all of last Wednesday, November 16, outside Mexico City. The purpose of the "retreat" was to: (i) reach as much agreement as possible on the analysis of the economic situation and the reform measures to be taken; (ii) get a feel for the political feasibility of the measures proposed; and (iii) establish a timetable for further work.

2. The Mexicans had read the "package" of reports as well as the policy matrices, and repeatedly praised the quality and the thrust of the recommendations.

3. On macro-economic prospects and policies, the Mexicans were in agreement with most of our assessments and recommendations. They concurred that a sustainable growth in GDP of, say, 3-5% p.a. over the medium term is imperative for Mexico and that, despite all internal adjustment efforts, there will most likely be a need for a considerable reduction in external transfers. They did point out, however, that the timing of some of the measures we are proposing (e.g., price decontrol, tax reform, adjustments in nominal anchors, most notably the exchange rate) will have to be weighed against the objectives of the anti-inflation program and the political constraints the new administration will be faced with. It was also clear that the Mexicans are determined to get inflation under control and are willing to subordinate economic recovery in the early months of the new administration to further macro stabilization. Despite our prodding, the Mexicans were not specific as to the unfreezing of the Pacto controls.

4. There was also considerable agreement between the two teams regarding future action on trade and financial policies, although the Mexicans were of the opinion that their banking sector was in a better shape and the overall financial system less overregulated than might be concluded from our analysis. They did not see any major problems, in principle, with most of the proposed policy action under the loan, but again the issue of timing, in the light of the practical constraints that the new administration will be faced with, was a major concern.

5. The discussion on the public enterprises (PEs) showed that there is little philosophical difference between us and the Mexicans about the future policy action to restructure this sector. The Mexicans emphasized, however, that some of the institutional proposals in our documents were going to be difficult to accept, that accelerated and pre-announced

privatization of larger parastatals will be politically very sensitive, and that price deregulation in the sector was only possible as a gradual process.

6. Regarding the proposed industrial sector operation, the Mexicans felt that it included a set of important policy actions that they fully concur with (elimination of subsidies, price decontrol, administrative simplification, phasing out of industrial programs, direct foreign investment and technology development, road transport and telecommunications). As in the other two operations, they emphasized that gradualism, timing of action and political constraints would have to be taken into account. They pointed out that labor aspects were particularly politically sensitive and urged caution. They indicated that they would want the issue of industrial pollution to be addressed by the new authorities before it could be decided whether the proposed loan should contain a component on environment.

7. The discussion of agricultural policies revealed that the Mexicans were well aware of the problems and distortions in this important sector and agreed with our assessment and recommendations. It became clear, however, that political constraints to immediate policy reform may be most serious in this sector. This seemed to be particularly the case with guaranteed prices, taxation, general subsidies, and food targetting. Our hosts indicated they would prefer to have these issues addressed separately, in a second agricultural sector loan, so that this would not slow down action in other areas envisaged under the proposed adjustment package.

8. In our concluding remarks, we stressed: (i) the need to agree upon a consistent macro-economic framework for our operations; (ii) the desirability to see eye-to-eye on the macro issues with the IMF (and the importance of IMF involvement); (iii) the necessity to develop a full financing plan for FY89/90, including the Japanese and the commercial banks; and (iv) the urgency of reaching agreement on several outstanding issues on the existing policy-based loans.

9. Our hosts agreed that: (i) the seminar was a very useful "intellectual exercise;" (ii) an agreed-upon macro framework would be necessary for the proposed package, but they were not yet in a position to make a proposal to the Bank; (iii) the Bank's role in assuring an external financing package (including debt reduction) would be critical and should be defined as soon as possible; and (iv) the Bank should recognize and reward the country for what had been already done (e.g., macro stabilization, fiscal adjustments, trade reform, privatization), in addition to conditionality which would be linked to future commitments for policy reform.

10. In sum, our discussions with the Mexicans led to an unprecedented broad agreement on what should be the thrust of further structural adjustment in practically all major areas. At the same time, the likely key members of the new administration are becoming increasingly aware of the political constraints to a swift and across-the-board reform in areas such as price decontrol, financial sector reform, labor issues, privatization of key industries, deregulation of services, to name only a few. President-elect Salinas' key advisers must have come to the

conclusion that the most effective approach to further structural adjustment would have to be gradual, negotiating with the key actors affected by the proposed reforms, and avoiding in the early months of the new Administration, if possible, action which requires Congressional approval. This approach will most likely characterize our policy dialogue and possible negotiations of the adjustment operations.

11. As far as next steps are concerned, our interlocutors considered an announcement of an agreement in principle with the Bank on the adjustment loans before December 1 as unlikely. They promised to let us have written comments on the package of reports by the end of next week. We, on our side, are now preparing green cover documents and outlines of policy letters for Mr. Husain's review by December 9, and for the Operations Committee in the week of December 12. The Mexicans indicated very informally that they might be ready for formal negotiations some time in December. (Note that the 1989 budget proposal, which is vital for our adjustment loans, will not go to the Mexican Congress until December 15.)

cc. Messrs. Selowsky, LAC
Segura, LAC
Management Team, LA2

Mexico

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 88/12/13 DUE DATE : 00/00/00
LOG NUMBER : 881215006 FROM : S. Husain (thru MAQ)
SUBJECT : MEXICO: Briefing for meeting with Secretary Brady.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- ____ APPROVED
- ____ PLEASE HANDLE
- ____ FOR YOUR INFORMATION
- ____ FOR YOUR REVIEW AND RECOMMENDATION
- ____ FOR THE FILES
- ____ PLEASE DISCUSS WITH ____
- ____ PLEASE PREPARE RESPONSE FOR ____ SIGNATURE
- ____ AS WE DISCUSSED
- ____ RETURN TO ____

COMMENTS :M. Haug, J. Volk (FF)

*IMPORTANT

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 13, 1988

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: MEXICO: Briefing

1. You will meet U.S. Secretary of the Treasury Nicholas Brady to discuss recent Mexican developments and issues which the international community will have to face in dealing with the country's external financing needs.

Economic Developments

2. Mexico, in spite of a history of high growth and low inflation, has not had any real growth since 1982. In response, Mexico has implemented farreaching structural reforms and a major opening up of the economy; tariffs and non-tariff barriers have been reduced beyond what was required under various Bank operations. Mexico is now embarking on a program of industrial deregulation and privatization of state enterprizes. At the same time, Mexico is in the middle of an imaginative stabilization program to establish the macroeconomic stability that was coming under stress in 1986 and 1987, when inflation accelerated to triple digit levels. Inflation is now down to 10-15 percent on an annualized basis. The key to this success has been an 8 percentage points of GDP cut in government expenditure, improved tax effort and a resulting improvement in the non-interest fiscal balance from a deficit of 6.4% of GDP in 1982 to a surplus of 7.6 percent of GDP in 1988.

Growth and External Finance

3. The major problem now is the renewal of growth. The government has strongly committed itself to a continuation and further deepening of the internal reforms. But with no room for fiscal expansion because of the stabilization effort, the government is relying on private investment to provide the impetus for renewed growth. For this to be possible, renewed access to international capital markets is necessary to complement Mexico's extensive internal adjustment program. This should probably involve a mixture of interest refinancing, new lending, and, possibly, actual debt relief. From the point of view of macroeconomic stability, the importance of a medium term solution, avoiding year-to-year crises, needs to be stressed. A cut-off from external capital markets, with the attendant short term macroeconomic problems and the likely slow down of growth it would also lead to, would compromise Mexico's ability to service even its current debt. Thus, paradoxically, renewed lending to Mexico would very likely increase Mexico's creditworthiness, the higher up-front borrowing notwithstanding.

Status of Three Adjustment Operation

4. In October/November we appraised a Finance and Trade Sector Adjustment Loan(FTSAL), and Industrial Sector Policy Loan and a Reform of Public Enterprise Loan. The three operations are designed to support the highest priority adjustment measures in the fiscal, industrial deregulation, finanace and trade areas. The measures supported would help strengthen fiscal performance, curbing public sector spending, and put in place an incentive framework to boost private investments, stimulating growth outside the fiscal area. The loans -- which may amount to US$1.5 billion -- will be ready for negotiation within a couple of weeks, and we can expect Board action in the third quarter of FY89. They would, under optimal circumstances, disburse one half of the total amount committed by end-FY89.

Bank Lending to Mexico

5. The Bank has lent to Mexico a record US$2.03 billion in FY88. Annual commitments over the medium term may be maintained at similar levels, provided that Mexico's adjustment effort and economic performance justify such Bank effort. Net disbursements, at this level of lending, are expected to remain positive through the Salinas presidency, but net transfers, after interest payments, would become negative by 1992, the high level of lending notwithstanding. The Bank would continue to support key reform measures through policy-based operations, but increasing amounts of Bank lending would be directed at traditional investment projects, in particular in the social sectors, to help alleviate absolute poverty and the burden of adjustment.

Follow

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

November 10, 1988

Mr. Moeen A. Qureshi

Moeen:

Re: Mexico

Following our meeting yesterday and our subsequent talks, I believe the mission in the field should go ahead and firm up the specifics of reforms the Mexican Authorities are willing to take as a basis for substantial policy lending by the Bank during the coming six months.

I do not want the mission to feel under time pressure, but focus on realistic, substantive reforms which we could support through lending and present to our Board within a six month time frame.

When reviewing the matter with the Mexican Authorities, I expect the mission to be clear on the following points:

(a) IMF involvement is vital - at least in the form of a CFF.

(b) Any macro-economic and sector policy program must be judged in the context of agreement and clear understanding on how the Mexican Government will proceed on:

(i) exchange rate adjustment/the Pacto;

(ii) the overall financing package.

The Mexicans should be aware that up-front action and/or an agreed program is needed before we go to the Board.

(b) Discussions on the overall financing package for FY89/90 should proceed in parallel to our own appraisal. I do not wish to be totally up-front on these loans, as in Argentina, but believe that we should bring in the financial community at large. Could you and your staff please proceed with the appropriate discussions with the Mexicans and the Banking Community.

(c) I would like to keep open both the amount of lending as well as the question whether one of the three policy loans will actually be a SAL. My final decision will be influenced by the substance of the macro-economic and sector reforms, evidence of broad international support and, if possible, the presence of the IMF.

Barber Conable

Barber B. Conable

cc: Messrs. Hopper, Shihata, Stern, Thahane & Steckhan

The World Bank
Washington, D.C. 20433
U.S.A.

December 20, 1988

MEXICO

1) Substance of Pacto has to be examined. Is this a satisfactory medium-term framework?

2) Financing

   - IMF portion
   - new money
   - debt restructuring

3) IMF position on:

   - financing
   - macroeconomic program

4) Conditionality

   - existing fast-disbursing loans
   - new

Mexico

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 6, 1988

TO: Mr. R. Steckhan, LA2DR

FROM: Paul M. Meo, Chief, IECIT (Dictated by Mr. Meo from Montreal but not seen)

EXTENSION: 33802

SUBJECT: Discussion with Mr. B. Conable and Jaime Serra, Mexican Secretary of Commerce and Industry

On Dec. 5, Mr. Conable met for about half an hour with Mr. Jaime Serra, the new Mexican Secretary of Commerce and Industry. Mr. Conable congratulated Mr. Serra on the Mexican economic performance and questioned the Minister's perception of the issues at stake at the Montreal Mid-Term Review of the Uruguay Round. During the discussion, Minister Serra made three points which may be of interest to you:

(a) He praised the work of the very large Mexican mission which has just visited Mexico. He claimed that there were absolutely no disagreements in principles and concepts between the Government and the mission, which he found technically excellent. He did mention, however, that you had pointed out that the Bank would prefer the "intellectual participation" of the IMF in a subsequent program and questioned Mr. Conable on this matter. Mr. Conable responded that we would indeed prefer the active participation of the IMF in a subsequent program. While he did not go into details, he did ask the Minister how the Compensatory Finance Facility option was proceeding and turned to discussions of other matters.

(b) Minister Serra said he was quite interested in asking for Bank assistance for an automotive parts/possible loan. He pointed out that reforming the highly complex, legally-bound automotive situation in Mexico would take both time and a major Bank assistance. He stated he would be speaking to the Bank about this matter.

(c) Minister Serra also indicated he was eager to set up an Office for Deregulation in his Ministry and would be requesting Bank assistance for this. He was particularly interested in the benefits coming from the deregulation of trucking and other transport modes.

cc: Messrs. Fischer, Martinez, Ms. Haug

/llt

P-1866

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

November 10, 1988

Mr. Moeen A. Qureshi

Moeen:

Re: Mexico

Following our meeting yesterday and our subsequent talks, I believe the mission in the field should go ahead and firm up the specifics of reforms the Mexican Authorities are willing to take as a basis for substantial policy lending by the Bank during the coming six months.

I do not want the mission to feel under time pressure, but focus on realistic, substantive reforms which we could support through lending and present to our Board within a six month time frame.

When reviewing the matter with the Mexican Authorities, I expect the mission to be clear on the following points:

(a) IMF involvement is vital - at least in the form of a CFF.

(b) Any macro-economic and sector policy program must be judged in the context of agreement and clear understanding on how the Mexican Government will proceed on:

(i) exchange rate adjustment/the Pacto;

(ii) the overall financing package.

The Mexicans should be aware that up-front action and/or an agreed program is needed before we go to the Board.

(b) Discussions on the overall financing package for FY89/90 should proceed in parallel to our own appraisal. I do not wish to be totally up-front on these loans, as in Argentina, but believe that we should bring in the financial community at large. Could you and your staff please proceed with the appropriate discussions with the Mexicans and the Banking Community.

(c) I would like to keep open both the amount of lending as well as the question whether one of the three policy loans will actually be a SAL. My final decision will be influenced by the substance of the macro-economic and sector reforms, evidence of broad international support and, if possible, the presence of the IMF.

Barber Conable

Barber B. Conable

cc: Messrs. Hopper, Shihata, Stern, Thahane & Steckhan

MH

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 88/11/08 DUE DATE : 00/00/00
LOG NUMBER : 881108012 FROM : MAQ/ Steckhan
SUBJECT : INTERIM BRIEFING: Mexico - Proposed Adjustment Operations for meeting on Wed. Nov. 9, 1988 at 2:30 pm.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

__________ APPROVED
__________ PLEASE HANDLE
__________ FOR YOUR INFORMATION
__________ FOR YOUR REVIEW AND RECOMMENDATION
__________ FOR THE FILES
__________ PLEASE DISCUSS WITH ____________________
__________ PLEASE PREPARE RESPONSE FOR _______________ SIGNATURE
__________ AS WE DISCUSSED
__________ RETURN TO ____________________

COMMENTS :cc: J. Tanaka, JV (follow file)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 8, 1988

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen Qureshi

FROM: Rainer B. Steckhan, LA2DR Steckhan

EXTENSION: 38074

SUBJECT: MEXICO -- Proposed Adjustment Operations - Interim Briefing

I. INTRODUCTION

1. As you know at the Annual Meetings in Berlin and subsequently in Washington in October, Finance Minister Petricioli asked the World Bank for US$1.5 billion worth of fast disbursing loans in support of policy reform. Secretary Petricioli emphasized the present Government's intention to make an announcement of an "agreement in principle" with the World Bank before it handed over to the Salinas team on December 1, 1988 and urged us to work up expeditiously a package of reform measures as a basis for World Bank lending.

2. We responded quickly and unbureaucratically and following initial visits by Mr. Husain and myself with President de la Madrid, the Economic Cabinet and President-Elect Salinas' advisers, a sizeable mission has been working since mid-October in Mexico with the authorities to lay the basis for: a possible SAL, an industrial sector adjustment loan, and a public enterprise sector adjustment loan.

3. For the last two weeks, an IMF mission has visited Mexico to explore the possibility of Compensatory Facility of some US$500 to 600 million for Mexico. I understand that mission returned without reaching any agreement on the Facility.

4. The purpose of this note is to: (i) bring you up to date on progress concerning the three proposed adjustment operations; (ii) highlight some of the main issues; (iii) describe briefly the initial reactions of the Mexicans to some of the ideas that have been informally raised with them; and (iv) list the likely future steps in preparing the adjustment package. In discussing this note with you, we would be seeking your reaction and guidance as to how to proceed in our dialogue with the Mexicans and in further preparing the proposed three operations.

II. RATIONALE AND MAIN OBJECTIVES OF THE PROPOSED PACKAGE

5. The coverage, policy content and main issues in each of the three operations are highlighted in paras. 18-42 of this memo and draft policy matrices.[1] We also have first drafts of the mission's reports. The common

---

1/ At this stage, the matrices are only illustrative of the type of policy measures required. They represent a large menu of conditions which still have to be weeded out and made fully consistent.

denominator of the three loans is that they are aimed at supporting the Mexican authorities' (both the incumbent and the incoming ones) stated commitment to further structural reforms of the economy. The analytical understanding for a number of policy areas proposed to be addressed in the package has been provided by a set of policy papers which we had prepared earlier this fiscal year and which have been submitted to the Mexican authorities (e.g., policy papers on macroeconomics, trade, industrial organization, agriculture, rural/regional development, health, nutrition and poverty alleviation, transport and ecology) together with green cover reports on foreign investment, impact of trade reforms, mining sector, etc. On many key policy areas to be addressed under the adjustment operations we have had an active dialogue with the authorities for quite some time. The proposed package could therefore be viewed as a continuation and intensification of our support to the country's stabilization and structural adjustment efforts. After six years of economic stagnation, Mexico's No. 1 priority is now sustainable growth, together with generation of employment, low inflation, and improved social welfare.

6. Two conditions of growth deserve particular attention: how to overcome the lack of confidence (as evidenced by high real interest rates, skyrocketting imports, etc.) and how to finance the external gap the country is going to face in 1989 and beyond because of the debt service burden and new developments regarding oil prices and rising international interest rates. Solving the second problem will clearly make the first more manageable.

7. These issues also explain why the authorities have requested increased Bank assistance at this point in time. It is hoped that the Bank in its role as the country's "lead bank" will help in calming down any possible jitters in the financial and foreign exchange markets in Mexico in the period of political transition, as well as act as a catalyst in mobilizing, for instance, Japanese cofinancing of adjustment loans and encourage commercial lenders to consider new money and acceptable debt reduction schemes in the early months of the new administration. The requested loans and any subsequent policy based loans should, therefore, form the basis for a broader financing strategy involving key actors such as government of Mexico, multilateral financial institutions, bilateral donors, developed country governments, international commercial banks and foreign investors. Otherwise, Bank money could well end up financing capital flight and/or bail out of the commercial banks. In addition, the Bank's conditionality could signal the permanence of the reforms, thus reducing uncertainty in the incentive structure.

III. GENERAL ISSUES

Timing

8. While Secretary Petricioli had originally aimed at an agreement "in principle" on a US$1.5 billion World Bank lending package before December 1, this has recently not been mentioned any more by the Mexicans. Hence, we do not expect any firm "agreement" with the Mexicans on policy reform until the new economic team is well in place.

Commitment by the New Government

9. Our team has worked closely not only with the senior officials of the present Government but also with the very few, already identified advisers of the President-Elect. All agree that there exists a high probability of continuity in economic policies in the transition period and beyond (something which was not the case in the past three transitions). But preparing a comprehensive policy package such as the one envisaged under our adjustment loans, becomes very difficult when the incumbent administration is on its way out and the new team has not been appointed yet. Any exchange of views and discussions regarding future direction and timing of policy reform the Bank is likely to have in the next weeks can, therefore, be tentative at best and cannot result in any firm commitment on the part of the new authorities whose signatures we shall need on the policy letters until they formally assume their positions.

Phasing Out the Controls Under the Economic Solidarity Pact

10. Another issue we are likely to face is the effect of the macro stabilization program on some of the policy areas we intend to address under the loans. The Economic Solidarity Pact (ESP) under which Mexico has been so successful so far in bringing down its inflation rate, is based on a few nominal anchors (the exchange rate, minimum wages and public sector prices) which have been kept unchanged for a number of months now. The authorities have indicated that the ESP with the freeze of some of the key prices (most notably the exchange rate) might continue even beyond its present phase which ends December 31. We will have to assess what implication the new government's possible insistence not to correct any of the key prices in the initial months of the new administration would have for the success of the policy reforms envisaged under our adjustment loans, particularly under the new and more adverse external environment.

Conditionality and Credit for Past Performance

11. Another area which will have to be assessed in more detail is the adequacy and timing of the proposed policy reforms and conditionality. Clearly the Mexicans will push for "recognition" of substantial progress already achieved in such areas as trade reform (well beyond the targets of TPL II) and privatization, while we will have to work out with the Mexican's medium-term targets for further reform, deadlines for individual measures and conditions of tranche release.

Past Policy-based Adjustment Loans

12. As you know, we have a number of ongoing policy-based operations, including the Steel, Fertilizer, and Agricultural Sector Loans. Because of the partial price freeze of the ESP certain covenants of the above loans are not being complied with for the time being. A mutually satisfactory solution to this will have to be found prior to presenting any future policy-based loan to the Board.

Relationship with the IMF

13. We have been in close touch with the IMF both at Headquarters and in the field and there appears to be broad agreement on the analysis of the

economic situation in Mexico and the "danger points." While there is no thought being given to any cross conditionality, it appears important to maintain the contact and assure that we continue to see eye to eye on the situation.

IV. INITIAL MEXICAN REACTION

14. We have generally had good reception and cooperation in Mexico in obtaining necessary information and in the informal discussion of ideas. Obviously, officials in the incumbent administration are somehow reserved in expressing their views as to what further reforms are needed in their respective sectors. On the other hand, the transition team which has only recently been appointed by the President-Elect, is extremely limited in numbers and has just begun to work on a program for the next sexenio. For all practical purposes, we have in the past three weeks had only two or three high level interlocutors who are likely to play key role in the new government and who may be involved in possible negotiations with the Bank.

15. The extensive and generally high quality discussions we have had so far with the transition team indicate that there is a remarkable degree of agreement between the Mexicans and the Bank on broad directions of future policy reform and on most of the policy actions required. However, there is no full commitment yet to any package of measures. Our counterparts seemingly appreciate our analysis but keep emphasizing the following five points: (i) the Bank should present a balanced assessment of Mexico's achievements in macro stabilization and structural adjustment so far and recognize/reward the country for action already taken; (ii) any future macro and sector adjustment reform supported by the Bank should be a gradual process, taking into account the political constraints and institutional rigidities; (iii) the design of the macro-economic policies which might be supported by a Bank SAL will influence sectoral policies (e.g., pricing policies); (iv) the Bank should not be too detailed and perfectionist in its recommendations for policy actions, leaving them some room for maneuver; and (v) wherever possible measures should be compatible with the existing laws since the Government does not want to inundate the (increasingly powerful) Congress with new laws at the beginning.

16. The above indicates that, on the one hand, the new government seems to be determined to move ahead with structural reforms regardless of whether the Bank will get involved by supporting these reforms or not. On the other hand, it looks like Mr. Salinas' representatives are increasingly concerned about the political constraints they may face in the Congress and with the public-at-large should they want to introduce further structural adjustments in an accelerated way at the beginning of the new administration. For this reason, they are sensitive to the issue of phasing reform properly and the design of supportive measures to minimize transition costs. The ultimate decision on the part of the new government as to whether or not to negotiate a policy package with the Bank may hinge on the perceived urgency of the need to obtain additional external resources partly in 1989 in the light of the international economic climate.

V. NEXT STEPS

17. We have confirmed to the authorities our agreement to prepare comprehensive analyses of each of the three areas of adjustment policies (SAL, industry, public enterprises) together with a broad policy matrix for individual operations by November 11 (as originally discussed in Berlin and Washington).[2] The mission emphasized in the field that these documents would only reflect mission members' professional views as to what could be policy actions under a possible Bank supported adjustment program and would in no way commit the Bank to any lending support. Subsequently, at our suggestion, a series of meetings (perhaps in a rather informal seminar form) will be probably held during the week of November 14 outside Mexico City, where these recommendations and proposals would be discussed with both the incumbent and the new government representatives. We would hope that these discussions would indicate to us how seriously interested and committed the Mexicans are to the proposed adjustment package and what could be the timing leading to formal negotiations with the Bank. Obviously this timetable will depend on how fast the new economic team is put into place and the time they will require to give a feedback.

VI. THE PROPOSED STRUCTURAL ADJUSTMENT LOAN (SAL)

18. The following paragraphs provide a summary of: (a) recent economic developments; (b) objectives of the proposed structural adjustment operation; (c) policy content of the proposed operation; (d) external financing requirements; and (e) loan amount and tranching. A draft mid-mission report is also available. This report presents--like the respective draft reports on the other two adjustment operations-- the intellectual foundations of the proposed reform program for the intended audience in the Mexican Government and it could be turned easily into a President Report for a proposed SAL. Attached as Annex I is a detailed draft policy matrix [3] which lists the main areas for the monitoring of the Government's Adjustment program, out of which three to five key policy actions will be selected as conditions for tranche release.

Recent Economic Developments

19. Mexico's growth rate averaged 6.6% between 1950 and 1974. Between 1982 and 1987, Mexico did not grow at all. This stark contrast sets the agenda for the new administration that will start its six years term on December 1. Restoration of growth to rates that offer some hope of per capita improvement will be the predominant economic concern of the incoming administration.

20. In the last few years, Mexico has undertaken an adjustment effort that is probably unmatched on a sustained basis in any country and which has made possible the annual transferring abroad of the equivalent of about 7% of GDP as interest payments on the foreign debt. A primary fiscal deficit of 9% of GDP by 1981 was turned into surplus of about 5% in 1987

2/ And, as explained, have drafts of these, which we will put in shape this week.

3/ Not yet attached.

and an estimated 7.5% in 1988. Non-interest government expenditure was reduced in the same period by about 9 percentage points of GDP. The public enterprise divestiture program was successful in closing or selling a large number of entities. Finally, the government also undertook one of the more far-reaching trade liberalization programs in the Region: import licences were reduced from 92% of production of tradeables in 1985 to only about 23% by 1988 and the average tariff (weighted by production of tradeables) went down from 23% in 1985 to only 11% in 1988. Rules governing foreign investment have been somewhat streamlined and liberalized.

21. In December 1987, concerned about dangerous tendencies toward hyperinflation (annual inflation had risen to nearly 160% by 1987), the government negotiated with representatives of labor, farming, and industry a program called the Economic Solidarity Pact (ESP or "the Pacto") to reduce inflation and set the stage for growth. This program consisted of further tightening of fiscal and monetary policy, and renewed structural reform efforts. These measures were supplemented by a freeze on minimum wages, public sector prices and the exchange rate (after substantial "up-front" adjustments). On almost every target that is under the direct or indirect control of the government, performance under the Pacto has been exemplary and often went beyond what was originally planned: the monthly inflation rate has been reduced from about 15% in January to about 1% in October. The main challenges ahead are the "soft landing" from the Pacto (a gradual relaxation of the controls, required to realign relative prices) and the resumption of growth. These challenges become now more serious given the recent decline in the price of oil and increase in world interest rates, particularly if these factors become a permanent feature of Mexico's external environment.

Objectives of the Proposed SAL

22. The objective of the proposed SAL is to provide the policy framework for the increase in private investment necessary to resume growth and to improve further the overall efficiency of resource use. Because of the short-term problems, fiscal efforts can not be the main source of growth. With fiscal retrenchment necessary in the face of low inflation targets and the likely negative impact of external shocks on public finances (each dollar off the price of oil cost Mexico about US$500 million and each percentage point increase in world interest rate increase foreign transfers by about US$1 billion), private investment will have to lead the way. The proposed SAL would support the continuation and deepening of the structural reform program initiated by the government.

Policy Content of the Proposed SAL

23. The proposed SAL would support policy actions in the following areas: Macroeconomic consistency, financial and agricultural sectors and trade policies. The main thrust of the reform program is discussed below:

a) Macroeconomic consistency: the projected operational deficit in the 1989 budget and the domestic sources of public sector financing should be consistent with the expected growth rate, inflation objectives, terms of trade, and availability of foreign financing. Economic policy during 1989 should ensure the consistency of objectives and a stable macroeconomic environment.

b) Financial Sector: improved access by the private sector to commercial banking funds; increased competition among commercial banks and private financial institutions; redefinition of the role of development banks and trust funds; reductions in interest rate subsidies and in the allocation of credit through forced loans; improved supervision, and prudential regulations of banks and private financial institutions.

c) Agricultural Sector: complementing and deepening of the policy reforms which are being supported by the on-going Agricultural Sector Loan. The focus would be on the continuation of the Agricultural Trade Reform, gradual relaxation of price controls, improvements in the targeting of food subsidies, further reductions in untargetted credit and input subsidies, composition and level of public investment in the sector and improvements in technological development and extension services.

d) Trade Policies: no backtracking and further advances over time to enhance the neutrality, transparency and simplicity of the trade regime. Further reductions in the remaining quantitative restrictions and on the coverage of export controls. Continuation of the reduction in the level and range of tariffs according to a pre-announced schedule.

External Financing Requirements

24. The net foreign capital requirements of Mexico's growth-oriented program (aiming at 4% real growth p.a. on average) amount to US$30.8 billion over 1989-94, roughly US$5.1 billion a year. If oil prices were to remain at US$10 per barrel in 1989 and increase only at 2.4% p.a. in real terms, the requirements may be US$6 billion higher for the six-year period. To help secure full funding for Mexico's adjustment program, the Bank should focus on the following issues: (a) how can the Bank use its leverage with the proposed adjustment loans to secure the required US$8 billion "new money" from bilaterals (Japan) and commercial banks for 1989-90; (b) what role should the Bank play if Mexico were to be denied voluntary new commercial bank financing; (c) how should the Bank assume its "lead bank" role to secure external finance for the rest of the program; (d) the need to put in place a financing facility contingent on fluctuations in the price of oil; and (e) monitoring of Mexico's external financing strategy with a view to determine appropriate lending levels beyond 1990.

Loan Amount and Tranching

25. A loan of US$500 million would be proposed. The release of the loan would be effected in two tranches. The main condition for the first tranche release would be agreement on the macroeconomic program for 1989. The second tranche would disbursed upon a satisfactory macroeconomic assessment and implementation of key actions in the financial and agricultural sectors and on trade policy.

VII. THE PROPOSED INDUSTRIAL SECTOR POLICY LOAN

Background

26. For three decades, Mexico sought to achieve the development of its industrial sector through rapid expansion of its domestic market behind high protective barriers. Resources were shifted to industry directly through public sector investments and indirectly through the incentive system for the private sector by means of quantitative restrictions, tariffs, fiscal and credit incentives and industrial regulations. Domestic industry was also protected by numerous barriers to entry, but had to face regulations affecting factor and service markets. Industrial sector policy based on import substitution and widespread controls resulted in poor performance in terms of overall productivity and international competitiveness of Mexican industry.

27. Within the context of the Government's program of economic reforms, the first stage of trade and industrial restructuring consisted of the profound trade liberalization program initiated in 1985. It is now important to complement the trade reform by an industrial policy that would encourage growth based on competitive goods and factor markets, an attractive investment environment, and technological change. Actions are now required to promote non-distorted markets, improve factor mobility, reduce the costs of doing business and improve crucial services to industry.

Scope of the Program

28. The proposed loan would support a program of reforms to be initiated in 1989 geared to deregulating the Mexican industrial sector. The program involves the phasing out of the sectoral approach to industrial development, dismantling of remaining QR's against imports, the easing of price restrictions, bureaucratic procedures, and barriers to entry, increasing factor mobility (especially direct foreign investment, technology, and to some extent labor) and improving key services to industry (transportation and telecommunications). The proposed loan would also support initiation of an industrial pollution control program. Of course, much needs to be done to restructure the regulatory framework and the institutions which administer it. The proposed loan in the main supports initial, although in many cases, fundamental change. It would also support studies to identify more specifically further changes or amendments in legislation needed to improve the regulatory environment. Deregulation measures supported by the proposed loan would follow up and complement other measures already taken by the Government in many important areas and those proposed under other existing or proposed Bank operations (including the recently negotiated Industrial Restructuring Project and the proposed SAL and Public Enterprise Loan). The proposed industrial sector policy reform program will require action in the following five main areas (the attached policy matrix[4] (Annex II) outlines possible specific actions):

4/ Not yet attached.

a) Subsector Programs. Subsectoral programs were developed in the early 1980s primarily to alleviate balance of payment difficulties and promote specific industries (e.g. automobiles and autoparts, pharmaceuticals, petrochemicals, computers, and textiles). The programs provide protection from imports, tax incentives, entry restrictions and price controls, and help ease balance of payments problems through domestic content requirements. The extensive distortions created by subsector programs have led to efficiency losses and a reduction in competition. The proposed loan would support the elimination of the Government's sectoral approach to industrial promotion and an action program for phasing out the existing programs and the QR's against imports that are embedded in these programs.

b) Direct Foreign Investment and Technology. Existing rules for direct foreign investment (DFI) require a case by case approval of investments with greater than 49% foreign participation. Moreover, investment in a number of important sectors is restricted to public, Mexican or majority Mexican ownership. In addition, the withholding tax on dividends exceeds the U.S. corporate tax rate which also discourages DFI. Some de facto relaxation of DFI rules and administrative procedures has occurred in recent years. However, considering the increasing importance of DFI in financing investment in Mexico, the proposed loan includes a program to increase further the flexibility of existing DFI rules and regulations, reduce the number of sectors from which DFI is excluded, eliminate the case by case approval process for majority foreign ownership except for a negative list of sectors and harmonize tax rates on dividend remittances. The proposed loan would also include a set of measures to improve the development of domestic technology and facilitate access to foreign technology to further the integration of the Mexican economy into the world economy.

c) Goods Markets. Basic and far-reaching measures have already been taken to open domestic markets and improve the incentive structure under the recent trade reform. Further measures may be supported under the proposed SAL. The range of prices subject to control has narrowed significantly since 1985, although as part of the Economic Solidarity Pact (ESP) prices of public goods and services were frozen by the end of 1987. The program supported under the loan would require a phasing out of price controls for industrial goods in coordination with the lifting of prices under the ESP with sensitive items phased out more slowly. The program would also involve reducing barriers to entry to industries with subsectoral programs, and reducing the cost of doing business in Mexico by simplifying bureaucratic licensing procedures.

d) Factor Markets. Mexico has relied on the selective use of tax and credit incentives to target investments to priority areas. These incentives distorted the cost of capital relative to that of labor and the cost of capital between sectors, and induced a misallocation of resources and loss of fiscal revenues. The program to be agreed upon with the Government would include measures to phase out selective tax incentives and to complete the process of eliminating subsidies on industrial credit. Job security legislation makes worker dismissal difficult and expensive and severely limits labor mobility. Existing programs to absorb, retrain and relocate laid-off workers are still inadequate. Greater inter-sectoral labor mobility is essential for industrial restructuring and the proposed loan would support studies to identify reforms and measures in this area.

e) Services. Road transport in Mexico is heavily regulated. The resulting inefficient and high cost transport services put Mexican firms at a competitive disadvantage with firms in other countries. Trucking concessions are granted by the Government for federal routes and there are severe restrictions to movements across routes. Cargo terminals have virtual monopoly power in assigning cargo, resulting in poor service, damaged and lost cargo and high trucking costs. There are also serious restrictions on the use of containers. The proposed loan would include a program to ease route restrictions, increase the freedom of users to select the providers of trucking services (reduce the role of cargo terminals), facilitate container use in trucking and support other actions to improve the efficiency and reduce the high cost of transport.

The telecommunication system in Mexico is inadequate and congested. This is a serious obstacle to raising industrial competitiveness. Efficient and modern telecommunications systems are essential to the rapid flow of information needed in business decisions. The proposed loan therefore supports a package of proposals to reform the pricing and taxation of telecommunication services, improve the regulatory framework and regulatory and competition policies. It also supports new mechanisms for investment financing and private sector investment in the sector.

f) Environment. A major step toward improving the control of industrial pollution has been the enactment of a new environmental law which places responsibility for control on the most directly affected entities (i.e., state and local governments). The Government has also revised the regulations governing environmental issues. The proposed loan would assist in developing an industrial pollution control strategy and action plan for reducing industrial pollution in the Mexico City metropolitan area.

Project Objectives

29. The proposed US$500 million loan would help create a policy environment supporting more efficient resource allocation and sustainable industrial sector growth. Together with the proposed SAL and public enterprise adjustment loan, it would strengthen private sector development in Mexico. The proposed loan would seek an agreement with the Government on broad direction and necessary specific changes in Mexico's industrial

policy, as discussed above. The loan would also make available funds to conduct studies to define further policy measures. The loan would have two tranches depending on the type and timing of the actions to be agreed upon

Mexican Reactions

30. There seems to be widespread support on the Mexican side concerning the general direction of the policy measures suggested under the proposed program. However, details and the speed of implementation of proposed policy components is likely to raise major issues. Regulatory changes in areas like transportation, subsector programs, telecommunications, foreign investment, and labor have always been sensitive because of strong vested interests. Little change has been seen in most of these areas so far. Opinions are also divided as to whether to include a component for industrial pollution.

VIII. THE PROPOSED PUBLIC ENTERPRISE ADJUSTMENT LOAN

The Mexican Public Enterprise Sector

31. One of the causes of Mexico's economic and financial crisis since the 1970s has been the large and poorly managed public sector, particularly the public enterprises (PEs). At present, these enterprises contribute about 12% of GDP, employ about one million people, and control the most important branches of basic industry and infrastructure. In 1982 the Government owned about 1,155 public enterprises. Since then, however, the Government has implemented a major divestiture program for most of the small and medium PEs and by the end of 1988, this process left only 450 entities in the public sector. The remaining PEs still absorb the bulk of government transfers to the sector. They represent about 85% of the asset value of the original 1,155 firms. The Secretarial of Energy, Mines and Public Industry (SEMIP), is the principal Government agency supervising the large PEs.

Main Sectoral Issues

32. The economic and financial performance of PEs during the last decade has not been satisfactory. The enterprises remaining in the public sector are still facing sluggish demand, low capacity utilization, high operating costs, and financial losses. In 1987, the total transfer of Government funds to PEs amounted to approximately Mex$3.6 trillion or 1.8% of GDP, of which 85% were accounted for by four PEs (the power company--CFE, the fertilizer company--Fertimex, a steel company--Sicarsa II, and the food marketing company--Conasupo). In 1988, the approved budget transfers to PEs amounts to Mex$5.1 trillion or 1.2% of GDP. In addition to the transfers, during the past four years, the Government has also absorbed outstanding debt of several PEs, which was not due during the year.

33. There are several core issues in the sector. In general, most PEs have conflicting objectives. The management of the PE sector is over-centralized, with the most important budgeting, personnel, salary, investment, procurement and even some operational decisions made at the ministerial level. The annual operational budget of the large enterprises are formulated at the ministerial level and are part of the Government

Fiscal Budget; the role of the PEs in this budgeting process is minimal. Furthermore, the budget for investments is approved annually for a single year, with the result that projects cannot be implemented on time due to annual fluctuations in the provision of financing. Labor rigidities make it difficult for the PEs to adjust to shifting market conditions. Many large capital intensive investments have been made without consideration for international competitiveness, with very little intersectoral coordination. A pressing need is the coordination of the investment in the basic industries with those in the hydrocarbon sector, as there is considerable concern that there may not be enough natural gas to supply US$5-8 billion of projects under construction in the steel, petrochemical and fertilizer industries with the needed feedstock when they come on stream.

Recent Government Actions in the Sector

34. In 1986, the Government embarked on a parastatal reform program. But the detailed regulations are still to be issued and the PEs are still subject to a web of legal, regulatory and administrative systems that deprive them of managerial and financial autonomy and negate their accountability.

The Proposed Adjustment Program

35. The success of Mexico in stabilizing its economy and resuming growth will depend on the reform of its public sector. This will require a substantial effort on two fronts: First, a determined effort to further reduce the size of the public sector by additional privatization action, principally in the larger PEs. And second, a major effort to improve efficiency and reduce budgetary transfers to the remaining PEs, which will in turn require changes in their policy, regulatory and institutional framework to enable them to operate on a commercial basis in a competitive environment. The proposed sector adjustment operation is intended to support an agreed, time-phased program of reform in these areas.

The Divestiture Program

36. The President-elect has stated that he intends to continue privatizing PEs that are not in strategic or priority sectors. The privatization process so far has been quite successful. Gross sales revenues from past privatizations are in the order of US$2.5 billion to US$3.0 billion. A significant part of the payments have been in the form of foreign Mexican debt obligations, currently traded at one-half of the nominal value. Further privatization of large enterprises, however, will involve complex political, social, economic and financial issues that may require a strengthening of the Government's oversight role. Here, some Government officials expressed concerns about making changes to an admittedly successful operation and suggested that the process should be pursued in the same discrete manner that has been adopted so far. Specifically, the mission's proposal is to agree with the Government on:

a) Redefining the list of "priority sectors" to remove legal and political impediments for privatization.

b) Strengthening the privatization unit in the Ministry of Finance with staff capable of assessing all complex issues in privatizing large PEs (legal, labor, organizational, financial) and establish a competitive and transparent process.

c) Changing the legal structure of selected PEs, by transferring Government shares to non-public sector trust funds to pursue the process of restructuring and privatization unhindered by the legal and regulatory public sector constraints. This was the approach adopted for privatizing two large mining companies.

d) Restructuring plans of selected PEs with the objective of improving their structure and efficiency to induce both local and foreign competition as a prelude to privatization (e.g. steel, fertilizer, mining and capital goods and petrochemical industries). In addition, it is essential that the Government makes an independent assessment of natural gas reserves, and their cost of production and distribution. It should also establish pricing policy based on international prices for inputs and outputs that would ensure that viable projects are implemented.

Institutional and Policy Reform to Improve Efficiency of Retained PEs

37. Even after completion of the proposed privatization program, there will be a number of companies that will remain under Government ownership. For these PEs, improvements in efficiency could be achieved by inducing them to operate on a commercial basis, as follows: (i) in a competitive environment that subjects them to market pressures; (ii) with sufficient managerial autonomy to allow them to seek agreed upon performance goals and, be rewarded if the goals are achieved, and under clear accountability rules; and (iii) with sufficient financial autonomy and accountability to enable them to use the firm's resources under a "hard budget" scheme. For this system to work, there would be a need to implement reforms of the policy, institutional, and procedural framework under which PEs operate. The major reforms to be undertaken should include the following:

1. Measures to Improve the Competitive Environment for PEs. In addition to the major deregulation measures to be taken in connection with the proposed parallel Industrial Sector Loan, additional measures pertaining public enterprises will include: (i) removing price controls and import quantitative restrictions in subsectors currently dominated by PEs; (ii) reducing policy and regulatory barriers to private sector entry into sector dominated by PEs, principally by redefining the concepts of strategic and priority areas; and (iii) facilitating labor and other factor mobility in public enterprises.

2. Measures to Improve Managerial Autonomy and Accountability. In order to encourage greater market orientation and efficiency, the Government will: (i) redefine the supervisory roles of Government agencies to convert them from ex-ante control of inputs and operations to ex-post control of results;

(ii) entrust the Board of Directors with adequate authority to manage PEs and de-politicize them by including a majority of private sector participation; (iii) establish an annual Performance Agreement system to set goals, monitor performance and provide rewards/penalties accordingly; and (iv) establish a small Directorate for Public Enterprises to implement the Performance Evaluation system.

3. Measures to Improve Financial Autonomy and Accountability. For this purpose, the Government will: (i) "desincorporate" the individual budgets of PEs from the Fiscal Budget and replace it by line items for PEs (either dividend payments or transfers/subsidies; (ii) reduce the level of transfers to PEs in 1989 to a level consistent with macroeconomic constraints, while liberalizing or setting PE tariffs and prices to economic levels; (iii) set overall--rather than enterprise-by-enterprise--credit limits to PEs to maintain macroeconomic control; (iv) undertake an inventory of ongoing projects with their annual financing requirements, and establish funding priorities based on macro-economic constraints and other considerations; (v) develop a multiyear investment planning program for those projects that would require Government financing; (vi) develop a multi-year program on debt assumption, consistent with the debt service capacity of the enterprises; and (vii) reduce the level of financial arrears accumulated in the sector.

Actions on Selected Public Enterprises

38. Under the proposed loan, the Government would develop the required legislation/regulations to achieve the policy, institutional and procedural changes discussed in preceding paragraphs. In addition, detailed programs to implement these reforms for "test cases" will be prepared and agreed upon for a number of key enterprises as follows: (a) Fertimex; (b) Sidermex; (c) Mining Sector; (d) NKS; (e) Concarril; and (f) the petrochemical sector. The details are provided in the attached Policy Matrix.[5] In addition to the reforms aimed at improving autonomy and accountability, the Policy Matrix proposes that for some of the PEs, additional organizational, business or financial restructuring activities may be incorporated as components of the proposed loan.

Technical Assistance

39. The proposed loan will contain a technical assistance component to facilitate the implementation of the proposed reforms.

Loan Amount and Tranche Release Conditions

40. Given the importance of the PE reform program and the foreign exchange requirements of the country, a loan of US$500 million is proposed. The release of the loan could be effected in two tranches as detailed in the attached Policy Matrix.[6]

5/ Matrix not yet attached.

6/ Matrix not yet attached.

Justification of the Operation

41. At this stage, Mexico's goal to re-establish growth, is dependent on its success to capture export markets and achieve full integration with the world economy. This objective cannot be achieved unless the Government restructures its public enterprises and establishes the conditions for an efficient basic industry. The proposed operation would serve this purpose.

42. During 1989, Mexico will need to give highest priority to improving its fiscal situation. It is anticipated that public enterprises will play a major role in helping the Government to achieve its fiscal/budgetary goals. However, rather than maintaining the tight but ineffective controls of the operations and costs of the PEs, the Government could mobilize PE management to achieve fiscal health, by agreeing on performance goals for 1989 directly linked to minimizing transfers and costs, and maximizing dividends; and then granting them the autonomy to reach these goals.

cc. Messrs. Dubey (with matrices)
Vergin (with matrices)

Amb. Keating

MEXICO

Suggested Questions and Answers
October 17, 1988

Question: What is the real reason that United States is undertaking this bridge? Is it to bail out U.S. banks that would be hurt if the value of their Mexican debt holdings suffered further erosion?

Question: The proposed bridge is very large, yet appears to be a strictly bilateral one. Have other creditor governments been approached with respect to participation? If not, why not? Do other countries now see Mexico as a "U.S. problem"?

Question: What is the source of funds for this proposed bridge? What interest rate will the Government of Mexico be charged? What will this loan cost the U.S. taxpayer?

Question: The Treasury press statement refers to a short-term bridge of "up to $3.5 billion" depending on development of loan programs with the World Bank and the IMF. What loans are pending with the Bank? How much are they worth? Does Mexico plan to seek a stand-by arrangement?

Question: The Treasury press statement refers to economic measures recently announced by the Government of Mexico. What do these measures consist of? Do they include any exchange rate adjustment?

Question: If Mexican economic policy is so good, why does the country need such a massive amount of money?

Question: This announcement is unexpected and comes as a complete surprise. Can we infer from this that the situation in Mexico is much worse than had been envisioned?

Question: The global debt crisis is generally conceded to have begun with Mexico in 1982. The Administration claims that great progress has been made since that time. However, you are now announcing a bridge operation that appears to be larger than any previous such operation. Isn't this an open admission of failure of the so-called Baker plan? Does it signal a new debt strategy?

→ given to BBC on 10/20

Question: What is the real reason that United States is undertaking this bridge? Is it to bail out U.S. banks that would be hurt if the value of their Mexican debt holdings suffered further erosion?

Answer:

- o Our agreement to develop a short-term bridge loan is an expression of U.S. support for Mexico's continuing adjustment efforts and is a vote of confidence in that government's economic management.
- o It is designed to provide additional short-term liquidity for Mexico and to reassure markets during this period of economic adjustment to an export shortfall.
- o This operation in no way "bails out" U.S. banks, which continue to support Mexico with needed trade finance and demonstrated broad support for that nation in the new money package and rescheduling of 1986.
- o We anticipate that commercial banks will continue to support Mexico's ongoing economic reforms.

Question: The proposed bridge is very large, yet appears to be a strictly bilateral one. Have other creditor governments been approached with respect to participation? If not, why not? Do other countries now see Mexico as a "U.S. problem"?

Answer:

- The United States and Mexico enjoy a long-standing special relationship as reflected in exceptionally close economic ties.
- We share Mexico's aspirations and are pleased to stand ready to support its sustained adjustment efforts.

Question: What is the source of funds for this proposed bridge? What interest rate will the Government of Mexico be charged? What will this loan cost the U.S. taxpayer?

Answer:

- The Treasury Department portion of the short-term loan will be a swap from the Exchange Stabilization Fund supplemented by a separate swap from the Federal Reserve.
- Mexico will be charged interest on any drawings sufficient to cover the United States Treasury's costs of borrowing from financial markets.
- There will be no cost to the U.S. taxpayer.

Question: The Treasury press statement refers to a short-term bridge of "up to $3.5 billion" depending on development of loan programs with the World Bank and the IMF. What loans are pending with the Bank? How much are they worth? Does Mexico plan to seek a stand-by arrangement?

Answer:

- o The Government of Mexico has been discussing a series of policy-based loans with the World Bank that could be worth at least $1.5 billion.
- o The IMF has a variety of facilities to assist members in adjusting to balance of payments problems.
- o Since Mexico is suffering a sharp drop in export earnings due to lower world oil prices, it will be discussing available options with the IMF.

Question: The Treasury press statement refers to economic measures recently announced by the Government of Mexico. What do these measures consist of? Do they include any exchange rate adjustment?

Answer:

- o The announcement last Saturday of the Mexican government in consultation with the President- elect sets out a package of measures involving both fiscal and monetary actions to reduce the deficit.

- o They are supplemented by strengthened privatization actions designed to generate revenues and enhance the efficiency of the Mexican economy.

- o The President-elect also announced last night that the Economic Solidarity Pact (scheduled to expire at the end of November) will be extended through the end of this year. Exchange rate stability is an element of that arrangement.

- o These measures have been developed by the Mexican Government and build upon and reinforce policies already in place. They address the problems brought on by the unanticipated decline in world oil prices.

- o These measures will lay the basis for balance of payments stabilization and enhanced economic growth in Mexico.

__Question__: If Mexican economic policy is so good, why does the country need such a massive amount of money?

__Answer__:

- o The current problems are attributable to an __unanticipated__ decline in world oil prices.
- o This decline has affected Mexican export receipts adversely. For example, a $1 decline in the price of oil reduces Mexico's export earnings by $500 million per year.
- o The recent oil price decline occurred abruptly and unexpectedly and had not been anticipated by the Mexican Government.
- o This decline, therefore, necessitated these new Mexican Government measures.
- o The measures announced will begin to have an impact right away. The proposed bridge loan will provide support for the Mexican Government while these measures take full effect.

Question: This announcement is unexpected and comes as a complete surprise. Do we have a new debt crisis at hand?

Answer:

- o The current action in no way implies that Mexico confronts a debt crisis of any kind.
- o The current situation was brought upon by a sharp, unanticipated decline in world oil prices.
- o The Mexican Government has acted responsibly and prudently in adjusting economic policies to meet this unexpected, adverse development.
- o The Mexican Government moved quickly to develop new economic measures to respond to this situation early and effectively.
- o We welcome these measures and initiatives and have demonstrated our support with the bridge loan.
- o By acting early in this way, the Mexicans have reassured the markets and laid the foundation for enhanced economic growth.

Question: The global debt crisis is generally conceded to have begun with Mexico in 1982. The Administration claims that great progress has been made since that time. However, you are now announcing a bridge operation that appears to be larger than any previous such operation. Isn't this an open admission of failure of the so-called Baker plan? Does it signal a new debt strategy?

Answer:

- o Great progress has been made over the past six years and the debt management capacity of nearly every major debtor has improved.

- o Similarly, the soundness of the international financial system is no longer in question.

- o This does not, however, mean that there will not continue to be problems requiring adjustment.

- o In particular, external shocks such as large and sudden movements in commodity prices require support if orderly adjustment is to take place with a minimum of disruption and suffering.

- o The development of substantial support for Mexico at a time when that nation's foreign exchange reserves are substantial (e.g., some $10 billion) shows how the system has become anticipatory in its provision of a "safety-net" that can provide needed support for orderly adjustment without disruption of financial markets.

- o There is no need to change the present debt strategy since that strategy is dynamic, adaptive, and is serving both creditors and debtors well.

*MH

C.F.

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 88/10/11 DUE DATE : 00/00/00
LOG NUMBER : 881011007 FROM : S.S. Husain
SUBJECT : Memo--- MEXICO: Adjustment Loan.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

______	APPROVED
______	PLEASE HANDLE
______	FOR YOUR INFORMATION
✓	FOR YOUR REVIEW ~~AND RECOMMENDATION~~
✓	FOR THE FILES
* ✓	PLEASE DISCUSS WITH BBC
______	PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
______	AS WE DISCUSSED
______	RETURN TO ______

COMMENTS :

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 11, 1988

TO: Barber B. Conable

FROM: S. Shahid Husain

EXTENSION: 39001

SUBJECT: MEXICO: Adjustment Loan

1. During the Annual Meetings in Berlin, Mexico's Finance Minister held several discussions with Bank officials, including you and Mr. Qureshi, on the intentions of President de La Madrid and President-elect Salinas to initiate substantial economic reform in Mexico to stimulate economic efficiency and growth. These were followed last weekend by visit to Washington of the President of the Central Bank and Jose Cordoba, Economic Advisor to Mr. Salinas. They visited the US Treasury and the Bank and elaborated on the plans of the Government and Mr. Salinas. They also reiterated Mr. Petrocelli's request for Bank assistance in formulating, monitoring and financing the program and in obtaining cofinancing from Japan. They mentioned that the urgency for Bank assistance arose from the stagnation of the economy despite the adjustment during the last six years, decline in the price of oil and increase in the interest rate. They mentioned that of all of Mexico's financial partners only the Bank had the technical capability and credibility to take lead in helping the Mexicans prepare a program that would require painful adjustments and would, no doubt be politically controversial.

2. The Mexican program would have three main elements:

(a) Macroeconomic adjustment. This would essentially center on the management of the transition from the "Pacto" to an orthodox fiscal, monetary and balance of payments management. The key issues here will be the consistency of policies in these areas with the revival growth, public investment, private sector activity, continued rapid expansion of non-oil exports and control of inflation and their sustainability.

(b) Industrial deregulation and restructuring. The issues here include governmental regulation, regime governing domestic and external investments and the financial system.

(c) Public enterprise reform. Policy questions here would be efficiency, competition, control and privatization.

We are planning three adjustment loans, each covering these three areas. Three missions would go to Mexico City next weekend to work on these. I would join the discussions as and when necessary. On the missions' return we would submit specific proposals for consideration by the Operations Committee.

cc: Mr. Qureshi

~~###~~

C. F.
(Argentina)

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 88/10/13 DUE DATE : 00/00/00
LOG NUMBER : 881013010 FROM : Mr. Qureshi
SUBJECT : Review Procedures for Adjustment Lending Operations - Argentina, Mexico and Morroco.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

_____ APPROVED
_____ PLEASE HANDLE
_____ FOR YOUR INFORMATION
_____ FOR YOUR REVIEW AND RECOMMENDATION
_____ FOR THE FILES
* ✓ PLEASE DISCUSS WITH BBC
_____ PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
_____ AS WE DISCUSSED
_____ RETURN TO _____

COMMENTS :

The World Bank
Washington, D.C. 20433
U.S.A.

MOEEN A. QURESHI
Senior Vice President, Operations

October 13, 1988

Mr. Conable

Re: Review Procedures for Adjustment Lending Operations

I am sorry that David Hopper has expressed his disquiet to you concerning what he perceived to be a departure from normal procedures on adjustment loans for Argentina, Mexico and Morocco. Had he conveyed his concerns to me, I would have clarified that these procedures are, and will continue to be, strictly followed.

With respect to Argentina, meetings of the Operations Committee took place under my chairmanship to discuss both the Banking Sector Loan, and the Trade Policy Loan. These meetings gave full opportunity to all Bank units to express their views on these operations. Furthermore, an additional meeting chaired by me took place on August 5 to discuss more specifically issues associated with the macro-economic framework in Argentina and the specific conditions under which the Bank would be prepared to make the Banking Sector loan effective and to invite the Argentine Government to formally negotiate the Trade Policy Loan. Stanley Fischer attended all these meetings. At no point did I, or any of my associates, ever state that we would only proceed to the Board after a commercial bank's package had been agreed upon. A condition for the January tranche releases is sufficient progress in obtaining external finance. Insistance on prior agreement with commercial banks would be unrealistic and tactically wrong because it would merely give leverage to commercial banks and may, in fact, delay an agreement.

The two other loans forming part of the Argentina "package" are investment operations (Low Income Housing and Power Sector) which are being processed and reviewed according to the procedures in force for such loans. Their viability would naturally be strengthened under the improved macro-economic framework to be put in place by the Argentine Government.

In the case of Morocco, also, the established procedures were also closely adhered to: first, the Initiating Memorandum for the SAL was reviewed in a meeting of the Operations Committee; all bank units were represented and did express their views at that time; second, after appraisal of the operation, the "Green Cover" report was circulated to all Operations Committee members on a no-objection basis (this was immediately before Berlin), which is also customary in those cases where no new issues have emerged between the "Initiating Memorandum" and "Green Cover" stages of the loan process; we actually received comments from most members of the Operations Committee (including PPR) and the consolidated comments were relayed to the Region by my Economic Advisory Staff. These comments are being taken into account. You should also know that according to established procedures, any member of the Operations Committee could have asked for a formal meeting (instead of written comments), and none did.

As far as Mexico is concerned, the Operations Committee will meet on specific and detailed loan proposals - these are not there yet. You are well aware that this matter was raised with us during the Berlin meetings. I have planned a brief restricted meeting with members of the Operations Committee on Friday, October 14, essentially to brief them on the request and to indicate to them the guidance given to the mission that is proceeding to Mexico. In view of your schedule, this meeting could not be held prior to our briefing for you on Mexico. You will see therefore that we fully intend to adhere to the established procedures, but equally it is not appropriate for this institution to ossify into a bureaucratic body that is unable to respond flexibly and quickly to its members' needs.

In order to alleviate your concerns about the integrity of and compliance with the processing procedures on adjustment lending, I would suggest that we meet at your convenience to discuss the issue in more depth. Vinod Dubey and his colleagues of the Economic Advisory Staff have done a superb job since the Reorganization in that respect, and would be delighted to give you a first hand account of the situation.

Moeen

Moeen A. Qureshi

cc: Mr. W. David Hopper

The World Bank
Washington, D.C. 20433
U.S.A.

ERNEST STERN
Senior Vice President
Finance

TO: Mr. Barber B. Conable September 28, 1988

FROM: Ernest Stern

SUBJECT: Mexico

I note that item 2 of Mexico's "International Development Pact" states that "as a group, international lending institutions...must make available a sufficient volume of resources at least to offset the principal and interest payment they receive from the debtor countries. If necessary, automatic recycling mechanisms, effective for limited periods, would be created to enable this objective to be achieved." (underlining supplied).

This is an unacceptable proposition on several grounds. By making this a group objective, the Mexicans have left themselves the option of holding each institution responsible for the total. Not only do they expect the World Bank to fully capitalize its interests but also to lend in sufficient volume to offset, say, IMF repayments. This is more extreme, and irresponsible, than any previous proposal. Second, even for the Bank's own account, we cannot accept this obligation---nor the way in which it is being proposed unilaterally and publicly. It does not speak well for the "partnership" Mexico claims to make this kind of statement in public without prior consultation. There is, of course, no reason why, in the abstract, we should accept a link between the volume of our disbursements and the payment of interest due on prior loans. Our lending to Mexico should be determined on the basis of the programs and projects to be financed, and a reasonable sharing of the external capital requirements with other lenders.

The proposal also is inconsistent with the assurances previously obtained from Mexico regarding our preferred creditor status.

It is important that, in the context of our current negotiations with Mexico, we get an explicit retraction of this objective. It may not be necessary to have this be a public retraction, but it should be explicit. We can surely not afford to have the Finance Minister of one of our largest borrowers put us on public notice that, in his view, repayments to the Bank are not determined by the loan agreements but conditional on other circumstances.

cc: Mr. Qureshi
Mr. Fischer
Mr. Shihata

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

(1) MH
(2) Mr. Conable
(3) CP

DECLASSIFIED
CONFIDENTIAL
AUG 2 7 2013
WBG ARCHIVES

DATE: June 16, 1988

TO: Files

FROM: J. Varallyay, Acting Chief, LA2CO

EXTENSION: 38731

SUBJECT: MEXICO -- Visit by Finance Secretary, Petricioli with Mr. Conable[1]

1. Mr. Petricioli reported on the Government's successful fight against inflation (in June it is likely to be at 1.5%, down from 15.5% in last January) expressing hope that stabilization should be successfully completed by the end of the year. Mexico will, however, need to grow, but the country's heavy debt burden and associated high resource transfer abroad are limiting investment opportunities. To remove this constraint, Mexico must reduce its stock of debt. The Secretary informed Mr. Conable that a new debt reduction scheme has been discussed with the US/FED.

2. Mr. Gurria explained that the new credit enhancement scheme consisted of the following main features: (a) principal to be guaranteed with zero coupon bonds; (b) interest payments for the first year to be guaranteed through an escrow account set up from Mexican reserves; and (c) interest payments for the next 3-5 years guaranteed by the Bank and, this guarantee, in turn, to be counter-guaranteed by, or funded from a line of credit from, four countries, France, Spain, Canada and Japan.

3. In response to questions by Messrs. Conable and Qureshi, the Mexican delegation explained that this scheme would enhance the market value of the new Mexican offer without any cost to to the Bank, because the Mexican risk would be borne ultimately by the four participating countries. The Government would press for a US$10 billion zero coupon operation with the US, bringing the total in 1988 to US$12.5 billion. Mr. Qureshi stressed to the Mexican party that they should be careful not to mortgage the Government's future access to new money with an overly ambitious debt reduction scheme. Secretary Petricioli cautioned that the international community must understand that because of domestic political pressures, the Government must move now and show results in alleviating Mexico's debt burden.

4. Mr. Conable welcomed the Mexican initiative to inform the Bank about their new proposal (which was a slightly different version of the proposal that was sent to Mr. Husain last week) and asked the Mexicans to keep him apprised of progress in getting it accepted by the key players. Further discussion focussed on some technical aspects, whether the Bank

---

1/ Mr. Conable received the Secretary on Monday, June 13, who was accompanied by Lic. Angel Gurria (Finance), Lic. Alfredo Acle (FERTIMEX), Lic. Guillermo Ortiz (ED at IMF), Lic. Jose Luis Flores (ED at IDB) and Lic. Luis Nava (NAFIN), Ms. Rubio (ED) was also present. Messrs. Qureshi, Lee, Knotter and Varallyay attended from the Bank.

would assume directly any Mexican risk or not. Mr. Qureshi accepted a proposal to continue consultations with Mr. Gurria the next day.

Cleared with & cc: Mr. Qureshi, SVPOP

cc: Messrs. Conable, EXC; Ms. Haug, EXC; Husain, LACVP; Steckhan, LA2DR; Martinez, LA2CO (o/r); Lee, LA2DR; Bock, DFS; Goldberg, VPLEG

JVarallyay/mds

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDANCE DATE : 88/06/07 DUE DATE : 00/00/00
LOG NUMBER : 880609005 FROM : S. Husain (thru MQ)
SUBJECT : MEXICO: Meeting with Finance Secretary, Petricioli on ~~Wednesday,~~ Monday June 13 at 4:30 pm.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

______ APPROVED
______ PLEASE HANDLE
______ FOR YOUR INFORMATION
______ FOR YOUR REVIEW AND RECOMMENDATION
______ FOR THE FILES
______ PLEASE DISCUSS WITH ______
______ PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
______ AS WE DISCUSSED
______ RETURN TO ______

COMMENTS :M. Haug, J. Volk (FF)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: June 7, 1988

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 69001

SUBJECT: MEXICO -- Briefing for your meeting with Finance Secretary, Petricioli

1. You are expected to receive Mexico's Finance Secretary, Lic. Gustavo Petricioli, on June 13, at 4:30 p.m. Although no agenda has been set for discussion, we expect that the problems of Mexico's recovery of growth and external debt will be discussed.

The Economy

2. With presidential elections scheduled for July 6, President Miguel de la Madrid's Administration is about to enter the last five months of the "sexenio". You should congratulate Lic. Petricioli for the most courageous adjustment effort of the Government, which has been designed to facilitate: (i) the successful completion of the quasi-heterodox stabilization program initiated last December ("Pacto de Solidaridad Economica"); and (ii) setting the foundation for the resumption of sustainable growth by the next Administration beginning December 1988.

3. The "Pacto" -- designed to reduce inflation -- has frozen the exchange rate, public sector prices and a basket of basic commodity prices and introduced a major fiscal effort since early 1988. Inflation has declined from a monthly 15.5% in January to 3.1% in April, and it is expected to remain below 2% for the month of May. These are very impressive results by any standard, and the real question now is how to provide for a transition to decontrols. While continuing with a strong fiscal effort, the freeze has been extended to the end of August recently, so that the next phase of the stabilization involving a system of forward indexing would not begin until some time later this year.

4. What has to be done in addition to successful macro-economic stabilization to create the preconditions of sustainable growth in Mexico? Mexico must keep a supporting macro-economic framework in place, complete the courageous trade liberalization effort by liberalizing the domestic regulatory environment, creating an efficient financial sector and -- as the adjustment process is consolidated -- cushioning against the cost of adjustment (declining wages and consumption per capita) through cost effective and well-targeted social programs. Initiatives in most of these areas are under way, but further progress will be necessary as the next Administration takes office.

An Emerging New Growth/Debt Strategy

5. In addition to reforms, Mexico will have to return to invest to achieve growth. Investments would have to be financed in a substantive measure by external financing. With a very low current account deficit expected in the balance of payments, low growth (0.5 - 1.0% in 1988) and a high net transfer of resources (6.6% of GDP in 1988), Mexico's policymakers have recently begun to question the sustainability of the country's external debt burden. They are asking what has the country benefitted by being a "model" debtor who pays its full debt service on time? Indeed, in some ways, Mexico's cooperative stance on debt has backfired in domestic politics and there is a sense that some concessions must now be obtained.

6. Recent statements by Angel Gurria, Mexico's debt negotiator, and presidential candidate Salinas de Gortari made it clear that if the debt service burden prevents Mexico from growing, Mexico would not be in a position to pay. Mr. Petricioli, in fact, suggested that Mexico must seek ways to reduce the stock of debt and/or interest payments, quoting as a medium term target for interest payments 3-4% of GDP, roughly one-half of the current high levels. The resources thus freed should be ploughed back into the economy to recover high economic growth in the short run.

7. It is expected that after the presidential elections in July 1988, the defeasance scheme and its variations may be put in the agenda. If these schemes did not produce the desired results, it is likely that the Government may present a broad negotiated framework for additional finance to capitalize interest, provide guarantees and net flows of capital designed to ensure the preconditions of a minimum economic growth that is compatible with political and social stability in Mexico.

Bank Action

8. We believe the Bank can act in two areas to assist Mexico, provided that any proposal for dealing with the country's debt problem is made in a cooperative framework:

a) keep the reform agenda and the adjustment process on track (both through economic and sector work and sustained lending[1] of up to US$2 billion per year); and

b) assist in implementing market-related solutions capable of reducing Mexico's debt burden, while maintaining access to critically needed external resources.

9. You should assure Lic. Petricioli that the Bank is prepared to continue its strong support to Mexico's adjustment effort. But, you should caution the Secretary that the Bank's full contributions are conditional on progress in deepening the adjustment, without which Mexico could not become more efficient and competitive abroad. Only under these circumstances

---

1/ Please note that Bank lending faces some uncertainty and potential bunching problems at the end of FY89, because the new Administration scheduled to take office in December 1988 will need time to sort out priorities, before new projects can be firmed up.

would it make any sense to reduce the debt burden, in an effort to engineer early recovery of growth. Otherwise, any relief may tempt the Mexicans to relapse into business as usual, which would not serve the best interest of Mexico or that of any of its partners.

JVarallyay/mds

6/13-4:30

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

URGENT

DATE: June 10, 1988

TO: Mr. Barber B. Conable
Through: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 69001

SUBJECT: **Mexico: Meeting with Mr. Petricioli**

1. As you know, Mr. Petricioli will be calling on you next week. As background to that meeting, we have received a communication from the Mexican authorities regarding their intention with respect to further use of market-oriented debt reduction techniques. Essentially, the Mexican authorities are proposing to repeat their earlier debt/bond exchange offer, this time utilizing several different options. As before, each of the options would provide for defeasance of principal obligations. In addition, however, each option would also provide for some form of credit enhancement on interest payments.

2. The Mexican authorities have apparently begun approaching the governments of Japan, Canada, Spain and France seeking partial guarantees from those governments to cover interest payments on the bonds. The Mexican authorities also suggest supplementing such guarantees by: (a) World Bank guarantees of one year's interest, and (b) a Mexico-funded escrow account equal to one year's interest. The objective is thus to secure total guarantees on up to 5-6 years worth of interest payments on up to US$10 billion in bonds.

3. Besides asking for our general support for market-oriented debt reduction and a partial IBRD guarantee of interest, we anticipate that Mr. Petricioli will also be seeking a further waiver of negative pledge--on this occasion needed for both the defeasance of principal and the interest escrow account--and possibly IBRD issuance of zero coupon bonds as collateral for principal.

4. These proposals are a key part of the general Mexican debt strategy. As you know, the Mexican authorities are managing their external affairs so as not to request further concerted new money from commercial banks. Accordingly, they do not intend to seek fresh financing from private sources this year or next. Thereafter, they will seek to raise funds on a strictly voluntary basis. In the meantime, they wish to take advantage of whatever options may be available to reduce the existing debt stock at a discount.

5. A second round of debt/bond swaps with extensive credit enhancement on interest payments is likely to yield greater debt service reductions than the earlier exchange offer. However, for shareholder relations reasons, we do not see any scope for the Bank to provide interest guarantees at this time. And as you know, the Finance Complex feels that we should be cautious about committing the Bank as a source of collateral for principal defeasance, especially since the Mexicans

may be seeking 30-year zeros on this occasion. You should indicate that we are prepared to consider such a role, but it would need to fit into our overall funding strategy.

6. On the subject of negative pledge, we recommend that the Bank agree to a further but carefully limited waiver. The Mexicans previously asked for a waiver covering up to US$10 billion in bonds of which $2.6 billion has been used. We would prefer to retain the limit of US$10 billion which is realistically about all that the Mexicans are likely to achieve (unless they were to obtain very substantial interest payment guarantees). However, we think that a new waiver of up to $10 billion (implying potential total waivers of $12.6 billion) would be acceptable.

7. We have reservations about the waiver of negative pledge with respect to an interest escrow account. This represents subordination of IBRD claims and would thus have to be limited in scope. Mr. Petricioli may not, of course, bring up an issue of this detail with you. We recommend that you indicate that we would be willing to consider a waiver of $1 billion for this purpose, but strongly prefer that this be done only if the eventual transaction is likely to yield significant debt reduction (which depends on how much success the Mexicans have in getting third-party guarantees).

8. More generally, we believe that Mexico needs to keep focussed on an eventual return to voluntary lending. They should not pursue debt reduction so aggressively as to jeopardize future sources of new money by trying to establish seniority for existing debt--even if reduced through exchange offers. This includes any steps that would diminish the preferred creditor standing of IBRD in Mexico, and make it more difficult for the Bank to support Mexico's return to the voluntary market. In this connection, it is worth noting that Mexico will need to use a variety of credit enhancement techniques in restoring voluntary borrowing capacity (e.g. project financing, IBRD cofinancing, etc.). It may be better for Mexico to reserve techniques such as interest escrows for future new money requirements. We would thus like to discourage the Mexicans from relying heavily on interest escrows and giving senior status to existing debt. Indeed, this is a central reason that waivers of negative pledge for this purpose by the World Bank would be strictly limited.

Cleared w/and cc: Mr. Steckhan

Discussed with and cc: Messrs. Goldberg, Morais, Steer, Roth

DBock:mac

Record Removal Notice

File Title	Barcode No.
Mexico - Country Files - Correspondence - Volume 1	1779794

Document Date	Document Type
Jun 7, 1988	Telex

Correspondents / Participants
Mr. Shahid Hussain

Mr. Angel Gurrta

Subject / Title
Notes on Debt Reduction Techniques for Mexico

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☑ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

Reason for Removal
Information Provided by Member Countries or Third Parties in Confidence

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	Aug 27, 2013

Presid... has seen

March 2, 1988

Mr. Conable:

re: Mexico Steel Projects

Barber, the chief engineering company working on the steel project in Mexico is a subsidiary of US Steel, United Engineers and Consultants (UEC) which is the chief consulting group for two out of the three beneficiaries of our loan.

A. ARMSA: - Chief Consultant U.S. Steel

1. This part of the project involves a section of the plant itself. So far, there have been purchases for over $2 million in spare parts. All purchases are from US companies but the main benefactor has been a company called Davey United located in Pittsburgh, Pa.

2. When the project is signed, the first contract to be let (tentatively approved) will be for four locomotives. There are only two bidders for these locomotives--they are the General Motors Corporation and the General Electric Company of the United States. Each locomotive is estimated to cost over $1 million.

3. The next major piece of equipment will be for a large central furnace. The Mexicans are mainly interested in dealing with the Davey United Company which are said to have an inside track because most of the spare parts were purchased from them.

4. The total amount for various procurements on Project #1 is $170 million. Bank personnel believe that over $100 million in contract will go to US corporations.

B. Project # 2 (CMC) Chief Consultant U.S. Steel

This project, engineered by UEC involves deep iron mines. After signing the contract, the first procurement will be for replacement of earth moving equipment. The Catapiller Corporation of Illinois is a low bidder for an estimated contract of $50 million.

C. Project # 3 (HYLSA) - Japanese Consultant

This last part of the project was designed by a Japanese engineering firm. Total foreign purchases for this contract are estimated at $75 million. Our Bank people estimate that $30m will go to US companies. The Japanese expect to receive the second largest share.

DRAFT

President has seen

MEXICO STEEL LOAN--1988

Mr. Conable, in his assessment, looked at the following:

1. Pricing Policy:

Controlled domestic prices were below international opportunity costs. Prices were adjusted for inflation on an ad hoc basis.

Action to be Taken Under Loan Agreement:

Elimination of price controls, during 1988 in three phases. 50% by spring -- complete decontrol by summer.

2. Trade Policy

High tariffs and high Official References Prices (ORP) did not allow for external competition.

Action to be Taken:

ORP to be eliminated and calls for reduction and uniformization of tariffs. By fall of 88, Tariff on Non-inflats reduced to 25%

3. Quantitative Import Restrictions:

Domestic content was required on steel users.

Action to be Taken:

Gradual elimination of some restrictions by use of proposed Industrial Restructuring Loan.

- 0 - 0 -

1. Mexico is expected to remain a net importer of steel over the long run. It is to the US' advantage to see tariffs removed, begin to eliminate domestic content requirements and price controls which have kept domestic prices below international opportunity.

2. It results in a reduction of approximately 20% in domestic steel making production.

3. Balance of Trade Figures: (130 million a year) U.S favored balance over mexico on Steel related items.

$$

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

C. F. (Mexico)

DATE: February 8, 1989

TO: FILES

FROM: Miguel E. Martinez, Chief, LA2CO MM

EXTENSION: 38729

DECLASSIFIED
~~CONFIDENTIAL~~
AUG 2 7 2013
WBG ARCHIVES

SUBJECT: MEXICO: Finance Secretary Pedro Aspe's visit with Mr. Conable

1. Mr. Aspe[1] visited Mr. Conable today to brief him on the status of Mexico's external financing requirements.

2. Mr. Aspe informed Mr. Conable that Mexico's external financing needs amount to about US$7 billion per year (based on oil prices of US$10-13 pbb and current interest rates). The Government's objectives are to: (a) put in place a multi-year financing package (4-6 years) which would provide certainty, thus enhancing investment and growth; (b) reduce net transfers from 6% of GDP to 2%, thus allowing economic growth around 4-5% per year over the period; and (c) offer a menu of financing instruments which can help achieve the 4% of GDP reduction of net transfers above.

3. He advised Mr. Conable that the status of discussions with key players is the following:

US Treasury. The US Treasury has as yet no clear consensus within the new Administration, nor does the G-7 have a unified position. They asked for a couple of more weeks before substantive discussions can start. Mr. Aspe will wait and not talk to commercial banks to give the Treasury more time.

Paris Club. They will be making informal contacts with the Paris Club in the next few weeks. The Mexicans want to reach a multi-year agreement (3-4 years), restructuring the principal and bringing the cutoff date to 1988, rescheduling interest payments to offset Paris Club outflows, and increasing the import coverage.

IMF. Mr. Aspe informed Mr. Conable that they started technical discussions with the IMF today seeking to articulate a 4-year program that would ensure quick resource transfers, respect growth objectives and pose no new upfront conditionality. He added that discussions will remain informal and it expected that in 4-6 weeks it should be clear whether an understanding can be reached on terms satisfactory to Mexico.

Commercial Banks. Because of the delays in the US Administration, there have been no official contacts between Mr. Aspe and money center bank CEOs.

1/ He was accompanied by Messrs. M. Mancera, J. A. Gurria, G. Ortiz, J. Pinto (EDS), E. Vilatela, and M. Pineda. From the Bank, present were Messrs. Husain, Fischer, Martinez, and Mrs. Haug.

CONFIDENTIAL

4. In response to a question from Mr. Conable on what would be their strategy in case that there is not a satisfactory response from the US Treasury, Mr. Aspe indicated that because of their critical foreign exchange reserve position they would be forced to suspend payments to commercial banks. He further explained that they have made this point clear to Treasury so that they would not be surprised later if this happen. He was not clear about the timing for this action, but it seem that it would be around late March. Mr. Aspe inquired about the likely position of the Bank if this would happen and Mr. Conable explained that provided that there is a program that the Bank and the Fund could support they could count on Bank lending and that the Bank would make its best effort to help them in securing cofinancing from the Japanese Government.

5. The meeting concluded with a discussion about the likely timing for the negotiations of the three adjustment operations. Mr. Aspe informed the Bank that substantive discussions are under way in the Administration concerning the three proposed adjustment operations. As soon as the technical comments are ready on the negotiating documents, the Government would respond to the Bank and we could proceed to more formal negotiations.

Cleared w/& cc: Mr. Tanaka, EXC

cc: Messrs/Ms.: Conable; Qureshi, OPNSV; Fischer, DECVP; Husain, LACVP; Haug, EXC; Steckhan, LA2DR; Bock, DFS

MEM:sct

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDANCE DATE : 88/01/04 DUE DATE : 00/00/00
LOG NUMBER : 880104017 FROM : Shahid Husain
SUBJECT : MEXICO: Briefing for Mtg. with Director-General of the Bank of Mexico, Miguel Mancera Aguayo, Tuesday, January 5 at 8:00 am.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- ________ APPROVED
- ________ PLEASE HANDLE
- ________ FOR YOUR INFORMATION
- ________ FOR YOUR REVIEW AND RECOMMENDATION
- ________ FOR THE FILES
- ________ PLEASE DISCUSS WITH ________
- ________ PLEASE PREPARE RESPONSE FOR ________ SIGNATURE
- ________ AS WE DISCUSSED
- ________ RETURN TO ________

COMMENTS : Jenny - original for BBC's follow file.
cc: Marianne Haug

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 4, 1988

TO: Mr. Barber B. Conable

FROM: S. Shahid Husain

EXTENSION: 69001

SUBJECT: MEXICO: Briefing for Your Meeting with the Director General of the Bank of Mexico, Miguel Mancera Aguayo, on Tuesday, January 5, at ~~2:30pm~~ 8AM.

Current Macroeconomic Issues

1. In the two-year period between July 1985 and July 1987, Mexico did much to correct fundamental macroeconomic imbalances, particularly in its external accounts, through substantial adjustments in the exchange rate, interest rates, reductions in non-interest public expenditures, tax reform, an improved structure of relative prices, and major structural reforms in external trade and public enterprises. These policy changes helped generate a record trade surplus, the highest-ever stock of official reserves (US$8 billion and US$13.5 billion in 1987, respectively), and substantial repatriation of capital for the first time in the 1980s.

2. Unfortunately, these gains were overshadowed by the decline in output (3% cumulatively in 1986-87), the continued deterioration in real wages (about 14% in 1986-87 in the real minimum wage), and unyielding increases in inflation (from 63% in 1985 to nearly 150% in 1987). The latter has been particularly disturbing, because the de la Madrid Administration had repeatedly staked its credibility on obtaining a major, sustained reduction of inflation.

3. Since November 18 of last year, the exchange rate, financial, and capital markets have experienced a sharp upswing in instability, as Mexico has faced a major test of confidence. During this period, the controlled exchange rate moved from Mex$1,706/US$1 to Mex$3,000/US$1 in one day, before settling back to around Mex$2,250/US$1. Interest rates, as measured by 28-day treasury bills, shot up from 135% annually to 240% in recent days. The stock exchange lost roughly three quarters of its value. And labor, after years of declining real wages, threatened a general strike if its demands for an emergency wage hike were not met.

4. The Government's initial reaction was to treat these problems as temporary and of a speculative character. Thus, initially, the Central Bank sold reserves to the free foreign exchange market in an effort to dampen the rise in the exchange rate, and slowed its issue of new treasury

bills to ease the pressure on interest rates. However, by early December, the Government began to realize that Mexico's macroeconomic difficulties were deeper than it had first been willing to acknowledge, and, therefore, would require more fundamental solutions. This set the stage for the announcement on December 16 of an Economic Solidarity Pact, an agreement signed by business, labor, farm, and governmental representatives aimed at reducing inflation from around 10% monthly at present to 2% or less by December 1988.

5. The key elements of the Pact include: (a) an increase in fiscal effort of nearly 3% of GDP; (b) an immediate 22% devaluation of the controlled exchange rate to near parity with the free rate; (c) a lowering of the maximum import tariff from 45% to 20%; (d) up front adjustments in public prices (64%), the minimum wage (38%), and basic goods (not yet complete), followed by; (e) a two-month wage and price freeze (controlled goods only) in January and February; and (f) a forward-looking monthly adjustment of wages and prices tied to a basket of 76 basic goods and services from March onward, until inflation falls to 2% or less per month.

6. We see this program as a comprehensive, serious attempt to tackle inflation, although we still have some questions about how it will work. Basically, our concerns are two-fold: whether the program has enough of a fiscal and monetary cushion built into it to deal with unexpected economic shocks, and whether the Government will be able to cope with the eventuality that its forward adjustments may for a time fall short of observed inflation, thus resulting in falling real wages and profits, and pressures to abandon the program. Assuming ways can be found to deal with these concerns, we are convinced that, once Mexico's inflation has been significantly reduced, prospects for further major structural reforms and a renewal of sustained growth appear promising.

Attachment

cc: Messrs. Qureshi, SVPOP; Steckhan, LA2DR; Selowsky, LACVP; Bock, DFA;
Corbo, LA2CO, Knotter, LA2TF; Halperin, LA2IE; Binswanger, LA2AG; Johnson, Croce, Varallyay, LA2CO
LA2CO Chron Files, LA2CO Black Book, LAC Files

Attachment

BIOGRAPHICAL SKETCHES

Miguel Mancera AGUAYO
Director General of the Bank of Mexico

Mr. Mancera received his M.A. in economics from Yale University. He served under the Presidency of the Republic as Investment Commissioner in 1960-61. From 1962 to 1982, he held several positions within the Bank of Mexico: as Administrator, under the Director of FOMEX (Manufactured Products Export Development Fund), and Deputy Director General of Banco de Mexico (BANXICO), before becoming its Director General in 1982. He resigned from this post during the latter months of Lopez Portillo Administration and was reappointed to the same position under President de la Madrid. Since then, Mr. Mancera has played a key role in the Government's efforts to coordinate macroeconomic policy, and mobilize international cooperation in resolving Mexico's external debt problems. Together with Hector Hernandez of Trade and Commerce, he is now the longest-serving member of the economic cabinet.

R88-

January ,1988

From: The President

MEXICO: Proposed Collateralized Debt Exchange Offer Scheme - Request of Mexico for Waiver of Negative Pledge Restriction in Existing Agreements*

1. The Government of Mexico is proposing to issue partially collateralized bonds in exchange for loan obligations presently held by its commercial bank creditors. Given Mexico's current favorable foreign exchange reserves position, the Government plans to use a portion of those reserves to reduce its stock of external debt. The specific scheme being proposed would involve the use of such reserves to purchase a special U.S. Treasury debt issue, which would be pledged as collateral. For the transaction to proceed, a limited waiver of the negative pledge provision contained in IBRD loan and guarantee agreements with Mexico is required and has been requested.

2. Under the proposed transaction, Mexico would issue secured long-term bonds in exchange for a greater principal amount of outstanding commercial bank loan obligations. The exchange would be voluntary and effected through an auction process. Each creditor under Mexico's public sector Restructure, New

DISTRIBUTION

Executive Directors and Alternates
Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC
Directors and Department Heads, Bank and IFC

* Questions on this document may be referred to Mr. Rainer Steckhan (Ext. 61003) or Mr. David R. Bock (Ext. 72942)

Restructure and 1983 and 1984 New Money Agreements would be invited to submit bids to exchange all or a portion of its existing loans for the secured bonds at the exchange ratio or ratios such creditor may propose. Upon receipt of all such bids, Mexico would determine the principal amount of bonds to be issued and then accept bids for such principal amount in descending order of the discount bid, i.e., Mexico would accept first those bids offering to exchange the highest principal amount of existing loans for each dollar of bonds to be issued. The bonds would be floating interest rate obligations and mature in 2008. Repayment of the principal amount of the bonds would be fully secured by the pledge by Mexico of a non-marketable United States Treasury zero-coupon obligation issued to the Government of Mexico, having a principal amount and maturity matching the bonds. The collateral would be realizable only at the scheduled maturity of the bonds. Although the aggregate principal amount of bonds to be issued would not be determined prior to completion of the auction process, Mexico has committed to use no more than U.S.$2.5 billion of its foreign exchange reserves to purchase the collateral needed to support the exchange offer.

3. The Government believes that the exchange will achieve the following objectives: (i) immediate reduction of Mexico's outstanding external debt and corresponding reduction in periodic debt service costs; (ii) further assured reduction of indebtedness through insubstance defeasance of the principal of the bonds (i.e., the principal of the bonds will be repaid from the collateral securing the bonds); (iii) enhancement of Mexico's creditworthiness and of its creditors' portfolios; (iv) increased liquidity of commercial bank portfolios; (v) return of Mexico to the capital markets; and (vi) refinancing of a portion of Mexico's outstanding commercial bank loan obligations through a voluntary, market-oriented transaction.

4. In order to implement the scheme, it is necessary for Mexico to obtain limited waivers of the restrictions against incurring secured debt (negative pledge restrictions) contained in the agreements that Mexico, its agencies and other public sector borrowers have entered into with the Bank and other external bank creditors. Mexico is requesting the necessary waivers from the Inter-American Development Bank and commercial bank creditors and is confident of obtaining such waivers. Negative pledge restrictions also exist in outstanding Mexican bond issues. Approximately U.S. $542 million of such bonds are currently outstanding. In view of the practical difficulty of obtaining waivers from individual holders of bearer bonds, to permit implementation of the scheme the Government intends to secure the debt owed to such bondholders by a pledge of additional United States Treasury zero-coupon obligations having a principal amount at maturity equal to the outstanding principal amount of such bonds. The cost of this collateral is estimated not to exceed U.S. $106 million. The Government intends to continue to service these bonds in accordance with their original payment terms. As these bonds are repaid, the collateral allocated to them will be released to Mexico and reintegrated into Mexico's reserves. Approximately one-half of such collateral would revert to Mexico before the end of 1992.

5. The Government has now requested the Bank to (i) consent to the pledge by Mexico of United States Treasury zero-coupon obligations to be acquired by it at a net cost not to exceed U.S. $2.5 billion and, (ii) subject to the following paragraph, waive compliance with the negative pledge restriction contained in the Bank's loan and guarantee agreements with Mexico, its agencies and other public sector borrowers. The negative pledge restriction provides that no other external debt shall have priority over the Bank's loans by way of

a lien on the public assets of the borrower. To that end, it is provided that if any lien is created on any public assets as security for any external debt (which results in a priority for the benefit of other creditors) such lien shall, unless the Bank shall otherwise agree, equally and ratably secure the principal of and interest on the Bank's loan; and that, in creating or permitting the creation of the lien, the borrower shall make express provision to that effect.

6. In making its request for the Bank's waiver of its negative pledge restrictions, the Government has affirmed its obligation to continue to make timely payment on its loans from the Bank and confirmed that Bank loans will not be subject to rescheduling. The Government also has acknowledged that such waiver would be limited to the proposed exchange offer and without prejudice to the Bank's position on the negative pledge restriction under its loan and guarantee agreements in general.

7. The circumstances which warrant the grant of the waiver in this case are that the proposed scheme is in the best development interest of Mexico in that it permits Mexico to extinguish a substantial portion of its external indebtedness; reduce its annual interest payments to external creditors; and immunize the resulting collateralized bond issue from future reschedulings -- all of which should lead to improved creditworthiness indicators enabling Mexico to re-enter international capital markets as a borrower or securities issuer sooner than otherwise would be the case. The fact that the amount of Mexico's foreign exchange reserves being allocated is clearly defined and restricted results in only a limited waiver of the Bank's negative pledge restrictions. It is also important to note that interest payments on the new bond issue are in no way secured or senior to Mexico's other external interest payments and that the collateral is pledged only to secure the principal of the bonds at their scheduled maturity and may not be liquidated prior to that time. Following the operation, the World Bank's position with respect to other bank creditors would be maintained as a result of the corresponding waivers granted by those creditors. In addition to the attractive characteristics of the transaction itself, it is noted that Mexico is a country which has made substantial progress in its economic adjustment efforts under very difficult circumstances and which has cooperated closely with the International Monetary Fund and the World Bank in meeting its financing requirements in recent years. In addition, Mexico has successfully honored its rescheduled debt commitments with commercial lenders and has maintained current status with regard to its interest payments to all creditors.

8. Although there are a few precedents where the Bank has agreed to a waiver of its negative pledge restriction, none of them involved situations similar to Mexico's proposal. Most of the precedents involved the pledge of the proceeds of the sale of commodities, taxes or revenues, or mortgage of real property and the amounts involved were considerably lower. In most cases, such waivers were given in respect of pledges of security under short-term commercial bank loans.

9. Although the grant of a waiver of the Bank's negative pledge restriction in this case may establish a precedent for the grant of such a waiver in other cases, any request for a similar waiver would need to be carefully considered on a case-by-case basis and the grant of such a waiver would normally be warranted only in circumstances similar to the present situation.

10. In view of the unusual nature of the proposed scheme and the possibility that similar schemes may be replicated in other highly-indebted member countries of the Bank, the Government's request for a waiver of the negative pledge restriction in the Bank's agreements with Mexico, its agencies and other public sector borrowers is being referred to the Board for consideration and approval.

Recommendation

11. I hereby recommend that the Bank consent to the pledge by Mexico of United States Treasury zero-coupon obligations and agree to waive the negative pledge restriction in agreements between the Bank and Mexico, its agencies and other public sector borrowers in the circumstances and manner described in this memorandum.

Barber B. Conable

Barber B. Conable
President

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Conable

Barber: We need to proceed on this but you should be aware that we shall be grilled on our policy regarding steel at the Board. Moeen. 11/19

DATE: November 18, 1987

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi MAQ.

FROM: S. Shahid Husain

EXTENSION: 69001

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

1. We are proceeding with the negotiations of a Steel Sector Restructuring Loan to Mexico. Its contents are based on a Steel Subsector Study completed by the Bank in mid-1986. The proposed US$400 million loan contains both sectoral adjustment lending and public and private sector investment components.

2. The major objective is to remove distortions in the steel sector and assist the industry in improving the quality of its products in order to compete without subsidy in a liberalized domestic market at internationally competitive prices. The key elements covered by the project include:

(a) further opening of the steel market in Mexico with tariffs reduced and equalized on all steel products;

(b) complete deregulation of steel prices in order to provide the incentive for market-driven performance and investment, particularly in the private sector;

(c) organizational and physical restructuring of the public sector producers including a shift in product mix, balancing and technically upgrading potentially efficient operations and an overall reduction in steel making capacity;

(d) financial and physical restructuring in the private sector including improvements in performance and efficiency in existing facilities to exploit their competitive advantages and resources; and

(e) continued policy dialogue and strategic planning limiting public sector investment to economic and financially viable projects while encouraging private sector investments to make up future gaps between production and domestic demand.

3. The proposed project is crucial to trade liberalization in the steel industry and in fact will not significantly change the current steel import/export balance as increases in production of higher quality, higher value added steel is only projected to keep pace with incremental increases in demand.

4. The most important beneficiaries of the loan will be the downstream industries whose performance and efficiency will be improved due to the availability of high-quality steel products at internationally competitive prices which will enhance their role in the further development of an open competitive economy. The conditions of the loan are in accordance with your suggestion to Mr. Petricioli when you discussed steel.

cc. Messrs. Steckhan, Corbo, Knotter, Iskander

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 12, 1987

TO: Mr. Moeen A. Qureshi

V. Dubey

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: Mexico: Proposed US$400 Million Steel Sector Restructuring Loan

The proposed loan is an investment operation that is being presented to the Operations Committee because (i) it has a substantial policy component backed up by a fast-disbursing component (of $100 million out of $400 million) and (ii) it deals with steel.

On the former, we are satisfied that the recommendations of the previous Loan Committee have been appropriately taken into account. In particular, Mr. Knotter's memorandum of November 6 (included in the package) adequately explains (i) the case for the fast-disbursing component (paras. 5 and 6 of his memorandum), (ii) the adequacy of the privatization measures (paras. 3, 4 and 13), and (iii) the price decontrol measures and the negotiating conditions (paras. 7, 8).

On the steel question, we must note that this is a soundly conceived operation with a high expected economic rate of return. The reforms of tariffs and domestic prices will significantly reduce the protection that the domestic steel industry has enjoyed in the past, in particular in the production of steel flats. Most of the project benefits are expected to occur through improvements in the efficiency of operations and in the quality of the various products. The trade effects are expected to be small (Table 6, page 107, SAR).

I do not therefore see the need for an Operations Committee meeting on this operation. Members' comments, if any, may be conveyed directly to the Region within the next three working days.

cc and cleared in substance: Mr. R. Harris

cc: Operations Committee

Messrs. Steckhan
Selowsky
Corbo
Knotter

ARay/eg

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 6, 1987

TO: Mr. Moeen A. Qureshi, SVPOP

FROM: S. Shahid Husain, LACVP

EXTENSION: 69001/2

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

I attach for review and approval of the Operations Committee (OC) the attached drafts of the Memorandum and Recommendations of the President, the Staff Appraisal Report, and the Loan, Guarantee and Project Agreements and Invitation to Negotiate for a proposed Steel Sector Restructuring Loan to Nacional Financiera S.N.C. (NAFIN), with the guarantee of the United Mexican States. In view of the sensitive nature of this proposed operation, you may wish to consider calling a meeting of the OC. I also attach a memorandum from Mr. Paul Knotter, Chief LA2TF, to me covering relevant issues.

Attachments

RVenkateswaran:ph

Distribution:

Messrs. Jaycox (AFR); Karaosmanoglu (ASI); W. Thalwitz (EMN); V. Rajagopalan (VPP); (Shihata (VPL); D.J. Wood (VPF)
D. Lee (COD); V. Dubey (EAS); A. Shakow (SPR); J. Holsen (CEC); D. C. Rao (FRS); J. Baneth (IEC); Thahane/Burmester (SEC); R. Liebenthal (SPR); A. Steer (FRS); Baudon (SVP)

For Information Only:

Messrs/Mmes. S. Fischer (DEC); D. Bock (DFA); J. W. Stanton (EXC); R. Frank (CFP); J. Parmar (CIO); Haug (EXC); D. M. Goldberg (VPL)

P-1867

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 6, 1987

TO: Mr. S. Shahid Husain, LACVP

THROUGH: Kye Woo Lee, Acting Director, LA2DR

FROM: Paul Knotter, Chief, LA2TF

EXTENSION: 61271

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

1. I attach for your approval and subsequent distribution to the Operations Committee (OC), revised drafts of the Memorandum and Recommendation of the President, the Staff Appraisal Report, and the Loan, Guarantee and Project Agreements and the Invitation to Negotiate for a proposed Steel Sector Restructuring Loan to Nacional Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States. The documents fully reflect the discussions and decisions of the Regional Loan Committee (RLC) meeting which you chaired on October 5. Also attached is a copy of the current lending program for Mexico. The Government attaches high priority to this operation, which is one of three industrial restructuring operations (the other two are the proposed Fertilizer Sector Adjustment and Industrial Restructuring Loans) any two of which would qualify as link loans for drawdowns under Mexico's multi-facility financial agreement. Negotiations have been tentatively scheduled for November 16, 1987, and Board presentation for January 12, 1988.

2. The major policy issue related to decontrol of steel prices apparently has been resolved by a recent Government decision to eliminate all price controls on steel products in three steps between January and June 1988. We have now received a letter from the Government dated October 26 (copy attached) informing us of the detailed program in this regard. The following paragraphs address the price control and other issues that were either raised in the Loan Committee (LC) meeting on February 17, 1987 (minutes attached), the RLC meeting (minutes attached), or are the result of later developments. As agreed by the RLC a SAR with a policy matrix was prepared for this blend operation with a predominant investment component.

Project Design and Loan Amount

3. Following the recommendations of the LC to remove the perceived imbalance between the assistance offered under the proposed project to the public and private sectors, respectively, the appraisal mission reviewed closely the problems of the two major private steel companies: HYLSA and TAMSA. In parallel, HYLSA (i) developed a sound physical rehabilitation plan with the help of Nippon Kokan (Japanese consultants); (ii) worked out a debt restructuring plan with its creditor banks; and (iii) agreed on a preliminary term sheet that would allow the company to retain sufficient funds for the implementation of the rehabilitation plan. The appraisal mission found Hylsa's rehabilitation plan suitable for Bank financing, and it is proposed that a US$75 million component be included to support the rehabilitation of the HYLSA Monterrey plant. The disbursement of the HYLSA component would be contingent upon the signing

of a satisfactory debt restructuring agreement between HYLSA and the creditor banks. The debt restructuring plan with the creditor banks also takes into account the above-mentioned Bank financing.

4. The mission could not develop a similar component for TAMSA because of (i) the severely depressed market situation for seamless tube, TAMSA's main product; and (ii) the lack of any serious restructuring plan of the company and no immediate prospects for agreement between TAMSA and its creditor banks. Since TAMSA has a very specialized production profile and serves a specific market (mainly PEMEX), its restructuring would only constitute a small part of the whole steel sector restructuring. Therefore, in this stage we propose no provision for financial assistance to TAMSA under the Bank loan. The technical assistance component of the Bank loan, however, would be available for assistance in preparation of physical-financial restructuring studies to any steel related companies, whether publicly or privately owned, including TAMSA.

5. A further issue relates to the policy-based component of the Loan. The LC approved the Region's proposal for a US$150 million fast disbursing policy-based component aimed at supporting the Governments comprehensive adjustment program for the steel industry. With regard to the entire steel industry, this program includes the liberalization of steel imports, agreement on a national steel policy framework and the investment program for the parastatal steel companies, removal of domestic price controls and improvement of operating and investment conditions for the private sector. It also includes rationalization of SIDERMEX's corporate structure, delegation of decision-making authority, closure of non-viable plants, massive divestiture and financial restructuring of the company. All these measures have been or are being implemented.

6. Since February the foreign exchange reserve position of Mexico has improved dramatically and a fast disbursing component would no longer appear to be justifiable on BOP grounds. We are concerned, however, that, given the advanced stage of processing, transformation of the project into an investment project with policy conditionality could be understood by the Mexicans as a withdrawal of Bank support for the policy changes, would likely be a blow to those in the Government who fought for the reform and could jeopardize both the successful completion of the steel sector reform and the credibility of the Bank. Therefore, we recommend to maintain the policy-based component but reduce it from US$150 million to US$100 million as indicated in the revised documents.

Price Decontrol

7. Since the complete removal of price controls is vital for a successful restructuring and healthy development of the steel industry, a satisfactory proposal on this issue is an indispensable precondition of negotiations. The Government's October 26 letter proposes a detailed program for price decontrol in three steps. The first step in January 1988 would eliminate controls on seamless tubes, steel wire and low carbon wire rod (about 20% of products by volume). The second one in March 1988 would eliminate controls on most non-flat products except reinforcing bar, and on many flat products (about 30% of products by volume). The third and final step would complete the decontrol of all flat and remaining non-flat products. Subject to the satisfactory clarifications referred to in para. 2 this phased approach is acceptable.

We would propose that tranche release conditions be as follows: First Tranche--events of January and March 1988, i.e., elimination of controls on most non-flat products (about 50% of steel products by volume); Second Tranche--complete elimination of price controls. The Government had already increased the controlled prices in July by 4-8% in real terms. Since we estimate the actual price increase from deregulation is approximately 10% in real terms on average, the final elimination of controls, in fact, would not lead to sharp additional price increases for most products. This should make the elimination of price control politically more acceptable. These latest developments have been reflected in the MOP, SAR and the legal documents.

8. Based on these recent developments we propose the following negotiating conditions: (i) with the presentation to the Bank of a satisfactory price liberalization program that clearly states the commitment of the Government to eliminate steel price controls in the first half of 1988, the precondition of negotiations would be fulfilled; (ii) the price decontrol actions should be the triggering events for the release of the first and second tranches, respectively, of the policy-based (raw materials and steel products import) component of the loan as explained in para. 7 above; and (iii) the price decontrol should also be a dated covenant of the Loan Agreement (reserving the right for the Bank of suspension of disbursement in case of non-compliance).

Input Subsidies

9. The LC instructed the appraisal mission to further analyze the input subsidies and the programs for phasing them out. The mission determined that (i) there are still indirect subsidies through the prices and tariffs of fuel oil, electric energy and railway transport, (ii) their impact on the cost of the steel products is minimal, (iii) their phasing out is addressed either in the Convenio between the Government and CFE (Comision Federal de Electricidad) or in the Railway Sector Loan. During the last two years the Government increased substantially the electricity and railway tariffs, the latter approaching now, in general, long term marginal costs, and raised the price of natural gas by about 500% in real terms. These, and the planned price adjustments, are satisfactory except for fuel oil, for which the Government considers that the price is adequate and does not plan any further adjustment. At any rate, its impact is negligible, since the price of fuel oil constitutes less than 0.5% of the total cost of the steel producers. As recommended by the RLC, we propose to obtain a specific statement from GOM with regard to complete elimination of subsidies in the medium term as part of the substantially strengthened steel sector policy statement.

Trade Liberalization Measures

10. The LC stressed that the trade liberalization measures for steel required under the First Trade Policy Loan should be a condition of the second tranche release of the policy-based component of the proposed loan. The Mexican authorities have confirmed the determination of the Government to carry out without any delay all the steel-related elements of the agreed trade liberalization program which removes all the non-tariff barriers and establishes a unified 25% ceiling for tariffs of both flat and non-flat products by October 1988. The actions planned for February 1987 have been carried out according to the program. The

official reference prices for most steel products were reduced to the level of the world market prices in July 1987. As had been requested by the LC, release of the second tranche would be conditional on compliance with the agreed tariff rationalization program. No further trade liberalization measures (beyond those mentioned above) are needed in the steel sector.

Steel Sector Policy

11. As requested by the LC the mission obtained from the Government a draft steel sector policy statement which states, inter alia, that:

(a) the Government intends to carry out deep reforms both in the steel industry and in its economic environment;

(b) the steel industry should service the domestic market in competition with foreign producers;

(c) the non-viable plants should be liquidated; and

(d) no new investment will be started except the rehabilitation of some of the existing plants and restart of the first phase of the SICARTSA II investment (the direct reduction plant and steelmaking shop).

Agreement on significant broadening of the steel sector policy statement will be reached during negotiations, especially concerning the roles to be played by the private and public sectors in steel and government policies criteria and plans for parastatal steel sector investments. Presentation by Government of an acceptable Steel Sector Policy Statement would be a condition of Board Presentation. In addition annual review and agreement by the Bank of the public sector steel investment plan would be a condition of the proposed loan.

Japanese Cofinancing

12. The Export Import Bank of Japan (JEX) expressed interest in cofinancing the project. JEX participation would allow greater flexibility in project implementation. We are exploring further any likely cofinancing possibilities without delaying the processing of the loan. In this regard, we have provided general information on the overall composition of the project and indicated the likely expenditure categories where parallel financing by JEX would be feasible from a technical and financial point of view, bearing in mind the maximum sustainable debt financing levels at each of the project beneficiaries.

Support for the Private Sector

13. It should be noted that the policy reform, especially the elimination of price controls, will strengthen the financial position of the private producers and the closure of some public plants and production lines will open more market segments for them. As mentioned above, Part D of this loan would be onlent to the other private producers for technical assistance; funding for ensuing investment program would be provided, partly from the existing Bank credit lines, and partly under the proposed Industrial Restructuring Loan. Furthermore, the Bank should explore during the implementation further assistance possibilities in this area, including possible technical assistance in the privatization of former SIDERMEX subsidiaries under the technical assistance component of this.

Other Issues

14. The following revisions will be made in the Grey Cover report:

(a) Price contingencies calculated as part of project costs in MOP Schedule A and SAR para 6.02 will be adjusted to reflect the latest information. These adjustments will not affect the amount of Bank financing included in the project or the project financing plan.

(b) The Disbursement Schedule will be revised from six to seven years to match the regional profile (relevant MOP and SAR tables).

Attachments:
1. Green Cover SAR
2. Draft MOP
3. Draft Legal Documents
4. Draft Notice of Invitation to Negotiate

cw & cc: Messrs. M. Linder, R. Goodland, T. Hill, J. Sugar

cc: Messrs. M. Selowsky, F. Aguirre-Sacasa, C. Quijano, G. Dolenc, Kye Woo Lee, V. Corbo, M. Voljc, J. Varallyay, J. Johhson, H. Ives, M. Iskander, H. Sethi, X. Simon, J. Malatinszky, R. Venkateswaran, E. Mangan, I. Rivera, F. Remy, S. von Klaudy

Asst. General Counsel, Operations

Files

RVenkateswaran/Mangan/Knotter:

THE WORLD BANK

CONFIDENTIAL

DECLASSIFIED
AUG 27 2013
WBG ARCHIVES

LOAN COMMITTEE

LC/M/87-03

February 24, 1987

Minutes of the Loan Committee Meeting to consider MEXICO - Steel Sector Restructuring Loan Held on February 17, 1987, in Conference Room E-1208

Present

Committee:

Chairman:	Mr. Stern
Finance:	Mr. Wood
Legal:	Mr. Shihata
ERS:	Mr. King
OPS:	Mr. Husain
Region:	Mr. Gué

Others:

Messrs/Mmes. Steckhan
Picciotto
Bottelier
Varallyay
Page
Golan
de Capitani
Rowat
Simon
Collell
Donovan
Clements
Roger
El Serafy
Huang
Myer
Sam

DISTRIBUTION

COMMITTEE
Senior Vice President, Operations (Chairman)
Senior Vice President, Finance
Vice President & General Counsel
Vice President, Operations Policy
Regional Vice President concerned
Vice President, Energy & Industry (for lending in these sectors and SALs)
Vice President, Economics and Research (for project lending)

OTHERS
[illegible]

B. Issues

2. The meeting was called to discuss the proposals in the Initiating Memorandum (IM) attached to Mr. Knox's memorandum of February 9, 1987, for a Steel Sector Restructuring Loan to Mexico. The discussion focussed on the main issues raised in the Country Policy Department's memorandum of February 13, 1987.

C. Discussion

Trade Liberalization

3. The meeting reviewed the relationship between the conditionality of the Bank's first Trade Policy Loan (TPL-I, Ln. 2745-ME) and the sector-specific measures proposed in the IM for the proposed loan. The Region noted that the proposed loan would fine-tune tariff measures for flat and non-flat steel products, but would not provide any other additional conditions; a unified tariff of about 25% would be established for all steel products by October 1988. The meeting agreed that the elimination of reference prices and trade adjustments for steel required under TPL-I should be a condition of second tranche release under the proposed operation.

Sectoral Reforms

4. The meeting questioned how small private steel mills were able to show profits at prevailing low controlled domestic price levels. It was explained that these companies had a positive cash flow, but not profits, resulting from input subsidies on energy and rail transport, and low real wages. These subsidies are being reduced. By the end of the restructuring process in 1988, SIDERMEX should be financially autonomous, no longer depending on transfers from the Góvernment. To create the preconditions for this, one-half of SIDERMEX's debt is being assumed by the Government ("convenio" signed in 1986), and further restructuring may be required by the SICARTSA-II facility now nearing completion. Substantial cost savings would be achieved from the restructuring measures and would be increasingly market-driven. The Committee agreed that all operating subsidies should be eliminated, and that the industry should be on a fully commercial basis, by the end of the program period. The Chairman stated that a detailed evaluation of input subsidies and programs for phasing them out should be made during appraisal and clearly reflected in the project documentation.

5. The Committee also agreed that the long-term investment strategy to be obtained from the Government should spell out the proposed future roles of the private and public sectors in steel. The Chairman stressed the need for a statement of policy which would, as a minimum, set out the Governments's own investment intentions. In this context, it was noted that investments for the SICARTSA-II plate mill would be made only if the outlays were economically justified. Over the next five years, a net reduction in capacity is expected, so that the bulk of investments would be for debottlenecking, modernizing, and maintenance.

Pricing

6. The meeting discussed the impact of the devaluation of the peso on the calculations contained in the IM regarding the competitiveness of the Mexican steel industry. It was explained that the estimates of short- and long-term marginal costs were based on early 1986 figures. Because of an additional 25% real term devaluation since then, those costs should be proportionally more competitive today.

7. The Committee questioned the continuation of price controls on some downstream users of steel and stressed the importance of a close linkage between upstream and downstream price decontrols. The Region stated that previously stringent price controls have been made more flexible, allowing for price increases which are registered ex post, together with the justification for the increase. The Committee emphasized the need for an assurance that steel price increases would be passed on automatically for those products still under price control. It also agreed that price registration was undesirable and that the Region should seek its elimination.

Project Design

8. The Committee expressed concern over the project's apparent emphasis on public sector companies. It was noted that private companies such as HYLSA and TAMSA will also need substantial capital to prepare themselves for rising competition after price decontrol. The source of this capital was not yet clear. In reviewing possible sources of finance for the private sector, the Chairman stated that IFC should be further consulted to determine what role, if any, it can play; other alternatives, such as making available a part of the quick-disbursing component of the proposed operation, increasing the loan size or preparing a separate Bank loan for private companies, should be considered. The meeting concluded that the appraisal mission should ensure that an overall long-term financing plan is developed for the steel sector as a whole, assuring that both the public and private sectors have access to finance on comparable terms. It was noted that the proposed US$25 million technical assistance component could be drawn upon on a loan basis by private companies if they so desired.

D. Conclusions

9. Subject to the above modifications, the Committee approved the Region's proposal to appraise the Steel Sector Restructuring Project as set out in the IM.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 6, 1987

TO: Files

FROM: Francisco Aguirre-Sacasa FAS, Sr. Operations Advisor, LAC

EXTENSION: 69003

SUBJECT: Mexico -- Steel Restructuring Project, Loan Committee Meeting

1. Mr. Shahid Husain chaired a meeting of the Regional Loan Committee on October 5, 1987, to discuss the Mexico - Steel Restructuring project. Those present included: Messrs. Steckhan, Wessels, Selowsky, Corbo, Iskander, Knotter, Lee, Quijano, Sethi, Rivera and myself from LAC; Ms. Garcia-Zamor, also from LAC; and Messrs. Goldberg and Hill from the Legal Department.

2. The meeting opened with a discussion on the suitability of the conditionality proposed for the loan. On this point, there was a consensus that the recommended reforms were important steps in the right direction and justified going ahead with this hybrid loan of $400 million ($100 million in quick disbursing funds and $300 million to finance investments in the steel sector). Major features of the reform package included: (i) total de-control of domestic steel prices; (ii) liberalization of steel imports; (iii) a financial restructuring of two of Mexico's largest steel companies; and (iv) agreement on a steel policy framework.

3. While the thrust of policy reform being recommended by Mr. Steckhan's Department was satisfactory, it was agreed that a number of refinements would be introduced in the policy package. These changes are highlighted in the following four paragraphs.

4. Public Investment: A condition of the loan should be that Bank staff would annually review and agree with the Government on the investment program of Mexico's parastatal steel companies. If necessary, Bank staff could avail themselves of the long-term steel sector strategy to be agreed between Mexico and the Bank --and, specifically, of its investment provisos--as a mechanism to effect the review. Regardless of how it was couched, however, Bank satisfaction with public investment in steel was critical to the loan. This safeguard was necessary since one of the major threats facing the sector was the possibility that Mexico would go ahead with a large ($2 billion plus) but economically questionable investment at its SICARTSA steel works.

5. Tariff Liberalization: It was agreed that the loan covenant on steel tariff liberalisation would not only provide for a reduction in steel tariffs to a maximum of 25 percent by October 1988 but would also make it clear that no other non tariff barriers (surtaxes or QRs) could be put on steel products. Moreover, as had been requested by the Loan Committee when it reviewed the IM for this operation, satisfactory compliance with the tariff rationalization program would be made a condition of release of the second tranche of the proposed loan's quick disbursing component.

6. <u>Policy Statement</u>: A satisfactory statement of steel sector policy would have to be provided by Government to the Bank before distribution of the loan to the Executive Directors. This statement should, <u>inter alia</u>, touch upon the roles to be played by the state and the private sectors in steel and what, in general terms, were the Government's intentions with regard to parastatal steel investments.

7. <u>Subsidy Elimination</u>: It was decided that the Bank ought to ask the Government and its major steel parastatals (SIDERMEX and its subsidiaries) to operate without subsidies from the fisc or other Government entities. How this commitment would be secured was left to the Department. Possibilities included covenants in the legal documents or a reference in the steel sector policy statement to be provided in connection with this loan. The date by which subsidies would be eliminated was also left flexible for negotiations with the understanding that it would be in the medium- and not long-term.

8. In addition to the policy-related changes referred to above, a number of other decisions were taken at the Loan Committee meeting. These are summarized below.

8. <u>Presentation</u>: The policy changes referred to in paras four to seven would be reflected in the loan package now. Moreover, the draft memorandum of the president (MOP) would be tightened up. Particular emphasis would be given to better highlighting the loan's policy features. To this end, an updated policy matrix would be included in the MOP.

9. <u>Consultants</u>: Bank staff would carefully review the technical assistance associated with the loan with the Mexicans during negotiation. Attention would be given to making sure that the amount of consultants services envisaged (nearly 2,300 staff months) was justified and that the average cost of consultants ($12,000 per month) was reasonable. In keeping with Bank procedures, draft terms of references for the major consulting activities would be reviewed at negotiations.

10. <u>Financial Covenants</u>: Regional staff would also carefully review the adequacy of the proposed financial covenants for AHMSA (a large steel parastatal). The current ratio, in particular, looked too low at 1.2.

8. <u>Operations Committee Review</u>: In light of the proposed loan's policy aspects and sensitive nature, Mr. Husain agreed with the Department's recommendation that it should be referred to the Operations Committee as soon as it was ready.

PJAguirre-Sacasa

Cleared with and cc: Mr. Husain

cc: Messrs. Steckhan, Wessels, Selowsky, Corbo, Iskander, Knotter, Lee and Quijano and Ms. Garcia-Zamor (LAC); and Messrs. Goldberg, Collel and Hill (Legal)

88E0253 October 29, 1987
Spanish (Mexico)
LA2TF RP:mec

United Mexican States
Secretariat of Finance and Public Credit
Directorate General of Public Credit
Directorate of International Financial Organizations
Subdirectorate of Industrial Sector Projects
Mexico, DF
Mexico

October 26, 1987

Mr. Marko Voljc
Resident Representative of the World Bank
Isabel la Católica No. 51, ler. Piso
Mexico, DF.

Memorandum No. 305. III. 4.- 9583

Dear Sir:

With reference to the Iron and Steel Restructuring Project, the preparation of which began in early 1986, and the communication dated October 1, 1987 sent to the Secretariat of Finance and Public Credit by the Subsecretariat of Internal Commerce of SECOFI (the Secretariat of Commerce and Industrial Development), I wish to inform you of the Government's main policies and objectives with respect to price control in the steel industry.

As you know, one of the most important measures adopted as part of restructuring is the gradual removal of price controls from steel products. The process began in May 1986, when strict cost-price controls were replaced by price supervision, thus updating the cost threshold and the resulting price structure so that prices could subsequently be increased at intervals of two months by an amount equivalent to 95% of the real cumulative inflation in those periods.

In addition, special increases were planned for this year, in order to put the industry on a sound financial footing and enable it to improve its maintenance standards, thus producing a 10% increase in total revenue for the country's principal steel plants and making domestic prices comparable with Japanese FOB export prices. As of September 11 this year, domestic prices for the following products exceeded Japanese export prices: cold rolled sheet (US$449 vs. US$420); billets (US$220.62 vs. US$175); rods (US$254 vs. US$210); lightweight shapes (US$253 vs. US$240). Mexican prices are, therefore, at almost the same level as those of the major exporting countries, providing its plants with sufficient buying power on the international market to enable them to maintain, modernize and increase their installed productive capacity.

Nevertheless, the Mexican Government has decided to implement the following price deregulation program:

FIRST PHASE (January 1988):

1. Seamed pipes.
2. Wire products.
3. Forged quality wire.
4. Low carbon wire.
5. Wire rod.

SECOND PHASE (March 1988):

6. Heavy shapes (structural).
7. Merchant rods and shapes.
8. Bodies and billets.
9. Coated sheet.

THIRD PHASE (June 1988):

10. Hot rolled sheet.
11. Cold rolled sheet.
12. Tin plate.
13. Corrugated rods.
14. Plates.

It should be noted that the existing price supervision system (based on real prices) will be used to adjust the prices of the above products until they are deregulated under this program. From November 1986 to May 1987, the procedure showed how practical it was, with authorizations issued for increases amounting to 52.57%, while the costs reported by enterprises increased by an average of 47.49%. The difference was mainly due to a decrease in the liability component of total costs.

At the beginning of 1988, the Directorate General of Prices of SECOFI will be issuing memorandums authorizing the progressive deregulation of products, in accordance with the above schedule.

Yours, etc.

/s/ José Luis Flores Hernández
Director, International
Financial Organizations,
on behalf of the Director
General of Public Credit

LATIN AMERICA & CARIBBEAN REGIONAL OFFICE

FIVE YEAR LENDING AND RESERVE PROGRAM (FY88 - FY92)

(COUNTRY SORT IN $ MILLIONS)

RUN DATE: ./87

FISCAL_YEAR

MEXICO

LENDING

FY88

PROJECT	BANK	IDA
090 [illegible]	70.0	.0
093 PORTS IV-D	60.0	.0
146 HWY MAINT D	125.0	.0
147 AGR SCTR LN I-	400.0	.0
156 TRADE POLICY L	500.0	.0
161 [illegible]	90.0	.0
TOTAL AMOUNTS	1245.0	.0
NO OF PROJECTS	6	0

FY89

PROJECT	BANK	IDA
S 107 [illegible]	300.0	.0
[illegible] ELEC PWR SCTR	400.0	.0
[illegible]	100.0	.0
171 [illegible]	75.0	.0
TOTAL AMOUNTS	875.0	.0
NO OF PROJECTS	4	0

FY90

PROJECT	BANK	IDA
102 AGR MARKETING II	75.0	.0
136 PORTS V-D	150.0	.0
S 144 FORESTRY DEV-C	60.0	.0
154 MULTI-STATE WS	100.0	.0
157 STATE HWYS-D	30.0	.0
S 160 FED DIST [illegible]	60.0	.0
163 [illegible]-D	300.0	.0
165 AG SCTR II-C	400.0	.0
166 ELEC PWR SCTR	400.0	.0
S 167 TRADE POLICY I	5:9.0	.0
TOTAL AMOUNTS	2075.0	.0
NO OF PROJECTS	10	0

FY91

PROJECT	BANK	IDA
108 [illegible]	150.0	.0
114 URBAN DEVT VI	175.0	.0
S 116 SOLID WASTE-D	50.0	.0
117 ADULT [illegible]-D	100.0	.0
S 149 [illegible] SCTR-D	200.0	.0
150 [illegible]	200.0	.0
152 URBAN TRANSPRT I	200.0	.0
140 ELECTRIC PWR S	400.0	.0
TOTAL AMOUNTS	1475.0	.0
NO OF PROJECTS	8	0

FY92

PROJECT	BANK	IDA
S 106 HWY SCTR III	250.0	.0
111 [illegible]	300.0	.0
S 115 WATER POLLUTION	75.0	.0
S 153 [illegible] III-D	300.0	.0
155 [illegible]	300.0	.0
TOTAL AMOUNTS	1225.0	.0
NO OF PROJECTS	5	0

5YR

	BANK	IDA
TOTAL AMOUNTS	6915.0	.0
NO OF PROJECTS	33	0

RESERVE

FISCAL YEAR	PROJECT	BANK	IDA
FY88			
FY88 TOTAL AMOUNTS		.0	.0
FY88 NO OF PROJECTS		0	0
FY89	140 [illegible]	125.0	.0
FY89	143 [illegible]	[illegible]	.0
FY89	[illegible]	400.0	.0
FY89	[illegible] DEVT-D	60.0	.0
FY89 TOTAL AMOUNTS		884.0	.0
FY89 NO OF PROJECTS		4	0
FY90	104 SMALL & MED IN	130.0	.0
FY90 TOTAL AMOUNTS		130.0	.0
FY90 NO OF PROJECTS		1	0
FY91	112 STEEL/CAP. GDS	130.0	.0
FY91 TOTAL AMOUNTS		130.0	.0
FY91 NO OF PROJECTS		1	0
FY92 TOTAL AMOUNTS		.0	.0
FY92 NO OF PROJECTS		0	0
5YR TOTAL AMOUNTS		1131.0	.0
5YR NO OF PROJECTS		6	0

FROM: Vice President and Secretary

SecM
November 6, 1987

NOTICE OF INVITATION TO NEGOTIATE

MEXICO

STEEL SECTOR RESTRUCTURING PROJECT

The Bank is inviting the Government of the United Mexican States and the Nacional Financiera, SNC, to send representatives to Washington, DC, to negotiate a proposed loan of $400 million equivalent to help finance a Steel Sector Restructuring Project.

The loan would finance the foreign exchange cost of a steel sector restructuring program covering the period 1987-91. It would support physical restructuring in the public sector flat products facility, AHMSA, the public sector iron and coal mines, and the private sector flat products facility, HYLSA. It would also finance imports of input materials and steel products during 1988 in support of important policy changes. Finally, the project would involve technical assistance to the government agencies concerned with sector planning and strategy formulation, to SIDERMEX in developing a long-term strategic plan, to AHMSA, the mining companies and HYLSA in project implementation, training and manpower development and to other private sector producers in formulating and assessing restructuring strategies and plans.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Directors and Department Heads, Bank and IFC

CONFIDENTIAL

Report No. P-4618-ME

MEMORANDUM AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

IN AN AMOUNT EQUIVALENT TO US$400 MILLION

TO THE NACIONAL FINANCIERA, SNC

WITH GUARANTEE OF THE UNITED MEXICAN STATES

FOR A

STEEL SECTOR RESTRUCTURING PROJECT

November 6, 1987

CURRENCY EQUIVALENTS - Peso (Mex$)

An exchange rate of

US$1 = Mex$1,235

representing the mid-June 1987 free market rate has been used in the project analysis.

The most recent exchange rate as at October 14, 1987, was:

US$1 = Mex$1,590.1 in the controlled market and
US$1 = Mex$1,582 in the free market

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

AHMSA	-	Altos Hornos de Mexico, S.A.
BOF	-	Basic Oxygen Furnace
CANACERO	-	Camara Nacional de la Industria del Hierro y del Acero
CMC 1/	-	Carbon y Minerales Coahuilla, S.A.
DRC	-	Domestic Resource Cost
EAF	-	Electric Arc Furnace
FMSA	-	Fundidora Monterrey S.A.
GOM	-	Government of Mexico
HYLSA	-	HYLSA S.A.
mtpy	-	million tonnes per year
NAFIN	-	National Financiera, S.N.C.
NKK	-	Nippon Kokan of Japan
OHF	-	Open Hearth Furnace
ORPs	-	Official Reference Prices
RMD	-	Raw Materials Division of Sidermex
SECOFI	-	Secretaria de Comercio y de Fomento Industrial
SEMIP	-	Secretaria de Energia, Minas y Industrial Paraestatal
SICARTSA	-	Siderurgica Lazaro Cardenas Las Truchas S.A.
SPP	-	Secretaria de Programacion y Presupuesto
TAMSA	-	Tubos de Acero de Mexico S.A.
tpy	-	tonnes per year
UEC	-	United Engineers and Consultants (Div. of US Steel)
UMS	-	United Mexican States

1/ CMC is the legal entity being set up to represent the Raw Materials Division of SIDERMEX RMD.

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Loan and Project Summary

Borrower: Nacional Financiera, SNC

Guarantor: United Mexican States

Beneficiaries: Government, SIDERMEX, AHMSA, SIDERMEX Mines, HYLSA, and other private steel sector producers.

Amount: US$400 million equivalent.

Terms: Fifteen years, including three years grace, at the standard variable interest rate.

Onlending Terms: Part A, the Input Materials and Steel Product Imports Component of the Project, to Government, at 0.25% above the Bank's standard variable interest rate and with the same terms as the Bank loan.
Parts B and C, the Support for the SIDERMEX Restructuring Program and HYLSA Restructuring, respectively, to SIDERMEX, AHMSA, SIDERMEX Mines (Carbon y Minerales de Coahuilla, SA, CMC) and HYLSA, at a rate not less than 110% of the Bank's standard variable interest rate and with the same terms as the Bank loan. Exchange risk will be borne by the subborrowers.
Part D, Sector-wide Technical Assistance, to the other private sector producers, at the Borrower's standard terms and conditions for financial intermediation services, viz., interest rate of 110% of the Bank's standard variable rate and with terms not to exceed seven years, including up to two years' grace. Exchange risk will be borne by the subborrowers.

Financing Plan:

	Local	Foreign	Total
	---- (US$ Million) ----		
IBRD	-	400.0	400.0
Short-term Debt	68.0	-	68.0
AHMSA	183.0	120.0	303.0
SIDERMEX Mines	78.0	60.0	138.0
SIDERMEX	3.0	-	3.0
HYLSA	125.0	63.0	188.0
Total	457.0	643.0	1,100.0

Economic Rate of Return: In excess of 18%.

Staff Appraisal Report: No. 6892-ME, dated October 30, 1987.

Maps: IBRD 20418, IBRD 20419

MEMORANDUM AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED LOAN TO NACIONAL FINANCIERA, SNC WITH GUARANTEE OF THE UNITED MEXICAN STATES FOR A STEEL SECTOR RESTRUCTURING PROJECT

1. I submit for approval the following report on a proposed loan of US$400 million to Nacional Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States (UMS), and a maturity of 15 years, including a 3-year grace period, at the standard variable interest rate. NAFIN will onlend the proceeds of the loan as follows: (a) US$100 million to the Government of Mexico (GOM) in support of a steel sector policy reform program; (b) US$165 million to Altos Hornos de Mexico, S.A. (AHMSA), US$50 million to Carbon y Minerales Coahuilla, S.A. (CMC) and US$5 million to SIDERMEX, S.A. in support of a Restructuring Program; and (c) US$75 million to HYLSA in support of a rehabilitation and modernization program of its flat products facility at Monterrey. NAFIN would use the remainder of the proceeds of the loan (US$5 million) to provide subloans to other private sector producers for technical assistance.

Background

2. The steel industry is an important part of Mexico's manufacturing sector, contributing 4.2% of industrial output and 1.3% of GDP, in 1986; it has a crucial impact on the availability, quality and cost of material inputs for downstream manufacturing activities, particularly the engineering and capital goods industries. With an installed capacity of 9 million tons of crude steel equivalent, the sector comprises two public (58% of capacity) and two private sector (24% of capacity) integrated producers, and several independent, non-integrated mini-mills (18% of capacity) and rerollers. Mexico has relatively favorable conditions for its steel industry, including competitive supplies of iron ore, coking coal and natural gas, a well-trained and motivated labor force, well-qualified technical and managerial cadre and a growing domestic market especially for higher quality steel products.

3. Following years of rapid growth from the mid-1940s, steel demand and output fell sharply with Mexico's economic crisis in 1982, and remain below the pre-crisis peak levels, despite a recovery since 1983; medium-term growth is projected at about 3-4% a year. Mexican production and consumption of steel products are about in balance. Non-flat producers, dominated by the private sector, but including the modern SICARTSA I public sector plant, are substantially competitive by international standards. The two flat producers, AHMSA in the public sector and HYLSA in the private, are not currently competitive internationally, particularly as regards quality. Highly protectionist trade policies prior to 1985 and controlled domestic prices below the full cost of efficient domestic producers and landed cost of imports had resulted in an inward-oriented industry, without much incentive to improve product quality and service to customers. This was particularly detrimental in flat products vital to developing competitive engineering and capital goods industries. By early 1986, the public and private sector entities were reeling under the combined effects of low demand, falling domestic prices in real terms, heavy debt service burdens contracted during the years of high growth, and

internal cash generation inadequate to maintain existing plant and equipment and reinvest in new technology to meet changing market needs for quality and product range.

4. In early 1986, the Government, recognizing the industry's financial and technological plight, began a long-term effort to restructure the steel sector within its overall economic reform agenda. As a critical element of that process, the Government developed a restructuring plan for SIDERMEX, the public sector steel holding corporation, and carried out the first steps, including financial restructuring of the viable entities, closure of the uneconomic integrated plant of the publicly owned Fundidora de Monterrey, S.A. (FMSA), organizational changes to ensure effective management, retrenchment and layoffs of operating personnel, and divestiture of virtually all non-steel related businesses. The organizational restructuring of SIDERMEX and the rehabilitation of physical plant is now under way. The Government is also assisting HYLSA, the major private sector producer, to restructure its massive US$1 billion-plus external debt.

5. On the policy front, the Government (i) has begun liberalizing domestic product prices; (ii) has prepared a program to complete elimination of price controls in June 1988, to complement the trade reform measures announced in mid-1986; and (iii) has initiated a program of gradual elimination of all input subsidies. On balance, these actions will allow Mexican steel to be competitively priced in the domestic market and provide the incentives and signals for market-driven performance and strategic planning in the sector. The remaining other major elements in the short-term restructuring agenda are urgently needed improvements in facilities and technology by the two flat producers, together with minor balancing, debottlenecking and modernization investments by the other sector producers. A long-term strategic plan will also be elaborated based on recently completed market studies. The consolidation and creation of leaner and more competitive units will remain the single most important steel sector restructuring objective in the coming decade. Annex 1 shows a matrix of actual or proposed GOM policy actions in support of the restructuring process.

<u>Rationale for Bank Involvement</u>

6. Previous Bank support to steel (Ln. 934-ME, 1973) contributed to making SICARTSA I the premier non-flat producer in Mexico and the only internationally competitive entity in the SIDERMEX complex. By its recent actions and declared policies, GOM has demonstrated its determination to address major sector issues, expose the Mexican steel industry to international competition, fundamentally restructure the subsector and promote more efficient and rational resource allocation and utilization. Actions taken support further Bank involvement in this subsector as part of and consistent with ongoing and planned assistance programs to GOM in a wide range of restructuring and adjustment actions in trade policy, agriculture, industry and parastatal (steel and fertilizer) restructuring. These actions aim at improving competitiveness of the Mexican economy through trade liberalization, price decontrol and private sector promotion. The proposed Bank involvement in the steel sector restructuring process will allow the public and private sector entities to complete their most

urgently needed rehabilitation investments consistent with the objectives of trade liberalization and will ensure that, during the period of structural change, the two major producers will be able to arrest deterioration, retain and improve their competitive positions in a liberalized domestic market. The support at the sectoral level will help maintain the momentum of sector policy reform.

Project Objectives

7. The overall objective of the project is to assist GOM in implementing comprehensive and far-reaching policy reforms for both the public and private steel sectors and in carrying out the needed restructuring actions. The project would assist (i) CMC in the supply of raw materials; (ii) AHMSA and HYLSA to strengthen and improve their competitive position in flat products through rehabilitation of plant and equipment, elimination of existing bottlenecks, improvement of technical, financial and managerial controls and information systems, and training of technical staff; and (iii) GOM in designing and implementing a sound steel sector policy and sectoral public investment program within the framework of a liberalized market environment and in financially restructuring the industry. Overall the restructuring process would result in a reduction of steel-making capacity of approximately 20% (including closure of uneconomic plants) while allowing the industry to raise utilization of existing capacity and concentrate its product lines in competitive market segments.

Project Description

8. The proposed project, with an estimated total cost of US$1,100 million (including taxes and duties of US$103 million equivalent) and a foreign exchange component of US$643 million, supports a steel restructuring program and consists of four parts: (a) Part A (US$100 million), an input materials and steel products import component tied to implementation of agreed policy reforms involving elimination of domestic price controls and completion of trade liberalization measures, viz., rationalization of tariffs on steel products and elimination of Official Reference Prices (ORPs); (b) Part B (total cost, US$698 million), involves physical investments and technical assistance in support of the SIDERMEX restructuring effort to: (i) improve quality and competitiveness and increase capacity utilization for the AHMSA flat product facility (US$502 million), (ii) raise productivity in CMC iron ore and coal mining operations (US$188 million); and (iii) enhance SIDERMEX strategic planning capacity and improve corporate-wide management information and control systems (US$8 million); (c) Part C (total cost, US$297 million), involves physical investments and technical assistance to support rehabilitation and modernization of the HYLSA flat products facility; and (d) Part D (US$5 million), provides technical assistance to (i) other private sector producers in improving operational efficiency and competitiveness; and (ii) GOM in formulating long-term sector strategy and monitoring its implementation. The project would be implemented over a four-year period. The main project beneficiaries would each be responsible for the implementation of their respective components, with the assistance of qualified engineering and project management consultants. AHMSA, CMC and HYLSA have also set up internal Project Management Units whose staffing, functions and duties will ensure smooth project implementation. A

breakdown of costs and financing plan are shown in Schedule A. Amounts and methods of procurement and the disbursement schedule are shown in Schedule B. A timetable of key project process events and the status of Bank Group operations in Mexico are given in Schedules C and D. Two maps showing the location of steel plants and iron ore and coal mines are attached. The Staff Appraisal Report (Report No. 6892-ME) dated October 30, 1987, is being circulated separately.

Agreed Actions

9. The GOM has agreed on the following policy actions: (a) eliminating all ORPs by December 1987; (b) eliminating all price controls by June 1988; and (c) implementing a uniform tariff on steel imports (25%) by October 1988. The elimination of ORPs and of price controls on at least 50% of steel products by volume would be a condition of disbursement of the first tranche of Part A; completion of the remaining decontrol and tariff policy actions would be a condition of release of the second tranche of Part A. At negotiations, assurances would be obtained that (a) the uniform tariff levels reached by October 1988 would be maintained, surcharges on tariffs would not be imposed, and ORPs and all other types of non-tariff barriers would not be reintroduced; (b) GOM would prepare a global steel sector policy statement acceptable to the Bank prior to Board presentation, specifying among others, the respective roles of the public and private sectors and the Government's parastatal steel sector investment policies; and (c) SIDERMEX would present its long-term strategy and investment plan for March 1988 Bank review, and thereafter implement the plan's agreed elements in accordance with investment criteria, financing plans and implementation schedules satisfactory to the Bank; it would also carry out annual reviews with the Bank on the progress of implementation as well as agree on the investment plan for the coming year. In addition agreement would be reached during negotiations on a schedule for eliminating all subsidies to steel sector enterprises.

Benefits

10. The proposed project would permit a deepening of trade liberalization in the steel industry and in the downstream industries and, thereby, enhance their strategic role in the development of an export-oriented competitive economy. The restructuring of AHMSA and HYLSA will involve closure of uneconomic capacity and eliminate production bottlenecks resulting in (i) some increase in production despite a lower production capacity and (ii) a shift in the respective product mixes to higher-quality, higher-value products. The incremental financial rates of return on a discounted cash flow basis are 32.7% for the AHMSA and 17.5% for the HYLSA investment programs, differing due to the current performance of the two companies. The estimated internal economic rate of return is a minimum of 18%. AHMSA and HYLSA would attain international competitiveness in the production of flat products after investments and staff reductions are completed. Local steel users will benefit most since their efficiency will be improved due to the availability of high-quality steel products at internationally competitive prices.

Project Risks

11. A delay in decontrolling steel prices could aggravate the financial position of the major steel producers and induce calls for higher protection. This potential major risk is minimized by actions to date to adjust steel prices and the agreed calendar for decontrol. Additional risks include a possible delay in trade liberalization and a sharp real appreciation of the exchange rate which could affect project viability. The potential adverse impact of the above risks is mitigated by Government commitment to the liberalization program, substantial physical restructuring and rehabilitation of the public sector companies, and clearer definition of future investment strategy as well as agreements related to action plans for operating performance of the target companies.

Recommendations

12. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the proposed loan.

Barber Conable
President

Attachments

Washington, DC

November 6, 1987

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Matrix of Issues, Measures and Actions

Subsector-wide Problems	Actions Taken	Actions To Be Taken	Monitoring Actions and Timing
I. Structural Issues 1. Pricing Policy			
Controlled domestic prices below international opportunity cost; adjusted for inflation on an ad hoc basis.	Monthly adjustment based on domestic inflation index. Adjustment in real terms to attain equivalent landed price levels by December 1987.	Elimination of price controls.	Government provides information on elimination of price controls by Board presentation. During 1988 - in three phases Phases 1 & 2 combined: At least 50% of products decontrolled by March 88 (Tranche 1 Release) Phase 2: Complete decontrol by June 88 (Tranche 2 Release)
2. Trade Policy			
High tariffs and high official references prices (ORP) do not allow external competition.	Partial reduction of tariffs and partial elimination of ORP.	Elimination of ORP.	Completed by December 1987. (Tranche 1 Release)
		Further reduction and uniformization of tariffs.	Feb. 87: Tariff on non-flats drops to 33%, on flats to 25%. Dec. 87: Tariff on non-flats drops to 29% (Tranche 1 Release 1) Oct. 88: Tariff of non-flats to 25% (Tranche 2 Release)
3. Global Subsector Policy			
Lack of definition of public sector scope and role.	Evaluation of the production and investment strategy of SIDERMEX. Preliminary conclusions led to actions under SIDERMEX Restructuring below.	Continue evaluation of longer term production and investment strategy of SIDERMEX.	Preparation of SIDERMEX long-term strategies by March 1988.
Lack of long-term policy framework.		Market and product mix study.	Completed in September 1987.
		Determine the long-term tariff, pricing, and tax/incentive policy for the sector such that no reversals occur on the agreed policy package.	Global Steel Sector Policy Statement by Board Presentation.
4. Quantitative Import Restrictions			
Domestic content requirements on steel users.	Further evaluation under way as part of subsector studies for proposed Industrial Restructuring Loan.	Gradual elimination of some restrictions.	Under the proposed Industrial Restructuring Loan.
II. SIDERMEX Restructuring 1. Organization			
Inefficient, centralized management.	Reorganization along five profit centers under SIDERMEX. SIDERMEX departments and functions reduced to only those necessary by a holding company and staff reduced by 700.	Complete formation of five independent companies under SIDERMEX acting as a holding company. Formalize holding company relationships.	During 1987.
		Develop management control and operating systems and procedures for holding company and profit centers.	During 1987 and 1988 as part of the project.

Subsector-wide Problems	Actions Taken	Actions To Be Taken	Monitoring Actions and Timing
Centralized marketing with service centers led to a breakdown of service to clients.	Sales responsibility devolved to plants and service centers converted to profit center.	Determine function of service centers, incorporate, and decide whether to privatize.	December 31, 1987 as part of the project.
Inefficient facilities.	Shutdown of FUMOSA and associated mines, and tentative decision to discontinue non-flats at AHMSA; 12,000 workers laid off.	Further rationalization of the AHMSA product line, including possible lay-off of 4,000 additional workers.	December 31, 1987 as part of the project.
2. Financial Structure			Done.
Inefficient organization brought lower productivity, maintenance, marketing and product mix problems that ended up in financial restrictions that made it impossible for the group to recover financial health without debt restructuring.	Signature of Convenio with Government under which about US$883 million equivalent, or 50% of the total debt on SIDERMEX's books will be converted to equity. SIDERMEX agrees to follow a technical restructuring plan with specific targets to receive this debt relief during 1986, 1987 and 1988.	SIDERMEX to take steps to fulfill the targets specified by the Convenio.	During 1987 and 1988 (as part of project implementation).
3. Technical Aspects			
Maintenance backlog, inefficient product-mix, low quality in existing production capacity.	Studies and formulation of a technical program for rehabilitation of SIDERMEX operating plants and utilization of FUMOSA facilities.	Completion of ongoing studies, implementation of first phase rehabilitation investments.	Early 1987 to 1989, as part of proposed project.
Capacity expansion in light of optimization (balancing) of existing and proposed new facilities including completion of the SICARTSA II investments.	Preliminary evaluation of SICARTSA II feasibility.	Completion of product/market studies and technical and economic evaluation of alternative routes for long-term development of the Mexican steel system, including a final decision on the whole of SICARTSA II.	During 1987. Studies to be completed by December 1987.
III. Private Sector			
1. HYLSA can contribute to debt service but cannot be financially viable without a debt restructuring.	Presentation of a comprehensive debt restructuring plan based on study by Morgan Bank to determine payment capacity.	Completion of negotiations on a debt restructuring package with commercial banks.	Done. Formalization of Restructuring Agreements by December 1987.
2. Mini-mills have restricted product quality because they are scrap based. Good potential clients for sponge iron.	Decision to complete SICARTSA II investment through DR plant stage to provide source of primary iron to feed domestic demand.	Review SICARTSA II decision, and complete plant through DR stage.	Studies to be completed during 1987; if positive, DR plant commissioned in early 1988.
3. Credit Availability			
Difficulties of private mini-mills to get credit lines for working and investment capital.	Onlending procedures of intermediaries of existing loans being reviewed.	Adjustment of existing industrial credit lines and preparation of proposed Industrial Restructuring Loan.	Under Existing Credit Lines and the proposed Industrial Restructuring Loan.

Country Department II
Industry, Trade, Finance Sector Operations Division
Latin America and the Caribbean Regional Office
November 1987

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Estimated Project Cost:

	Local	Foreign	Total
	---- (US$ million) ----		
Part A	-	100	100
Parts B, C and D			
Equipment and Spares	88	328	416
Civil Works/Erection	91	10	101
Engineering/Project Management	8	21	29
TA/Training	16	17	33
Base Cost	203	376	579
Physical Contingencies	35	36	71
Price Escalation	32	74	106
Installed Cost	270	486	756
Taxes and Duties	103	-	103
Total Installed Cost	373	486	859
Incremental Working Capital	80	21	101
Total Project Cost	453	507	960
Interest during Construction	4	36	40
Total Financing Required	457	543	1,000
GRAND TOTAL	457	643	1,100

Financing Plan:

	Local	Foreign	Total
IBRD	-	400.0	400.0
Short-term Debt	68.0	-	68.0
AHMSA	183.0	120.0	303.0
SIDERMEX Mines	78.0	60.0	138.0
SIDERMEX	3.0	-	3.0
HYLSA	125.0	63.0	188.0
	457.0	643.0	1,100.0

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Procurement Arrangements a/
(US$ million)

	ICB	LIB/IS b/	LCB	Other	Cost
Part A	100c/ (100)	-	-	-	100 (100)
Parts B, C and D					
Equipment and Spares	316 (210)	41 (30)	110	75 (23)	542 (263)
Civil Works/Erection	-	-	133	-	133
Engineering/Project Management	-	-	-	43 (15)	43 (15)
Technical Assistance & Training	-	-	-	38 (22)	38 (22)
Total Parts B, C & D	316 (210)	41 (30)	243 -	156 (60)	756 (300)

a/ Not including interest during construction, incremental working capital and taxes and duties.
b/ Limited International Bidding/International Shopping.
c/ For contracts expected to exceed US$5.0 million. Other contracts would follow normal procurement procedures of purchasers.

Note: Figures in parenthesis indicate amounts financed from proposed Bank loan.

Loan Allocation

	Part A	Part B	Part C	Part D	Total	% of Total	% of Expenditures To Be Financed
I. Raw Materials & Other Eligible Imports	100.0	-	-	-	100.0	25.0	100% of foreign expenditures
II. Equipment & Spare Parts	-	163.0	57.5	-	220.5	55.0	100% of foreign expenditures & 100% of local expenditures (ex-factory)
III. Consultant Services	-	18.0	3.5	3.0	24.5	6.0	100%
IV. Unallocated	-	39.0	14.0	2.0	55.0	14.0	-
Total	100.0	220.0	75.0	5.0	400.0	100.0	

Summary Estimated Disbursement Schedule

IBRD FY:	1988	1989	1990	1991	1992	1993
Annual	73.9	105.4	103.6	91.0	25.0	1.1
Cumulative	73.9	179.3	282.9	373.9	398.9	400.0

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT

Timetable of Key Project Processing Events

(a)	Time Taken to Prepare	:	Six months
(b)	Prepared by	:	SIDERMEX and HYLSA with consultant and Bank assistance
(c)	First Bank Mission	:	May 1986
(d)	Appraisal Mission Departure	:	March 1987
(e)	Negotiations	:	November 1987
(f)	Planned Date of Effectiveness	:	January 1988
(g)	List of Relevant PCR and PPARs	:	PCR on SICARTSA I Investment Project, dated June 14, 1979

STATUS OF BANK GROUP OPERATIONS IN MEXICO 1/

A. Statement of Bank Loans
(As of June 30, 1987)
(US$ million)

Loan No.	Fiscal Year	Borrower	Purpose	Amount Less Cancellations	Undisbursed
		70 loans fully disbursed		4,700.91	
1708-5	1979	NAFINSA	Irrigation	92.00	91.11
1859-5	1980	NAFINSA	Irrigation	160.00	120.89
1913	1981	BANOBRAS	Water Supply	125.00	44.43
1990	1981	BANOBRAS	Urban Development II	164.00	54.77
2043	1982	NAFINSA	Integrated Rural Dev.	175.00	28.36
2142	1982	NAFINSA	Capital Goods Industry	152.30	84.63
2154	1982	NAFINSA	Pollution Control	25.00	11.91
2194	1983	BANOBRAS	Urban Engineering	9.20	5.43
2262	1983	NAFINSA	Agricultural Marketing	115.00	52.21
2281	1983	BANOBRAS	Third Water Supply	100.30	63.17
2325	1983	NAFINSA	Third Sm/Med Industry	175.00	17.50
2331	1983	BANCOMEXT	Export Development	350.00	64.87
2428	1984	BANOBRAS	Highways	200.00	107.12
2450	1984	BANPESCA	Ports	78.30	65.22
2525	1985	NAFINSA	Chiapas Rural Roads	22.00	19.95
2528	1985	NAFINSA	Chiapas Agric Dev.	90.00	81.04
2546	1985	NAFINSA	Sm/Med Scale Mining II	105.00	92.56
2559	1985	NAFINSA	Vocational Education	81.00	55.18
2575	1985	BANOBRAS	Railways V	300.00	237.46
2610	1986	NAFINSA	Agricultural Credit	180.00	44.36
2612	1986	BANOBRAS	Low-Income Housing I	150.00	113.23
2658	1986	NAFIN	Proderith II	109.00	99.15
2665	1986	BANOBRAS	Earthquake Rehab.	400.00	147.51
2666	1986	BANOBRAS	Municipal Strengthening	40.00	37.98
2669	1986	BANOBRAS	Solid Waste Pilot	25.00	22.98
2745	1987	BANCOMEXT	Trade Policy Loan I	500.00	10.99
2746	1987	NAFIN	Industrial Recovery	150.00	120.86
2747	1987	NAFIN	Technology Development	48.00	43.39
2777	1987	BNCE	Export Development II	250.00	227.51
2824 3/	1987	BANOBRAS	Urban Transport	125.00	125.00
2837 3/	1987	NAFIN	Agricultural Credit	400.00	400.00
2858 3/	1987	NAFIN	Sm/Med Industries IV	185.00	185.00
2850 3/	1987	NAFIN	Agricultural Extension	20.00	20.00
		TOTAL		9,799.91	
		Of which has been repaid to the Bank		2,198.56	
		Total now outstanding		7,601.35	
		Amount sold	92.34		
		Of which as been repaid	92.34	0.00	
		Total now held by Bank 2/		7,601.35	
		Total undisbursed			2,835.77

1/ The status of the projects listed in Part A is in a separated report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.
2/ Prior to exchange adjustments.
3/ Not yet effective.

BNKOPER4: [A1.J75]
EBArevalo:LA2CO
August 25, 1987

B. Statement of IFC Investments
As of June 30, 1987
(US$ million)

Fiscal Year	Obligor	Type of Business	Original Approvals Equity	Original Approvals Loan	Original Approvals Total
1958/59	Industrial Perfect Circle, S.A. a/	Industrial Equipment	0.0	0.8	0.8
1958	Bristol de Mexico S.A. a/	A.C. Engine Overhaul	0.0	0.5	0.5
1961	Acero Solar, S.A. a/	Twist Drills	0.0	0.3	0.3
1962/5/6/8	Fundidora Monterrey, S.A. a/	Steel	21.4	2.3	23.7
1963	Tubos de Acero de Mexico	Stainless Steel Pipes	0.1	0.9	1.0
1963	Quimica del Rey, S.A. a/	Sodium Sulphate	0.0	0.7	0.7
1964/6	Industria del Hierro, S.A.	Construction Equipment	2.0	0.0	2.0
1970	Minera del Norte a/	Iron Ore Mining	0.0	1.5	1.5
1971	Celanes Mexicana, S.A. a/	Textiles	0.0	12.0	12.0
1972	Promotora de Papel Periodicos, S.A. de C.V. a/	Pulp and Paper	b/	0.0	b/
1973/9	Cementos Veracruz, S.A.	Cement	0.0	15.9	15.9
1974/81	Cancun Aristos Hotel	Tourism	0.3	1.0	1.3
1975/78	Mexinox, S.A.	Stainless Steel	3.2	12.0	15.2
1978/81/83	Papeles Ponderosa, S.A.	Pulp and Paper	5.0	10.7	15.7
1978	Tereftalatos Mexicanos, S.A.	Petrochemicals	0.0	19.0	19.0
1979/81	Hotel Camino Real Ixtapa, S.A. de C.V.	Tourism	4.2	0.0	4.2
1979/83	Empresas Tolteca, S.A.	Cement	7.9	168.0	175.9
1979	Conductores Monterrey, S.A.	Electrical Wire & Cable	0.0	18.0	18.0
1980	Industrias Resistol, S.A.	Particle Board	0.0	25.0	25.0
1980	Vidrio Plano de Mexico, S.A.	Flat Glass	0.0	114.9	114.9
1980	Minera Real de Angeles, S.A. de C.V.	Mining	0.0	110.0	110.0
1981	Celulosicos Centauro, S.A. c/	Pulp and Paper	0.0	64.8	64.8
1981	Corporacion Agroindustrial S.A. de C.V.	Agri-Business	3.0	11.3	14.3
1983	Capital Goods Facility a/	Capital Goods Financing	0.0	100.0	100.0
1984	Metalsa, S.A.	Auto Chassis	1.4	3.0	4.4
1984	Proteinon, S.A. de C.V.	Agri-Business	0.8	2.0	2.8
1985	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemicals	0.0	16.4	16.4
1986	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and Paper	1.9	10.0	11.9
1986	Agromex Phase I (AESA)	Veg. & Fruit Processing	0.5	1.5	2.0
1986	Sulfamex	Chemical & petrochemical	0.5	2.0	2.5
	Total Gross Commitments		52.2	724.5	776.7
	Less Cancellations, Terminations, Repayment, and Sales		23.7	622.2	645.9
	Total Commitments Now Held by IFC		28.5	102.3	130.8
	Total Undisbursed (including participants)		7.5	5.4	12.9

a/ Investments which have been fully cancelled, terminated, written off, sold, redeemed or repaid.
b/ US$25,000.
c/ Excludes US$5.289 capitalized interest.

IFCT3:[A1.H75]
EBArevalo:LA2CO
August 25, 1987

IBRD 20418

JUNE 1987

IBRD 20419

JUNE 1987

THE WORLD BANK

Office of the President

MEXICO

1. Impact of recent events on Mexican Government strategy and debt management?

2. Steel:

   (a) Mexican steel exports and imports with and without the Project?

   (b) Lack of cofinancing: when will we know Japanese participation? Possible reduction of $400 million?

   (c) Conditionality:

      - how realistic?

      - come back if negotiations do not achieve the proposed conditions

      - link fast disbursing portion (Part A) to meeting conditions of Part B, C and D

   (d) Strategy vis-a-vis Congress and ~~Hill~~ Treasury

MH - original to BBC

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mr. Conable

Barber: We need to proceed on this but you should be aware that we shall be grilled on our policy regarding steel at the Board. Moeen. 11/19

DATE: November 18, 1987

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi MAQ.

FROM: S. Shahid Husain SH

EXTENSION: 69001

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

1. We are proceeding with the negotiations of a Steel Sector Restructuring Loan to Mexico. Its contents are based on a Steel Subsector Study completed by the Bank in mid-1986. The proposed US$400 million loan contains both sectoral adjustment lending and public and private sector investment components.

2. The major objective is to remove distortions in the steel sector and assist the industry in improving the quality of its products in order to compete without subsidy in a liberalized domestic market at internationally competitive prices. The key elements covered by the project include:

(a) further opening of the steel market in Mexico with tariffs reduced and equalized on all steel products;

(b) complete deregulation of steel prices in order to provide the incentive for market-driven performance and investment, particularly in the private sector;

(c) organizational and physical restructuring of the public sector producers including a shift in product mix, balancing and technically upgrading potentially efficient operations and an overall reduction in steel making capacity;

(d) financial and physical restructuring in the private sector including improvements in performance and efficiency in existing facilities to exploit their competitive advantages and resources; and

(e) continued policy dialogue and strategic planning limiting public sector investment to economic and financially viable projects while encouraging private sector investments to make up future gaps between production and domestic demand.

3. The proposed project is crucial to trade liberalization in the steel industry and in fact will not significantly change the current steel import/export balance as increases in production of higher quality, higher value added steel is only projected to keep pace with incremental increases in demand.

4. The most important beneficiaries of the loan will be the downstream industries whose performance and efficiency will be improved due to the availability of high-quality steel products at internationally competitive prices which will enhance their role in the further development of an open competitive economy. The conditions of the loan are in accordance with your suggestion to Mr. Petricioli when you discussed steel.

cc. Messrs. Steckhan, Corbo, Knotter, Iskander

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 6, 1987

TO: Mr. S. Shahid Husain, LACVP

THROUGH: Kye Woo Lee, Acting Director, LA2DR

FROM: Paul Knotter, Chief, LA2TF

EXTENSION: 61271

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

1. I attach for your approval and subsequent distribution to the Operations Committee (OC), revised drafts of the Memorandum and Recommendation of the President, the Staff Appraisal Report, and the Loan, Guarantee and Project Agreements and the Invitation to Negotiate for a proposed Steel Sector Restructuring Loan to Nacional Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States. The documents fully reflect the discussions and decisions of the Regional Loan Committee (RLC) meeting which you chaired on October 5. Also attached is a copy of the current lending program for Mexico. The Government attaches high priority to this operation, which is one of three industrial restructuring operations (the other two are the proposed Fertilizer Sector Adjustment and Industrial Restructuring Loans) any two of which would qualify as link loans for drawdowns under Mexico's multi-facility financial agreement. Negotiations have been tentatively scheduled for November 16, 1987, and Board presentation for January 12, 1988.

2. The major policy issue related to decontrol of steel prices apparently has been resolved by a recent Government decision to eliminate all price controls on steel products in three steps between January and June 1988. We have now received a letter from the Government dated October 26 (copy attached) informing us of the detailed program in this regard. The following paragraphs address the price control and other issues that were either raised in the Loan Committee (LC) meeting on February 17, 1987 (minutes attached), the RLC meeting (minutes attached), or are the result of later developments. As agreed by the RLC a SAR with a policy matrix was prepared for this blend operation with a predominant investment component.

Project Design and Loan Amount

3. Following the recommendations of the LC to remove the perceived imbalance between the assistance offered under the proposed project to the public and private sectors, respectively, the appraisal mission reviewed closely the problems of the two major private steel companies: HYLSA and TAMSA. In parallel, HYLSA (i) developed a sound physical rehabilitation plan with the help of Nippon Kokan (Japanese consultants); (ii) worked out a debt restructuring plan with its creditor banks; and (iii) agreed on a preliminary term sheet that would allow the company to retain sufficient funds for the implementation of the rehabilitation plan. The appraisal mission found Hylsa's rehabilitation plan suitable for Bank financing, and it is proposed that a US$75 million component be included to support the rehabilitation of the HYLSA Monterrey plant. The disbursement of the HYLSA component would be contingent upon the signing

P-1867

of a satisfactory debt restructuring agreement between HYLSA and the creditor banks. The debt restructuring plan with the creditor banks also takes into account the above-mentioned Bank financing.

4. The mission could not develop a similar component for TAMSA because of (i) the severely depressed market situation for seamless tube, TAMSA's main product; and (ii) the lack of any serious restructuring plan of the company and no immediate prospects for agreement between TAMSA and its creditor banks. Since TAMSA has a very specialized production profile and serves a specific market (mainly PEMEX), its restructuring would only constitute a small part of the whole steel sector restructuring. Therefore, in this stage we propose no provision for financial assistance to TAMSA under the Bank loan. The technical assistance component of the Bank loan, however, would be available for assistance in preparation of physical-financial restructuring studies to any steel related companies, whether publicly or privately owned, including TAMSA.

5. A further issue relates to the policy-based component of the Loan. The LC approved the Region's proposal for a US$150 million fast disbursing policy-based component aimed at supporting the Governments comprehensive adjustment program for the steel industry. With regard to the entire steel industry, this program includes the liberalization of steel imports, agreement on a national steel policy framework and the investment program for the parastatal steel companies, removal of domestic price controls and improvement of operating and investment conditions for the private sector. It also includes rationalization of SIDERMEX's corporate structure, delegation of decision-making authority, closure of non-viable plants, massive divestiture and financial restructuring of the company. All these measures have been or are being implemented.

6. Since February the foreign exchange reserve position of Mexico has improved dramatically and a fast disbursing component would no longer appear to be justifiable on BOP grounds. We are concerned, however, that, given the advanced stage of processing, transformation of the project into an investment project with policy conditionality could be understood by the Mexicans as a withdrawal of Bank support for the policy changes, would likely be a blow to those in the Government who fought for the reform and could jeopardize both the successful completion of the steel sector reform and the credibility of the Bank. Therefore, we recommend to maintain the policy-based component but reduce it from US$150 million to US$100 million as indicated in the revised documents.

<u>Price Decontrol</u>

7. Since the complete removal of price controls is vital for a successful restructuring and healthy development of the steel industry, a satisfactory proposal on this issue is an indispensable precondition of negotiations. The Government's October 26 letter proposes a detailed program for price decontrol in three steps. The first step in January 1988 would eliminate controls on seamless tubes, steel wire and low carbon wire rod (about 20% of products by volume). The second one in March 1988 would eliminate controls on most non-flat products except reinforcing bar, and on many flat products (about 30% of products by volume). The third and final step would complete the decontrol of all flat and remaining non-flat products. Subject to the satisfactory clarifications referred to in para. 2 this phased approach is acceptable.

We would propose that tranche release conditions be as follows: First Tranche--events of January and March 1988, i.e., elimination of controls on most non-flat products (about 50% of steel products by volume); Second Tranche--complete elimination of price controls. The Government had already increased the controlled prices in July by 4-8% in real terms. Since we estimate the actual price increase from deregulation is approximately 10% in real terms on average, the final elimination of controls, in fact, would not lead to sharp additional price increases for most products. This should make the elimination of price control politically more acceptable. These latest developments have been reflected in the MOP, SAR and the legal documents.

8. Based on these recent developments we propose the following negotiating conditions: (i) with the presentation to the Bank of a satisfactory price liberalization program that clearly states the commitment of the Government to eliminate steel price controls in the first half of 1988, the precondition of negotiations would be fulfilled; (ii) the price decontrol actions should be the triggering events for the release of the first and second tranches, respectively, of the policy-based (raw materials and steel products import) component of the loan as explained in para. 7 above; and (iii) the price decontrol should also be a dated covenant of the Loan Agreement (reserving the right for the Bank of suspension of disbursement in case of non-compliance).

Input Subsidies

9. The LC instructed the appraisal mission to further analyze the input subsidies and the programs for phasing them out. The mission determined that (i) there are still indirect subsidies through the prices and tariffs of fuel oil, electric energy and railway transport, (ii) their impact on the cost of the steel products is minimal, (iii) their phasing out is addressed either in the Convenio between the Government and CFE (Comision Federal de Electricidad) or in the Railway Sector Loan. During the last two years the Government increased substantially the electricity and railway tariffs, the latter approaching now, in general, long term marginal costs, and raised the price of natural gas by about 500% in real terms. These, and the planned price adjustments, are satisfactory except for fuel oil, for which the Government considers that the price is adequate and does not plan any further adjustment. At any rate, its impact is negligible, since the price of fuel oil constitutes less than 0.5% of the total cost of the steel producers. As recommended by the RLC, we propose to obtain a specific statement from GOM with regard to complete elimination of subsidies in the medium term as part of the substantially strengthened steel sector policy statement.

Trade Liberalization Measures

10. The LC stressed that the trade liberalization measures for steel required under the First Trade Policy Loan should be a condition of the second tranche release of the policy-based component of the proposed loan. The Mexican authorities have confirmed the determination of the Government to carry out without any delay all the steel-related elements of the agreed trade liberalization program which removes all the non-tariff barriers and establishes a unified 25% ceiling for tariffs of both flat and non-flat products by October 1988. The actions planned for February 1987 have been carried out according to the program. The

official reference prices for most steel products were reduced to the level of the world market prices in July 1987. As had been requested by the LC, release of the second tranche would be conditional on compliance with the agreed tariff rationalization program. No further trade liberalization measures (beyond those mentioned above) are needed in the steel sector.

Steel Sector Policy

11. As requested by the LC the mission obtained from the Government a draft steel sector policy statement which states, inter alia, that:

(a) the Government intends to carry out deep reforms both in the steel industry and in its economic environment;

(b) the steel industry should service the domestic market in competition with foreign producers;

(c) the non-viable plants should be liquidated; and

(d) no new investment will be started except the rehabilitation of some of the existing plants and restart of the first phase of the SICARTSA II investment (the direct reduction plant and steelmaking shop).

Agreement on significant broadening of the steel sector policy statement will be reached during negotiations, especially concerning the roles to be played by the private and public sectors in steel and government policies criteria and plans for parastatal steel sector investments. Presentation by Government of an acceptable Steel Sector Policy Statement would be a condition of Board Presentation. In addition annual review and agreement by the Bank of the public sector steel investment plan would be a condition of the proposed loan.

Japanese Cofinancing

12. The Export Import Bank of Japan (JEX) expressed interest in cofinancing the project. JEX participation would allow greater flexibility in project implementation. We are exploring further any likely cofinancing possibilities without delaying the processing of the loan. In this regard, we have provided general information on the overall composition of the project and indicated the likely expenditure categories where parallel financing by JEX would be feasible from a technical and financial point of view, bearing in mind the maximum sustainable debt financing levels at each of the project beneficiaries.

Support for the Private Sector

13. It should be noted that the policy reform, especially the elimination of price controls, will strengthen the financial position of the private producers and the closure of some public plants and production lines will open more market segments for them. As mentioned above, Part D of this loan would be onlent to the other private producers for technical assistance; funding for ensuing investment program would be provided, partly from the existing Bank credit lines, and partly under the proposed Industrial Restructuring Loan. Furthermore, the Bank should explore during the implementation further assistance possibilities in this area, including possible technical assistance in the privatization of former SIDERMEX subsidiaries under the technical assistance component of this.

Other Issues

14. The following revisions will be made in the Grey Cover report:

(a) Price contingencies calculated as part of project costs in MOP Schedule A and SAR para 6.02 will be adjusted to reflect the latest information. These adjustments will not affect the amount of Bank financing included in the project or the project financing plan.

(b) The Disbursement Schedule will be revised from six to seven years to match the regional profile (relevant MOP and SAR tables).

Attachments:
1. Green Cover SAR
2. Draft MOP
3. Draft Legal Documents
4. Draft Notice of Invitation to Negotiate

cw & cc: Messrs. M. Linder, R. Goodland, T. Hill, J. Sugar

cc: Messrs. M. Selowsky, F. Aguirre-Sacasa, C. Quijano, G. Dolenc, Kye Woo Lee, V. Corbo, M. Voljc, J. Varallyay, J. Johhson, H. Ives, M. Iskander, H. Sethi, X. Simon, J. Malatinszky, R. Venkateswaran, E. Mangan, I. Rivera, F. Remy, S. von Klaudy

Asst. General Counsel, Operations

Files

RVenkateswaran/Mangan/Knotter:

THE WORLD BANK

CONFIDENTIAL

DECLASSIFIED
AUG 27 2013
WBG ARCHIVES

LOAN COMMITTEE

LC/M/87-03

February 24, 1987

Minutes of the Loan Committee Meeting to consider
MEXICO - Steel Sector Restructuring Loan
Held on February 17, 1987, in Conference Room E-1208

Present

Committee:

Chairman:	Mr. Stern
Finance:	Mr. Wood
Legal:	Mr. Shihata
ERS:	Mr. King
OPS:	Mr. Husain
Region:	Mr. Gué

Others:

Messrs/Mmes. Steckhan
Picciotto
Bottelier
Varallyay
Page
Golan
de Capitani
Rowat
Simon
Collell
Donovan
Clements
Roger
El Serafy
Huang
Myer
Sam

DISTRIBUTION

COMMITTEE
Senior Vice President, Operations (Chairman)
Senior Vice President, Finance
Vice President & General Counsel
Vice President, Operations Policy
Regional Vice President concerned*
Vice President, Energy & Industry (for lending in these sectors and SALs)
Vice President, Economics and Research (for [illegible] lending)

OTHERS
[illegible]

[illegible]

B. Issues

2. The meeting was called to discuss the proposals in the Initiating Memorandum (IM) attached to Mr. Knox's memorandum of February 9, 1987, for a Steel Sector Restructuring Loan to Mexico. The discussion focussed on the main issues raised in the Country Policy Department's memorandum of Februr-y 13, 1987.

C. Discussion

Trade Liberalization

3. The meeting reviewed the relationship between the conditionality of the Bank's first Trade Policy Loan (TPL-I, Ln. 2745-ME) and the sector-specific measures proposed in the IM for the proposed loan. The Region noted that the proposed loan would fine-tune tariff measures for flat and non-flat steel products, but would not provide any other additional conditions; a unified tariff of about 25% would be established for all steel products by October 1988. The meeting agreed that the elimination of reference prices and trade adjustments for steel required under TPL-I should be a condition of second tranche release under the proposed operation.

Sectoral Reforms

4. The meeting questioned how small private steel mills were able to show profits at prevailing low controlled domestic price levels. It was explained that these companies had a positive cash flow, but not profits, resulting from input subsidies on energy and rail transport, and low real wages. These subsidies are being reduced. By the end of the restructuring process in 1988, SIDERMEX should be financially autonomous, no longer depending on transfers from the Government. To create the preconditions for this, one-half of SIDERMEX's debt is being assumed by the Government ("convenio" signed in 1986), and further restructuring may be required by the SICARTSA-II facility now nearing completion. Substantial cost savings would be achieved from the restructuring measures and would be increasingly market-driven. The Committee agreed that all operating subsidies should be eliminated, and that the industry should be on a fully commercial basis, by the end of the program period. The Chairman stated that a detailed evaluation of input subsidies and programs for phasing them out should be made during appraisal and clearly reflected in the project documentation.

5. The Committee also agreed that the long-term investment strategy to be obtained from the Government should spell out the proposed future roles of the private and public sectors in steel. The Chairman stressed the need for a statement of policy which would, as a minimum, set out the Governments's own investment intentions. In this context, it was noted that investments for the SICARTSA-II plate mill would be made only if the outlays were economically justified. Over the next five years, a net reduction in capacity is expected, so that the bulk of investments would be for debottlenecking, modernizing, and maintenance.

Pricing

6. The meeting discussed the impact of the devaluation of the peso on the calculations contained in the IM regarding the competitiveness of the Mexican steel industry. It was explained that the estimates of short- and long-term marginal costs were based on early 1986 figures. Because of an additional 25% real term devaluation since then, those costs should be proportionally more competitive today.

7. The Committee questioned the continuation of price controls on some downstream users of steel and stressed the importance of a close linkage between upstream and downstream price decontrols. The Region stated that previously stringent price controls have been made more flexible, allowing for price increases which are registered ex post, together with the justification for the increase. The Committee emphasized the need for an assurance that steel price increases would be passed on automatically for those products still under price control. It also agreed that price registration was undesirable and that the Region should seek its elimination.

Project Design

8. The Committee expressed concern over the project's apparent emphasis on public sector companies. It was noted that private companies such as HYLSA and TAMSA will also need substantial capital to prepare themselves for rising competition after price decontrol. The source of this capital was not yet clear. In reviewing possible sources of finance for the private sector, the Chairman stated that IFC should be further consulted to determine what role, if any, it can play; other alternatives, such as making available a part of the quick-disbursing component of the proposed operation, increasing the loan size or preparing a separate Bank loan for private companies, should be considered. The meeting concluded that the appraisal mission should ensure that an overall long-term financing plan is developed for the steel sector as a whole, assuring that both the public and private sectors have access to finance on comparable terms. It was noted that the proposed US$25 million technical assistance component could be drawn upon on a loan basis by private companies if they so desired.

D. Conclusions

9. Subject to the above modifications, the Committee approved the Region's proposal to appraise the Steel Sector Restructuring Project as set out in the IM.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 6, 1987

TO: Files

FROM: Francisco Aguirre-Sacasa FAS, Sr. Operations Advisor, LAC

EXTENSION: 69003

SUBJECT: Mexico -- Steel Restructuring Project, Loan Committee Meeting

1. Mr. Shahid Husain chaired a meeting of the Regional Loan Committee on October 5, 1987, to discuss the Mexico - Steel Restructuring project. Those present included: Messrs. Steckhan, Wessels, Selowsky, Corbo, Iskander, Knotter, Lee, Quijano, Sethi, Rivera and myself from LAC; Ms. Garcia-Zamor, also from LAC; and Messrs. Goldberg and Hill from the Legal Department.

2. The meeting opened with a discussion on the suitability of the conditionality proposed for the loan. On this point, there was a consensus that the recommended reforms were important steps in the right direction and justified going ahead with this hybrid loan of $400 million ($100 million in quick disbursing funds and $300 million to finance investments in the steel sector). Major features of the reform package included: (i) total de-control of domestic steel prices; (ii) liberalization of steel imports; (iii) a financial restructuring of two of Mexico's largest steel companies; and (iv) agreement on a steel policy framework.

3. While the thrust of policy reform being recommended by Mr. Steckhan's Department was satisfactory, it was agreed that a number of refinements would be introduced in the policy package. These changes are highlighted in the following four paragraphs.

4. Public Investment: A condition of the loan should be that Bank staff would annually review and agree with the Government on the investment program of Mexico's parastatal steel companies. If necessary, Bank staff could avail themselves of the long-term steel sector strategy to be agreed between Mexico and the Bank --and, specifically, of its investment provisos--as a mechanism to effect the review. Regardless of how it was couched, however, Bank satisfaction with public investment in steel was critical to the loan. This safeguard was necessary since one of the major threats facing the sector was the possibility that Mexico would go ahead with a large ($2 billion plus) but economically questionable investment at its SICARTSA steel works.

5. Tariff Liberalization: It was agreed that the loan covenant on steel tariff liberalization would not only provide for a reduction in steel tariffs to a maximum of 25 percent by October 1988 but would also make it clear that no other non tariff barriers (surtaxes or QRs) could be put on steel products. Moreover, as had been requested by the Loan Committee when it reviewed the IM for this operation, satisfactory compliance with the tariff rationalization program would be made a condition of release of the second tranche of the proposed loan's quick disbursing component.

6. <u>Policy Statement</u>: A satisfactory statement of steel sector policy would have to be provided by Government to the Bank before distribution of the loan to the Executive Directors. This statement should, <u>inter alia</u>, touch upon the roles to be played by the state and the private sectors in steel and what, in general terms, were the Government's intentions with regard to parastatal steel investments.

7. <u>Subsidy Elimination</u>: It was decided that the Bank ought to ask the Government and its major steel parastatals (SIDERMEX and its subsidiaries) to operate without subsidies from the fisc or other Government entities. How this commitment would be secured was left to the Department. Possibilities included covenants in the legal documents or a reference in the steel sector policy statement to be provided in connection with this loan. The date by which subsidies would be eliminated was also left flexible for negotiations with the understanding that it would be in the medium- and not long-term.

8. In addition to the policy-related changes referred to above, a number of other decisions were taken at the Loan Committee meeting. These are summarized below.

8. <u>Presentation</u>: The policy changes referred to in paras four to seven would be reflected in the loan package now. Moreover, the draft memorandum of the president (MOP) would be tightened up. Particular emphasis would be given to better highlighting the loan's policy features. To this end, an updated policy matrix would be included in the MOP.

9. <u>Consultants</u>: Bank staff would carefully review the technical assistance associated with the loan with the Mexicans during negotiation. Attention would be given to making sure that the amount of consultants services envisaged (nearly 2,300 staff months) was justified and that the average cost of consultants ($12,000 per month) was reasonable. In keeping with Bank procedures, draft terms of references for the major consulting activities would be reviewed at negotiations.

10. <u>Financial Covenants</u>: Regional staff would also carefully review the adequacy of the proposed financial covenants for AHMSA (a large steel parastatal). The current ratio, in particular, looked too low at 1.2.

8. <u>Operations Committee Review</u>: In light of the proposed loan's policy aspects and sensitive nature, Mr. Husain agreed with the Department's recommendation that it should be referred to the Operations Committee as soon as it was ready.

FJAguirre-Sacasa

Cleared with and cc: Mr. Husain

cc: Messrs. Steckhan, Wessels, Selowsky, Corbo, Iskander, Knotter, Lee and Quijano and Ms. Garcia-Zamor (LAC); and Messrs. Goldberg, Collel and Hill (Legal)

88E0253 October 29, 1987
Spanish (Mexico)
LA2TF RP:mec

United Mexican States
Secretariat of Finance and Public Credit
Directorate General of Public Credit
Directorate of International Financial Organizations
Subdirectorate of Industrial Sector Projects
Mexico, DF
Mexico

October 26, 1987

Mr. Marko Voljc
Resident Representative of the World Bank
Isabel la Católica No. 51, 1er. Piso
Mexico, DF.

Memorandum No. 305. III. 4.- 9583

Dear Sir:

With reference to the Iron and Steel Restructuring Project, the preparation of which began in early 1986, and the communication dated October 1, 1987 sent to the Secretariat of Finance and Public Credit by the Subsecretariat of Internal Commerce of SECOFI (the Secretariat of Commerce and Industrial Development), I wish to inform you of the Government's main policies and objectives with respect to price control in the steel industry.

As you know, one of the most important measures adopted as part of restructuring is the gradual removal of price controls from steel products. The process began in May 1986, when strict cost-price controls were replaced by price supervision, thus updating the cost threshold and the resulting price structure so that prices could subsequently be increased at intervals of two months by an amount equivalent to 95% of the real cumulative inflation in those periods.

In addition, special increases were planned for this year, in order to put the industry on a sound financial footing and enable it to improve its maintenance standards, thus producing a 10% increase in total revenue for the country's principal steel plants and making domestic prices comparable with Japanese FOB export prices. As of September 11 this year, domestic prices for the following products exceeded Japanese export prices: cold rolled sheet (US$449 vs. US$420); billets (US$220.62 vs. US$175); rods (US$254 vs. US$210); lightweight shapes (US$253 vs. US$240). Mexican prices are, therefore, at almost the same level as those of the major exporting countries, providing its plants with sufficient buying power on the international market to enable them to maintain, modernize and increase their installed productive capacity.

Nevertheless, the Mexican Government has decided to implement the following price deregulation program:

FIRST PHASE (January 1988):

1. Seamed pipes.
2. Wire products.
3. Forged quality wire.
4. Low carbon wire.
5. Wire rod.

SECOND PHASE (March 1988):

6. Heavy shapes (structural).
7. Merchant rods and shapes.
8. Bodies and billets.
9. Coated sheet.

THIRD PHASE (June 1988):

10. Hot rolled sheet.
11. Cold rolled sheet.
12. Tin plate.
13. Corrugated rods.
14. Plates.

It should be noted that the existing price supervision system (based on real prices) will be used to adjust the prices of the above products until they are deregulated under this program. From November 1986 to May 1987, the procedure showed how practical it was, with authorizations issued for increases amounting to 52.57%, while the costs reported by enterprises increased by an average of 47.49%. The difference was mainly due to a decrease in the liability component of total costs.

At the beginning of 1988, the Directorate General of Prices of SECOFI will be issuing memorandums authorizing the progressive deregulation of products, in accordance with the above schedule.

Yours, etc.

/s/ José Luis Flores Hernández
Director, International
Financial Organizations,
on behalf of the Director
General of Public Credit

PAGE

LATIN AMERICA & CARIBBEAN REGIONAL OFFICE

RUN DATE [illegible]/87

FIVE YEAR LENDING AND RESERVE PROGRAM (FY88 - FY92)

(COUNTRY SORT IN $ MILLIONS)

FISCAL_YEAR

MEXICO

LENDING

FY88 PROJECT	BANK	IDA	FY89 PROJECT	BANK	IDA	FY90 PROJECT	BANK	IDA	FY91 PROJECT	BANK	IDA	FY92 PROJECT	BANK	IDA	5YR BANK	5YR IDA
090 [illegible]	70.0	.0	S 107 [illegible]	300.0	.0	102 AGR MARKETING II	75.0	.0	108 [illegible]	150.0	.0	S 106 [illegible] SCTR III	250.0	.0		
093 PORTS IV-D	60.0	.0	[illegible]	400.0	.0	136 PORTS V-D	150.0	.0	114 [illegible] VI	175.0	.0	111 [illegible]	300.0	.0		
146 [illegible]	135.0	.0	[illegible]	100.0	.0	S 144 FORESTRY DEV-C	60.0	.0	S 116 SOLID WASTE-D	50.0	.0	S 115 WATER POLLUTION	75.0	.0		
147 AGR SCTR LN I-	400.0	.0	171 [illegible]	75.0	.0	151 MULTI-STATE [illegible]	100.0	.0	117 [illegible]-D	100.0	.0	S 153 EDP III-D	300.0	.0		
154 TRADE POLICY L	500.0	.0				157 STATE ROADS-D	30.0	.0	S 149 RAILWAY SCTR-D	200.0	.0	155 [illegible]	300.0	.0		
161 [illegible]	80.0	.0				S 160 FED [illegible]	60.0	.0	150 [illegible]	200.0	.0					
						163 [illegible]-D	300.0	.0	152 URBAN TRANSPRT I	200.0	.0					
						165 AG SCTR II-C	400.0	.0	148 ELECTRIC PWR S	400.0	.0					
						166 ELEC PWR SCTR	400.0	.0								
						S 167 TRADE POLICY I	[illegible]	.0								
TOTAL AMOUNTS	1245.0	.0		875.0	.0		2095.0	.0		1475.0	.0		1225.0	.0	6915.0	.0
NO OF PROJECTS	6	0		4	0		10	0		8	0		5	0	33	0

RESERVE

FY88 PROJECT	BANK	IDA	FY89 PROJECT	BANK	IDA	FY90 PROJECT	BANK	IDA	FY91 PROJECT	BANK	IDA	FY92 PROJECT	BANK	IDA	5YR BANK	5YR IDA
			140 [illegible]	125.0	.0	104 SMALL & MED IN	150.0	.0	112 STEEL/CAP. GOO	150.0	.0					
			[illegible]	266.0	.0											
			[illegible]	403.0	.0											
			167 [illegible] DEVT-D	60.0	.0											
TOTAL AMOUNTS	.0	.0		854.0	.0		150.0	.0		150.0	.0		.0	.0	1151.0	.0
NO OF PROJECTS	0	0		4	0		1	0		1	0		0	0	6	0

FROM: Vice President and Secretary

SecM
November 6, 1987

NOTICE OF INVITATION TO NEGOTIATE

MEXICO

STEEL SECTOR RESTRUCTURING PROJECT

The Bank is inviting the Government of the United Mexican States and the Nacional Financiera, SNC, to send representatives to Washington, DC, to negotiate a proposed loan of $400 million equivalent to help finance a Steel Sector Restructuring Project.

The loan would finance the foreign exchange cost of a steel sector restructuring program covering the period 1987-91. It would support physical restructuring in the public sector flat products facility, AHMSA, the public sector iron and coal mines, and the private sector flat products facility, HYLSA. It would also finance imports of input materials and steel products during 1988 in support of important policy changes. Finally, the project would involve technical assistance to the government agencies concerned with sector planning and strategy formulation, to SIDERMEX in developing a long-term strategic plan, to AHMSA, the mining companies and HYLSA in project implementation, training and manpower development and to other private sector producers in formulating and assessing restructuring strategies and plans.

Distribution:

Executive Directors and Alternates
President
Senior Vice Presidents
Senior Management Council
Directors and Department Heads, Bank and IFC

Reg ~~① MH~~
~~② BBC~~
③ CP

THE WORLD BANK

From the
Vice President and General Counsel

November 19, 1987

Mr. Qureshi:

Attached is the exchange of letters which might be entered into regarding the Mexican Defeasement agreement. You will note that the exchange is now proposed to be initiated by the Government of Mexico with a response from the Bank.

Attachment

cc: Mr. Conable

Ibrahim F. I. Shihata

DRAFT: Nov. 18, 1987
HVMorais

DRAFT LETTER FROM MEXICO

November ___, 1987

Mr. Barber Conable
President
The World Bank
Washington, D.C.

Dear Mr. President:

The United Mexican States (Mexico) proposes to undertake a collateralized debt defeasance scheme with respect to a portion of its existing commercial bank debt. Under this scheme, Mexico would issue 20-year bonds with a face value of [US$6.75 billion] in exchange for current 20-year maturity commercial bank loan obligations; the exchange would be effected through a Dutch auction in which creditors would bid for the bonds by tendering their existing Mexican credits at some discount. The bonds would carry a fixed interest rate and provide for the repayment of principal in one bullet payment at the end of 20 years. Mexico would purchase and pledge [U.S. Treasury] zero coupon bonds as collateral to secure its principal repayment obligation under its new bonds. We believe that the scheme would not only lead to an improvement in Mexico's creditworthiness and its external debt-servicing capacity but would also be in the best developmental interests of the country. We understand that the World Bank staff who analyzed the proposed scheme concur with this assessment.

In order to implement the proposed scheme, it would be necessary for Mexico to obtain a waiver of the negative pledge restriction that is contained in the various loan agreements which Mexico has entered into with commercial banks and with the International Bank for Reconstruction and Development (the World Bank). [We are pleased to inform you that] Mexico has requested and obtained the agreement of all its commercial bank creditors to waive the negative pledge restriction in their existing loan agreements with Mexico. With respect to bondholders under earlier Mexican bond issues, we propose to provide an equal and ratable security in view of the practical difficulties of obtaining waivers from individual bondholders.

We would now like to request the agreement of the World Bank to waive the negative pledge restriction contained in its existing loan agreements with Mexico. In view of the World Bank's status as a preferred creditor, and of its established policy of not participating in rescheduling agreements, we trust that the World Bank would agree to waive the negative pledge restriction so as to permit the implementation of the proposed scheme. I am authorized to confirm on behalf of the Government of Mexico that any such waiver granted by the World Bank would be with specific reference to the proposed scheme and without prejudice to the World Bank's preferred creditor status and its position on the negative pledge restriction under its loan agreements in general.

Sincerely yours,

UNITED MEXICAN STATES

Gustavo Petricioli
Secretary of Finance and
Public Credit

cc: Agent Banks
(Commercial Bank Loan Agreements)

DRAFT: Nov. 18, 1987
HVMorais

DRAFT REPLY FROM WORLD BANK

November ___, 1987

Mr. Gustavo Petricioli
Secretary of Finance and Public Credit
United Mexican States
Mexico City

Dear Mr. Secretary:

We refer to your letter dated November _____, 1987 outlining the proposal of the United Mexican States (Mexico) to undertake a collateralized debt defeasance scheme with respect to a portion of its existing commercial bank debt. Your letter indicates that, under this scheme, Mexico would issue 20-year bonds with a face value of [US$6.75 billion] in exchange for current 20-year maturity commercial bank loan obligations; the exchange would be effected through a Dutch auction in which creditors would bid for the bonds by tendering their existing Mexican credits at some discount. The bonds would carry a fixed interest rate and provide for the repayment of principal in one bullet payment at the end of 20 years. Mexico would purchase and pledge [U.S. Treasury] zero coupon bonds as collateral to secure its principal repayment obligation under its new bonds. We also note your statement that the scheme would not only lead to an improvement in Mexico's creditworthiness and its external debt-servicing capacity but would also be in the best developmental interests of the country.

In order to implement the proposed scheme, you have indicated that it would be necessary for Mexico to obtain a waiver of the negative pledge restriction that is contained in the various loan agreements which Mexico has entered into with commercial banks and with the International Bank for Reconstruction and Development (the World Bank). In this regard, we note your statement that Mexico has requested and obtained the agreement of all its commercial bank creditors to waive the negative pledge restriction in their existing loan agreements with Mexico. We also note that Mexico proposes to provide an equal and ratable security to bondholders under earlier Mexican bond issues in view of the practical difficulties of obtaining waivers from individual bondholders.

By your letter, you have requested the agreement of the World Bank to waive the negative pledge restriction contained in our existing loan agreements with Mexico while confirming your commitment to the preferred creditor status of the Bank and your understanding of its policy against participation in rescheduling agreements.

In view of the World Bank's status as a preferred creditor, and of its policy of not participating in rescheduling agreements, the World Bank agrees to waive the negative pledge restriction under its existing loan agreements with Mexico so as to permit the implementation of the proposed scheme. This waiver is being granted by the World Bank with specific reference to the proposed scheme and without prejudice to the World Bank's position on the negative pledge restriction under its loan agreements in general.

Sincerely yours,

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

Barber B. Conable
President

cc: Agent Banks
(Commercial Bank Loan Agreements)

Original given to MH (11/17)

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDANCE DATE : 87/11/18 DUE DATE : 00/00/00
LOG NUMBER : 871118001 FROM : Moeen A. Qureshi
SUBJECT : Memo on: Mexico/Collateralized Defeasance Scheme.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

_____ APPROVED
_____ PLEASE HANDLE
_____ FOR YOUR INFORMATION
__✓__ FOR YOUR REVIEW AND RECOMMENDATION / Approval
_____ FOR THE FILES
_____ PLEASE DISCUSS WITH _____
_____ PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
_____ AS WE DISCUSSED
_____ RETURN TO _____

COMMENTS : Handle: URGENT

file

Chitra - Marianne said this has been taken care of.
Pls. log/out + file

✓ done 12/1 C.P.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 17, 1987

TO: Barber B. Conable, President

FROM: Moeen A. Qureshi, SVPOP MAQ

EXTENSION: 73665

SUBJECT: Mexico/Collateralized Defeasance Scheme

1. As you know, the Government of Mexico has informally broached the subject with the Bank of using $1 billion or more of the country's foreign exchange reserves as collateral for an external bond issue to be exchanged (at a discount)0for existing commercial bank debt.

2. In order for the operation to take place, the World Bank would have to waive the negative pledge restrictions embodied in our Mexican loan agreements with respect to the reserves being pledged. There has also been some discussion of the possibility that the Bank could provide a partial guarantee of interest payable under the new bo~d issue.

3. I have discussed the negative pledge waiver with Messrs. Stern, Hopper and Shihata, and we have caused a statement of general criteria for such waivers to be developed (I have attached to this memorandum a copy of that statement). Given that the contemplated Mexican transaction seems to comply with the criteria, we would recommend that the Bank agree to waive its negative pledge restrictions if formally requested to do so.

4. Our waiver would naturally be granted only after requisite waivers are provided by Mexico's other external creditors. In the interim, we would privately advise the Mexican Government that we have no intention to block the transaction by withholding our waiver.

5. Additionally, since we would only grant the waiver because we feel that our preferred creditor status does not rest on having a security interest, we would undertake an exchange of letters with the Mexican Government which would serve to reiterate the existence of our preferred creditor status. I have attached for your review a preliminary draft of a letter which could be sent by the Bank to the Government on this matter. (The Region and the Legal Department are also in the process of drafting a suggested letter which could serve as the Government's formal request.)

6. On the question of our providing a partial guarantee with respect to this transaction, it is felt that it would be most difficult for us to evaluate proporerly the need for such a guarantee and the consequences of our providing it within the brief time frame allotted. (Mexico's financial adviser, Morgan Guaranty, and legal counsel, Cleary Gottlieb, have told us the Government will wish to undertake this operation before year end.) Therefore, we have privately indicated to Morgan Guaranty that we would not wish the Government to request our guarantee on this operation. Notwithstanding our suggestion in that respect, we understand that the Minister of Finance met with Secretary Baker last week and asked if the U.S. Treasury would support the World Bank's providing a guarantee on this operation. Apparently, Mr. Mulford was opposed to the use of the World Bank guarantee while other (unnamed) Treasury officials felt it should be considered.

7. If you approve, we would intend to agree to the Mexican request if and when it is formally tendered.

8. In addition to the statement regarding criteria and the draft letter to the Mexican Government, I am attaching a brief analysis of the effects this transaction could have on Mexico's external debt figures.

Att.

cc: Mr. Stern
Mr. Hopper
Mr. Shihata

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Mexico - Country Files - Correspondence - Volume 1	1779794

Document Date	Document Type
Oct 23, 1987	Memorandum

Correspondents / Participants
Mr. Moeen A. Qureshi

Mr. Ibrahim F.I. Shihata

Subject / Title
Mexico - Collateralized Debt Defeasance Scheme

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☑ 4 ☐ 5 ☐ 6 ☐ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

Reason for Removal
Attorney - Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	Aug 27, 2013

10/6/87

Thanks C-Bug-
Back to you.
L-

Marianne - Mr. Steckhan says the AM brief for Mexico is probably better — that is, shorter. In fact, it's only a 15 min. appt. & BBC knows Chuck Pilliod from other times and the St. Dept. says he has no agenda — just wants to say hello. I've told Mr. Steckhan therefore, that there's no need for Steckhan to attend.

I've asked Chitra to find the Mexico A.M. brief.

Chitra, pls.

L-

P-1852

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Marianne
Consider it as a draft. The Annual Meeting brief is really still up to date but this has valuable economic info.
RBS Kaiser

DATE: October 6, 1987

TO: Mr. Barber B. Conable

THROUGH: Mr. Moeen A. Qureshi

FROM: S. Shahid Husain

EXTENSION: 69001

SUBJECT: MEXICO - Briefing for Your October 7 Meeting with U.S. Ambassador Charles Pilliod

1. In one respect, the collapse of oil export earnings in 1986, coming as it did in the wake of a prolonged external payments crisis, may prove to have been a blessing in disguise. It triggered a heightened awareness within Mexico's political elite that an effective solution to Mexico's dilemma of staggering debt and stagnant growth would require macroeconomic adjustment and wide-ranging structural changes in the trade regime, the public sector, and the major production sectors, agriculture and industry.

2. Until mid-1985, scant progress had been made toward these structural changes. However, since then, a major program of import liberalization has been launched, a number of major state enterprises have undergone major physical and financial restructuring, and subsidies to consumers of food and energy have been sharply reduced. These reforms were complemented by supportive macroeconomic measures, including a 60% real devaluation of the peso, the adjustment of interest rates to highly positive real levels, sharp cutbacks in non-financial public sector expenditures, and a major reform of corporate and value-added taxes.

3. In terms of overall economic performance, the results of these efforts have been impressive. At $9.7 billion, non-oil merchandize exports in 1986 were nearly double their level of 1982, growing 18% yearly. Since mid-1985, this rate has nearly doubled to about 35% yearly. A diversified list of manufactured and agricultural goods has participated in this growth. The trade balance has shifted from deficits averaging $5 billion annually in the early 1980s to a surplus of $5.7 billion in 1986. Despite oil export revenues running some $6 billion below 1985, the trade surplus is still expected to rise to around $10 billion in 1987. Capital flight has been halted and reversed, with repatriation estimated at $1.5 billion in 1986, and running at over twice that level in 1987. As of August of this year, international reserves reached $15 billion, the highest in Mexico's history. And the economy, after experiencing a severe recession in 1986 and early 1987, has shown signs of vigorous recovery since June.

4. Only inflation, which has more than doubled from 64% in 1985 to 134% in the year ending in August 1987, has failed to accompany the economy's other improving indicators. Therein lies the key dilemma for Mexican policymakers at present, namely a critical inconsistency among fiscal, monetary, and trade policies. If not promptly corrected, this incompatibility threatens bringing on accelerating inflation and balance of payments difficulties, undoing the significant gains in development prospects won at such high cost. There are several key aspects involved in this inconsistency:

(a) the fiscal deficit remains unacceptably large. Future progress in reducing the deficit will depend on reducing still large transfers to some public enterprises, such as the electric power and fertilizer companies, public sector prices for services such as water, urban transport, and credit which are closer to true opportunity costs, and improved control over the growth in the number of public employees.

(b) the trade liberalization process needs to be accelerated. Much progress has been made in reducing tariffs and quantitative restrictions, however there still remains a substantial anti-export bias.

(c) the Government's present reliance on slowing the depreciation of the peso and allowing interest rates to fall to negative real levels is an ineffective strategy for combatting inflation. If continued, this strategy will ultimately damage the export drive and lead to renewed balance of payments difficulties. A tightening of fiscal and monetary policies, combined with more import competition, would be a more effective way to combat inflation.

Attachment

cc: Messrs. Steckhan, LA2DR
Selowsky, LACVP
Corbo, LA2CO
Binswanger, LA2AG
Knotter, LA2TF
Halperin, LA2IE
Croce, LA2CO
Varallyay, LA2CO
Castaneda, LA2CO

Attachment

Current Lending Program

1. The Bank is contributing to Mexico's external financing needs in 1986-87 in a very substantial way through continued project lending and quick-disbursing operations in support of policy reforms and structural adjustment in key sectors. The Bank's annual commitments in 1987 could reach nearly US$2 billion, assisting Government initiatives in trade, agriculture, industry, transport, and urban sectors.

2. Because of the difficult structural problems of agriculture and the sector's crucial importance for one-third of the nation's population living in rural areas, the Bank has made agriculture the leading sector for its lending. The Bank has made 16 loans in FYs80-87 totalling US$2,638.93 million, for irrigation, rural and agricultural investment projects, and agro-industrial and livestock credit programs. Projects for irrigation rehabilitation, forestry, and agro-industries, are in various stages of preparation. Special emphasis has been placed in recent years on the development of rainfed areas. A broad sector adjustment operation is also in an advanced stage of processing, which would help correct the incentive regime in agriculture and reduce subsidies.

3. The Bank's lending work for industry supports: (a) trade policy reform to move towards greater uniformity of incentives and greater international competitiveness; (b) complementary financial sector policies to reverse the prolonged contraction experienced by Mexico's financial system, including its securities market; and (c) measures and programs required to encourage adequate supply responses, particularly in export promotion and industrial restructuring. Working towards the objectives of its strategy, the Bank in FY87 processed a US$500.0 million Trade Policy loan, which was complemented by a US$250.0 million Second Export Development operation. To strengthen industry's supply response to policy reform and structural change, the Bank also made a US$150.0 million Industrial Recovery loan, a US$48.0 million Industrial Technology Development loan and a US$185.0 million Fourth Small and Medium Industry loan. Projects in industrial restructuring, including the fertilizer, steel, automotive parts, textile, and agroindustry sectors are under preparation, and would help achieve the strategy objectives over the medium term.

4. Bank lending for transport has focussed on regional development, strengthening of institutions, and rationalization of public investment outlays and pricing policies. Between FYs80-87, six loans amounting to US$752.84 million were approved, including two in each of the following three subsectors: highway, railways, and ports. Additional projects to support similar goals in the urban sector were undertaken. During FYs80-87, ten urban loans were approved, totalling US$1,263.50 million, in the fields of water supply and sewerage and urban development, including a US$125.0 million Urban Transport Project which was approved on May 28, 1987. In response to Mexico's 1985 earthquake emergency, the Bank

processed a US$400.0 million Earthquake Rehabilitation Project, which the Executive Directors approved on March 25, 1986. A federal highway maintenance project was approved October 6, 1987. Additional projects are under consideration in the transport and urban sectors which would aim at strengthening the various institutions in the areas of planning, management, and finance.

ANNUAL MEETING BRIEF

Name of Country: Mexico   Date: September 2, 1987

Meeting with: Lic. Gustavo Petricioli Iturbide
Secretary, Secretariat of Finance and Public Credit
Lic. Miguel Mancera Aguayo
Director General, Central Bank
Lic. Ernesto Marcos Giacoman
Director General, NAFIN
Lic. Alfredo Philips Olmedo
Director General, BANCOMEXT
Lic. Carlos Sales Gutierrez
Director General, BANOBRAS

Population: 78.5 m (1985)   Estimated Growth Rate: 2.8% (1984-1985)

GNP per capita: $2,340 (1985)

	($m)			($m)
Total Commitments to date:	9,799.91	FY87:	Commitments:	1,678.00
of which:			Disbursements:	1,218.14
Bank (103)	9,799.91		Amortization:	506.97
IDA	-			
Total Undisbursed:	2,837.77			
Lending Program: FY88-89	2,125.00			

Summary Data	Average 1983-86	1987 (C.E.M.) (Proj.)	
GDP growth1/	0.8	3.0	IMF Status as of August 1987:
Export growth2/	-10.5	7.5	Active Standby Agreement
Import growth2/	10.3	14.0	(approved November 19, 1986)
Current Account Balance % GDP	1.4	-	
Gross Debt Service Ratio	60.1	53.8	
Annual Inflation Rate	71.4	106.0	

1/ Real GDP growth
2/ Compounded average rate of growth of dollar values.

Background:

Although Mexico has made significant efforts towards structural reforms, continuity of adjustment efforts becomes vital in order to overcome the present crisis characterized by high inflation, unemployment and deteriorating living standards. These adjustment efforts are increasingly costly for both political and social reasons.

Issues Likely to be raised by Delegation:

1. Status of Policy-Based and Restructuring Operations
2. Growth Facility
3. General Interest Rate Agreement

Issues to be raised by Bank Management:

1. Government policies in last year of Sexenio
2. Managing net transfers to Mexico
3. Bank assistance strategy
4. Delegation's views on debt crisis and Bank role

Attachments:

FIVE-YEAR LENDING PROGRAM: FY88-92

Biographical Information

Economic Background

1. In spite of the sharp fall in oil prices in 1985/86, Mexico has made major progress in its adjustment program. Supported by gains in exports, tourism and a mild recovery in construction and commerce, real GDP is expected to grow by 2% in 1987. Non-oil export earnings could surpass its 1986 value ($16 billion). International reserves, which reached US$15 billion in June 1987, continue to increase providing Mexico with a strong reserve position (about one year of imports). The imbalance on the fiscal side, however, coupled with the high exchange rate and the accumulation of reserves, has resulted in an acceleration of inflation which by end-June had reached 140% on an annualized basis. The higher inflation has a direct effect on the public sector borrowing requirements which are expected to reach about 18% of GDP by year's end (16.2% in 1986).

2. Behind the export boom lies the influence of a strong real devaluation (60% since June 1985) and the elimination of many trade restrictions. Import liberalization advanced considerably with the removal of most QRs, the phased reduction of tariffs and official reference prices (ORPs), and the signing of four key GATT codes on export subsidies, dumping, countervailing, and valuation. The aggressive management of the real exchange rate, however, needs to be supported with further trade liberalization measures and an additional effort on the fiscal side.

Prospects

3. Economic prospects are clouded by the Government's recent exchange rate and interest rate policies, and by the advent of an election year. In what appears as an attempt to lower inflation, since June the Government has slowed the pace of the adjustment in the exchange rate and lowered interest rates. Although these policies may temporarily lower the rate of inflation, if continued for too long, the competitiveness of most tradable industries and their potential to contribute to a sound rate of GDP growth in 1988 could suffer severe setbacks. Also they could result in renewed capital flight. Thus, these policies could lead to a repetition of the 1985 events when an overvalued peso and GDP growth forced by increasing public spending, led to a balance of payments crisis.

4. In our dialogue with the Mexicans, we have pressed for further trade liberalization and further fiscal efforts as a way of keeping the competitiveness of Mexican exports and reducing inflation. We have been encouraged by a recent cabinet decision to deepen the fiscal adjustment during 1987. Also, recently some further trade liberalization was achieved through the elimination of a large number of reference prices. However, because of the political pressures in an election year (1988) the Mexicans may not achieve further major trade liberalization and reductions of the operational public sector deficit. Without such actions, we estimate that by end 1987 the real exchange rate will appreciate 10 to 15 percent while the annual inflation rate will only drop to the 100-110 percent range, events that may reopen discussion within the Government on a general price freeze in the economy.

You may want to impress on the Mexicans the need for continued liberalization and budget austerity, and assure them of our support for a continuation of their adjustment programs.

Issues Likely to be Raised by Delegation

1. Status of Policy-Based and Restructuring Operations

A number of large policy/sector adjustment and restructuring operations (some of which are "trigger" loans for disbursements under Mexico's 1986-87 external financing package) are in an advanced stage of processing, but behind schedule because of delays by the Mexican authorities on key policy issues. The delegation may wish to discuss these operations.

With respect to policy based operations, you may wish to emphasize the following. Conclusion of negotiations of a Second Trade Policy Loan is pending agreement on the end target for non-tariff barrier reductions, on issuance of a statement on domestic price decontrols, and upon a study of the economic impact of procurement policies. Upon receipt of a shortened and meaningful agricultural development policy letter we can negotiate the Agricultural Sector Loan. A major issue will be how far Mexico will go in decontrolling food prices.

With respect to the Fertilizer Restructuring Loan, the main issue still to be resolved concerns the request for financing of two urea plants. As an appraisal of the economic viability of these plants could not take place before early 1988, we propose to consider financing these plants under a follow-up operation, if any. Negotiations of the proposed Steel Sector Loan are pending decisions on domestic price decontrols. Appraisal of a Power Project depends on revised tariff policies and investment program. The Mexicans have requested a quick-disbursing component under this loan which would need to be justified against broader loan conditionality covering sector-wide issues. The Industrial Restructuring Loan covering agro-industries, auto parts and textiles, will be ready for appraisal when we receive the subsector adjustment programs and proposed arrangements for channelling finance to eligible companies.

2. Growth Facility

Mexico's 1986-87 commercial financing package contains a US$500 million facility for contingency projects. The IMF has already confirmed that this facility may be triggered, and the Bank, together with the Government, is reviewing informally selected investments which would generate employment and have spillover effects on the private sector. The delegation may press for activating the facility. You should urge the Mexicans to submit a formal request to the Bank and provide all technical details required to make a judgment on the suitability of the investments proposed. We would need to agree with the Government upon procedures for investment implementation and reporting (including auditing of accounts).

3. General Interest Rate Agreement (GIRA)

We have reached an understanding with the Government on the operating principles for a new Credit Subsidy Control and Budgetting Agreement which would replace the existing General Interest Rate Agreement (GIRA). The new agreement will aim at a gradual reduction of interest subsidies sector by sector rather than fixing nominal interest rates for a multitude of subsectors as under GIRA. The Government may express reservations over the Bank's insistence that GIRA remain in effect until a new agreement is reached and convey difficulties in complying with rates in GIRA. In response, you should stress the importance of working out a methodology for measuring credit subsidies, so that a new agreement can be in place before end-1987--when further adjustments would be required under GIRA.

Issues to be Raised by Bank Management

1. Government Policies in last year of the "Sexenio"

The country is entering an election year with the Government Party (PRI)'s candidate expected to be nominated in October, and presidential elections to follow in July 1988. Over this period, the Government will face the challenge of consolidating structural reform and macro policy gains, while political pressures for more spending will build up. So far, the Government has stayed the course, as recent trade liberalization and fiscal measures confirm. You may point out to the Mexicans that the Bank's ability to assist the country with adjustment loans will depend on sound economic policies, and ask the Minister about his economic program for 1988.

2. Managing Net Transfers to Mexico

In view of Mexico's strong reserve position, there is little justification for the quick transfers of World Bank funds to Mexico. (Net disbursements are expected to reach about US$700 million in CY87). We have recently resisted requests for high levels of retroactive financing and very large major quick-disbursing loan components to ensure that we can maintain net positive transfers to Mexico during the critical next two years. You may wish to seek the delegation's understanding for this stance.

3. Bank's Medium-Term Assistance Strategy

Continued support of key structural adjustments through timely processing of policy based loans remains a principal objective of the Bank's assistance strategy in 1987-88. Concurrently, we intend to carry out an expanded program of joint economic and sector work (ESW) focusing on the main factors impeding the resumption of sustainable growth to prepare for our dialogue with the new administration and to build a strong project pipeline for the next sexenio. In late July, we proposed a comprehensive ESW program in areas of recent Bank involvement and in new areas such as the social sectors and the environment. You might invite their general reaction to how the Bank's ESW would be of better help to the Government during the 1988 transition period.

As over the next few years, the potential for new broad policy-based operations seems limited (with the possible exception of a third Trade Policy loan), we plan to emphasize Bank lending for sector investment in support of improvement on sectoral policies. You might stress, however, that we will still require assurances that macro and sectoral policies are conducive to the effective execution of such investment projects.

4. Delegation's Views on Debt Crisis and Bank Role

Since the debt crisis erupted five years ago, Mexico has maintained a non-confrontational negotiating strategy with external creditors. The Government accepted a central role for the Bank in the 1986-87 financing package. Mexico will also be host to a Latin American "summit" of eight heads of state in November dealing with debt etc. You might ask the delegation for its views on solutions to the Latin American debt crisis and the Bank's role in this respect.

LATIN AMERICA AND THE CARIBBEAN REGION

COUNTRY: MEXICO
OPERATIONS PROGRAM: FY87-91
AS OF END AUGUST 87

SECTOR			FY87	FY88	FY89	FY90	FY91	FY88_91
AGRICULTURE	PA096-AGR CR/FIRA IX-A	L	400.0	.0	.0	.0	.0	.0
	PA097-AG EXTNSN*A	L	20.0	.0	.0	.0	.0	.0
	PA090-N.W. IRRIG RHAB-C	L	.0	70.0	.0	.0	.0	70.0
	PA147-AGR SCTR LN I-C	L	.0	400.0	.0	.0	.0	400.0
	PA171-NRTH-CENTRL IRR RHB-	L	.0	.0	75.0	.0	.0	75.0
	PA102-AGR MARKTNG II-D	L	.0	.0	.0	75.0	.0	75.0
	PA165-AG SCTR II-C	L	.0	.0	.0	400.0	.0	400.0
	PA144-FORESTRY DEV-C	S	.0	.0	.0	60.0	.0	60.0
	*SUB-TOTAL AGRICULTURE		420.0	470.0	75.0	535.0	.0	1080.0
EDUC + PHN	PA161-MANPWR TRG PRJ-C	L	.0	80.0	.0	.0	.0	80.0
	PA159-HLTH PROJ-C	L	.0	.0	100.0	.0	.0	100.0
	PA117-ADULT TRG-D	L	.0	.0	.0	.0	100.0	100.0
	*SUB-TOTAL EDUC + PHN		.0	80.0	100.0	.0	100.0	280.0
ENERGY + POWER	PA113-ELEC PWR SCTR I-C	L	.0	.0	400.0	.0	.0	400.0
	PA166-ELEC PWR SCTR II-C	L	.0	.0	.0	400.0	.0	400.0
	PA168-ELECTRIC PWR SCTR II	L	.0	.0	.0	.0	400.0	400.0
	*SUB-TOTAL ENERGY + POWER		.0	.0	400.0	400.0	400.0	1200.0
INDUSTRY + IDF	PA092-EDP II-A	L	250.0	.0	.0	.0	.0	.0
	PA099-SMALL & MED IND IV*A	L	185.0	.0	.0	.0	.0	.0
	PA100-TECHNOLOGY DEVT-A	L	48.0	.0	.0	.0	.0	.0
	PA103-INDUS RECOVERY-A	L	150.0	.0	.0	.0	.0	.0
	PA129-TRADE POLICY LN-A	L	500.0	.0	.0	.0	.0	.0
	PA156-TRADE POLICY LN II-B	L	.0	500.0	.0	.0	.0	500.0
	PA107-HOUSNG FIN-D	S	.0	.0	300.0	.0	.0	300.0
	PA163-IND RESTRUC-D	L	.0	.0	.0	300.0	.0	300.0
	PA167-TRADE POLICY III-C	S	.0	.0	.0	500.0	.0	500.0
	*SUB-TOTAL INDUSTRY + IDF		1133.0	500.0	300.0	900.0	.0	1600.0
INFRASTRUCTURE	PA119-URBN TRNSPRT I-A	L	125.0	.0	.0	.0	.0	.0
	PA093-PORTS IV-B	L	.0	60.0	.0	.0	.0	60.0
	PA146-HWY MAINT-B	L	.0	135.0	.0	.0	.0	135.0
	PA136-PORTS V-D	L	.0	.0	.0	150.0	.0	150.0
	PA151-MULTI-STATE WTR-D	L	.0	.0	.0	100.0	.0	100.0
	PA157-STATE HWYS-D	L	.0	.0	.0	50.0	.0	50.0
	PA160-FED DIST WTR/SWRG-C	S	.0	.0	.0	60.0	.0	60.0
	PA108-FIFAPA IV WTR-D	L	.0	.0	.0	.0	150.0	150.0
	PA114-URBAN DEVT VI	L	.0	.0	.0	.0	175.0	175.0
	PA150-MUNIC STRENGTH	L	.0	.0	.0	.0	200.0	200.0
	PA152-URBN TRNSPRT II-D	L	.0	.0	.0	.0	200.0	200.0
	PA116-SOLID WASTE-D	S	.0	.0	.0	.0	50.0	50.0
	PA149-RAILWY SCTR-D	S	.0	.0	.0	.0	200.0	200.0
	*SUB-TOTAL INFRASTRUCTURE		125.0	195.0	.0	360.0	975.0	1530.0
	*TOTAL MEXICO		1678.0	1245.0	875.0	2095.0	1475.0	5690.0

MMcCarthy, LACCA
08/31/87

BIOGRAPHICAL SKETCHES

Gustavo PETRICIOLI
Secretary of Finance and Public Credit

Economist from Technological Institute of Mexico (IMAM). Postgraduate economic studies, Yale University. Held important positions in the Bank of Mexico and Secretaria de Hacienda y Credito Publico (SHCP) before assuming leadership of the National Stock Exchange Commission from 1976 through November 1982 when he became Director General of Comermex and General Coordinator of the Mexican Banking System. In December of 1982, he was appointed Director General of Nacional Financiera (NAFIN) until his appointment to his present position in June 1986.

Miguel Mancera AGUAYO
Director General of the Bank of Mexico

M.A. in economics from Yale University. Served under the Presidency of the Republic as Investment Commissioner. From 1962 to 1982 has held several positions within the Bank of Mexico: as Administrator, under the Director of FOMEX (Manufactured Products Export Development Fund), and Deputy Director General of Banco de Mexico (BANXICO), becoming its Director General in 1982. He resigned from this post during the latter months of Lopez Portillo Administration and was reappointed to the same position under President de la Madrid.

Ernesto Marcos GIACOMAN
Director General of Nacional Financiera

M.A. in Economics from Instituto Regiomontano. Doctorate, Notre Dame University. From 1965-1967, was Chief of Investigation, Commission on Industrial Promotion and Economic Development in Nuevo Leon. Served under the Presidency of the Republic from 1972-1975 as Chief of the Department of Economic and Social Programs. From 1976-1981 was Director General of Industries in the Secretaria de Patrimonio y Fomento Industrial (SEPAFIN), and in 1982 became its Subsecretary for Industrial Parastatals. He was Associate Director of Industrial Promotion and Subsidiary Enterprises in NAFIN before replacing Gustavo Petricioli as its Director General.

Carlos Sales GUTIERREZ
Director General of Banco Nacional de Obras y Servicios Publicos

Economics graduate from the Tecnological Institute of Mexico (IMAM). Held various positions in SHCP from 1956 to 1976 including Director General of Domestic Taxation from 1970-1975, and Director General of Treasury and International Affairs in 1976. In 1977, he transferred to NAFIN as General Manager of Fiscal Programming. He returned to SHCP in 1979, first as Deputy Director General of Public Credit and then Deputy Secretary of National Banking before assuming his present position in Banco Nacional de Obras y Servicios Publicos (BANOBRAS).

Alfredo Philips OLMEDO
Director General of Banco Nacional de Comercio Exterior

Graduate in Economics from London University and Cambridge University. Postgraduate in Economics, George Washington University. Held several positions in SHCP including Adviser to the Director General in Income Tax 1960-1961, Chief of the Department on Economic and Fiscal Programs, Director General of Economic Studies, 1962-1966, and Deputy Chief of the Department on Banking, Currency and Investments. From 1971-1975, he was Manager of International Economic Affairs in Banco de Mexico (BANXICO) and from 1975-1982 was Deputy Director of its International Affairs. In addition, between 1981-1982, he was adviser on International Affairs to the Secretary of SHCP until he assumed his current position.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

April 10, 1987

Dear David:

The recent signing of the Mexico financial package gave me an opportunity to reflect on the contributions the Bank is making to help Mexico move toward sustainable growth. I know there are often difficult circumstances involved.

I am proud of the staff's dedication to this important effort. Please convey to the staffs of the Mexico Programs Division, the Legal Department and Projects Divisions associated with the Mexico package my sincere appreciation for their continuing high-quality work.

Sincerely,

Barber

Mr. A. David Knox
Vice President
Latin America and the Caribbean Regional Office
The World Bank
A-907

cc: Messrs. Stern, Shihata, Sam

Mr. Collell

Signed

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE March 12, 1987

URGENT

TO Mr. Ossi J. Rahkonen (SECGE)

FROM Herbert V. Morais (LEGVP) Herbert Morais

EXTENSION 76321

SUBJECT MEXICO: Cofinancing - President's Memorandum

Kindly arrange to issue the attached President's Memorandum to the Executive Directors today.

The issuance of this President's Memorandum has been authorized by Mr. Stern in a telephone call from Bonn last night. (The text incorporates his comments and suggestions on an earlier draft which was faxed to him in Paris.)

Attachment.

cc: President; Messrs. Stern (o/r), Karaosmanoglu, Shihata, Knox (o/r), Steckhan, Goldberg, Vibert, Bottelier, Collell, de Souza, Rajasingham, Paul; Ms. Donovan.

R87-

From: The President

March 12, 1987

MEXICO: Proposed Cofinancing for the Second Highway Sector Project (Loan No. 2428-ME) and the Railway Sector Project (Loan No. 2575-ME); and the Growth Contingency Facility in 1987*

1. On October 3, 1986, the Executive Directors authorized the Bank to negotiate participation in two cofinancing facilities which form part of the commercial banks' overall financing package of about US$7.7 billion for Mexico, substantially in accordance with the terms and conditions described in my memorandum of October 2, 1986 (R86-245). The Government of Mexico and the commercial banks had requested the Bank to: (i) guarantee up to a maximum amount of US$500 million or 50% of the total amount drawn down and outstanding (whichever is lower) of a US$1.0 billion cofinancing loan for the Second Highway Sector Project (Loan No. 2428-ME) and the Railway Sector Project (Loan No. 2575-ME), and (ii) guarantee up to a maximum amount of US$250 million or 50% of the total amount drawn down and outstanding (whichever is lower) of a possible US$500 million Growth Contingency facility to be available from June 1987. The Bank's presence in these loans was considered to be essential in assisting the Government and the Advisory Committee representing the commercial banks in raising the necessary new money for Mexico.

Distribution

Executive Directors and Alternates
Senior Vice Presidents
Senior Management Council
Vice Presidents, IFC
Directors and Department Heads,
Bank and IFC

*Questions on this document may be referred to Mr. Pieter P. Bottelier (Ext. 72543)

2. At the Board meeting held on October 14, 1986, the Executive Directors were advised by Mr. Stern that the first stage of the negotiations, which involved the finalization of the term sheets for the two cofinancing loans, had been successfully concluded along the lines approved by the Board and that the term sheets were being issued to the commercial banks. Subsequently, in my memorandum of November 4, 1986 (SecM86-1211), I provided you with further details of the terms and conditions and the term sheets.

3. I am now pleased to inform you that the second stage of the negotiations with the commercial banks and Mexico on the legal documentation for the two cofinancing facilities has been concluded along the lines approved by the Board. The legal documentation consists of a single Multi-Facility Agreement covering all four facilities of the commercial banks' overall financing package, namely: Parallel New Money Facility of approximately US$5.0 billion (Facility 1), Cofinancing Facility for the two transport sector projects of US$1.0 billion (Facility 2), Growth Contingency Cofinancing Facility of US$500 million (Facility 3) and Investment Support Facility of US$1.2 billion (Facility 4); and an Indemnity Agreement between the Bank and Mexico. The Bank's commitments under the Multi-Facility Agreement are limited to its partial guarantee of the two cofinancing facilities (Facility 2 and Facility 3). The draft Multi-Facility Agreement, as negotiated, conforms with commercial syndicated loan practices. It has, however, been adapted to incorporate the special provisions required by the Bank to protect its own position and its special relationship with its borrower.

4. The consents required under Article IV, Section 1(b) of the Bank's Articles of Agreement have been obtained from most of the member countries in whose currencies the two cofinanced facilities are to be denominated. The few remaining consents will be obtained prior to signature of the Multi-Facility Agreement.

5. I am satisfied that the proposed participation by the Bank, through the provision of partial guarantees in respect of the two cofinancing facilities, would comply with the Articles of Agreement of the Bank.

6. Mexico and the commercial banks are planning to sign the Multi-Facility Agreement on March 20, 1987. In order to enable the Bank to sign the Multi-Facility Agreement, I recommend that the Executive Directors approve the Bank's participation in the proposed two cofinancing facilities as negotiated. In the absence of objection (to be communicated to the Vice President and Secretary, or the Deputy Secretary) by the close of business on March 17, 1987, the above recommendation will be deemed approved, and will be so recorded in the minutes of a subsequent meeting of the Executive Directors.

Barber B. Conable
President

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
CONFIDENTIAL
AUG 27 2013
WBG ARCHIVES

DATE October 9, 1987

TO Messrs. ~~Moeen~~ Qureshi, S. Shahid Husain

FROM David Bock, Director, DFS and Rainer B. Steckhan, Director, LA2

EXTENSION 72942

SUBJECT **Mexico**

1. During the Annual Meetings Mexican officials approached the Bank and briefed us with regard to a collateralized debt defeasance scheme they are contemplating. They appear to be quite serious about pursuing the scheme and have requested World Bank support. They have specifically requested that we maintain a high level of confidentiality concerning this matter.

2. Attached for your consideration is a memorandum outlining the transaction and its state of development.

3. Before proceeding further, we need your guidance on two main issues:

a) Should the Bank permit an exception to the negative pledge covenant in IBRD loans?

b) What role, if any, should the Bank play in providing comfort?

c) Related to this, is this the right time and place for the Bank to become involved in a debt defeasance scheme, given the state of other countries' negotiations?

Attachment

Weak point is issuance of s'tee.
Thanks

DF/DB:lrd

P-1866

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

DATE October 9, 1987

TO Messrs. Moeen Qureshi, S. Shahid Husain

FROM David Bock, Director, DFS and Rainer B. Steckhan, Director, LA2

EXTENSION 72942

SUBJECT **Mexico**

1. During the Annual Meetings Mexican officials approached the Bank and briefed us with regard to a collateralized debt defeasance scheme they are contemplating. They appear to be quite serious about pursuing the scheme and have requested World Bank support. They have specifically requested that we maintain a high level of confidentiality concerning this matter.

2. Attached for your consideration is a memorandum outlining the transaction and its state of development.

3. Before proceeding further, we need your guidance on two main issues:

a) Should the Bank permit an exception to the negative pledge covenant in IBRD loans?

b) What role, if any, should the Bank play in providing comfort?

c) Related to this, is this the right time and place for the Bank to become involved in a debt defeasance scheme, given the state of other countries' negotiations?

Attachment

DF/DB:lrd

CONFIDENTIAL

United Mexican States
Collateralized Debt Defeasance Scheme

The following are the principal salient features of a collateralized debt defeasance scheme being explored by UMS government officials:

- UMS would purchase a series of zero coupon bonds with a maturity of 20 years using $2 billion of its official foreign exchange reserves to effect the purchase. The face value of such bonds would total approximately $13.5 billion assuming a discount rate of 10%. The issuer of the bonds would either be the United States Treasury (UST) or the World Bank (or a combination of the two).

- UMS would issue new bonds with a 20 year maturity and a market fixed interest rate with a bullet maturity and a face value of $13.5 billion.

- UMS would pledge the zero coupon bonds as collateral to secure its principal repayment obligation under the new UMS bond issue.

- UMS would offer its commercial bank creditors the opportunity to exchange their current 20-year maturity bank loans for the newly issued UMS bonds. The exchange would be effected through a Dutch auction in which creditors would bid for the bonds by tendering their existing UMS credits at some discount. (At an average discount of 40%, approximately $22 billion of UMS bank loans would be exchanged for $13.5 billion in bonds.)

- The bonds would have somewhat of an "exit" flavor to them in that debt exchanged would be declared exempt from the "new money base" for future debt restructuring operations.

- It is anticipated that the bonds would be in bearer form and eventually listed on the Luxembourg Stock Exchange.

Current Status of Discussions

- UMS Director of External Credit, Mr. Jose Angel Gurria, met with Messrs. Steckhan, Bock, and Flannery during the Annual Meetings and outlined on a confidential basis the contemplated transaction. At that time, Mr. Gurria requested the Bank to consider providing credit enhancement support to the transaction.

- UMS officials have consulted with Secretary Baker and other UST officials and report that UST supports this transaction.

- UMS has assigned its international counsel, Messrs. Cleary, Gottlieb, Steen, and Hamilton to study the legal aspects of the transaction and design a practical structure.

- UMS has apparently mandated Morgan Guaranty Trust Company to act as its agent in undertaking this transaction.

- Cleary, Gottlieb/Morgan Guaranty officials have conducted technical discussions with UST officials and seemed optimistic on resolving outstanding technical issues.

- Cleary, Gottlieb have briefed the Bank on the current state of play and have explored various mechanisms by which the Bank might be involved.

- UMS desires to conduct the exchange offer in two tranches: the first in November/December 1987; and the second in early 1988.

<u>Issues to be resolved</u>

- In order for UMS to pledge the zero coupon investment as security for the bond issue, it will be necessary to seek the consent of its external creditors to waive negative pledge provisions of existing credit agreements. The World Bank has been asked to consider the possibility of consenting to such a waiver with regard to its UMS loan agreements with respect to this transaction. (The Legal Department is examining the request). UMS has outstanding 11 external public bond issues amounting to approximately $500 million with regard to which it will be practically impossible to secure negative pledge waivers. The solution will probably be that these bonds be secured ratably in some fashion with the new bonds.

- Morgan Guaranty has recommended that all of the collateral be based on UST zero coupon bonds. However, UST is under an informal prohibition against allowing UST securities to be used to collateralize more than 50% of any bearer bond issue. Therefore, it will have to be resolved if the collateral can include World Bank securities; or perhaps the new UMS bonds can be issued in registered form. A number of variations are being studied.

- One of the greatest uncertainties will be the level of discount at which banks will tender their existing UMS debt in the exchange offer. Morgan Guaranty has indicated a range between 30% and 50% (the current secondary market discount is 52%).

<u>Possible World Bank Participation</u>

- The World Bank might be asked to issue zero coupon bonds to be purchased by UMS and used as collateral for the transaction.
- The World Bank might consider performing some sort of agency function in which the Bank acts as a conduit of payments to bond holders and as an information clearing house.
- The Bank might establish a parallel financing link between the new UMS bond issue and all or part of the Bank's Mexican portfolio, using the optional cross default mechanism.
- The interest payments due under the new bond issue could be partially guaranteed by the World Bank. Perhaps one year's interest could be guaranteed on a rolling basis. The same effect might be achieved by having the Bank hold available some sort of revolving credit facility to fund interest payments if necessary. It has been suggested that outstanding maturities on World Bank loans made prior to 1982 could be prepaid as a means of "funding" the World Bank financial participation. Variation on this participation might involve the Bank guarantee's taking effect only after 5-7 years.
- As previously mentioned, the Bank has been asked to consider the possibility of waiving the negative pledge provisions of existing UMS loan agreements with respect to this transaction.

Attached is an annex which provides an analysis of the effect of this transaction under differing interest rate and discount assumptions.

<u>Annex</u>

Mexico: The Economics of Collateralized Debt Defeasance

1. This annex briefly presents an illustrative analysis of the economics of the collateralized debt defeasance scheme for Mexico. In particular, it illustrates the relationship between the exchange price (at which collateralized bonds replace the existing debt) and the net foreign exchange savings from the scheme that may accrue to the country.

2. Table 1 shows the steps involved in the calculations. It is assumed that an amount of $2 billion from the country's reserves is invested in 20-year (US Treasury and World Bank) zero coupon bonds to be held as collateral against the bonds replacing the debt. The combined yield is assumed at 10% per annum which implies a maturity value of $13.5 billion for the zeros.

3. An important determinant of the amount of existing debt that may be defeased with the zeros is the exchange price. It is assumed that the collateralized bonds replacing the debt would carry a coupon rate of 11.5% per annum and that at this coupon an exchange price of 60 cents to the dollar could be negotiated. At this exchange price, it would be possible to defease $22.4 billion of existing debt

4. The net saving in annual outflows is calculated by taking the difference between the scheduled interest payments on the defeased debt [1] (at an assumed interest rate of 9% per annum) and the interest payable on the bonds replacing the debt, and subtracting from this difference the dollar return on the best alternative use of the invested funds (a rate of return of 15% per annum is assumed). The net annual saving for a 60 cent exchange price thus amounts to $171 million. The net present value of total savings is also calculated and equals $1.9 billion.

5. In order to assess the impact of exchange price on potential savings, the above steps are repeated for different values of the exchange price. Tables 2 and 3 show the annual saving and the NPV of total savings respectively at various exchange prices. The relationship between price and savings is also shown graphically in Figures 1 and 2.

6. It may be seen in the charts that up to an exchange price of about 65 cents to the dollar there would be positive net savings. At higher prices savings would turn negative and the scheme may not be economically viable.

1/ Implicit here is the assumption that at present the country may be expected to continue servicing its entire debt at the current interest rates.

Table 1

MEXICO : Collateralized Exchange Scheme

Collateralized Exchange	Year		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Amount invested in zeros ($ m)		2000																				
Yield on zeros		10.00%																				
Maturity of zeros (years)		20																				
Maturity value of zeros ($ m)		13455																				
Exchange price (c/$)		60																				
Debt to be converted to bonds ($ m)		22425																				
Leverage of funds invested		11																				
Outflows under the scheme																						
Initial investment		2000	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Interest @	11.50%	0	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547
Total		2000	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547	1547
Alternative use																						
Initial investment		2000	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Return on inv. @	15.00%	0	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300	-300
Interest @	9.00%	0	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018	2018
Total		2000	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718	1718
Net savings in outflows		0	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171	171
Discount rate	9.00%																					
NPV of savings		1899																				

Table 2

Exchange price (c/$)	Annual saving($ m)
40	171
50	575
60	171
70	-117
80	-334
90	-502
100	-636

Table 3

Exchange price (c/$)	NPV of Total savings ($ m)
40	13112
50	6384
60	1899
70	-1304
80	-3707
90	-5576
100	-7071

Figure 1

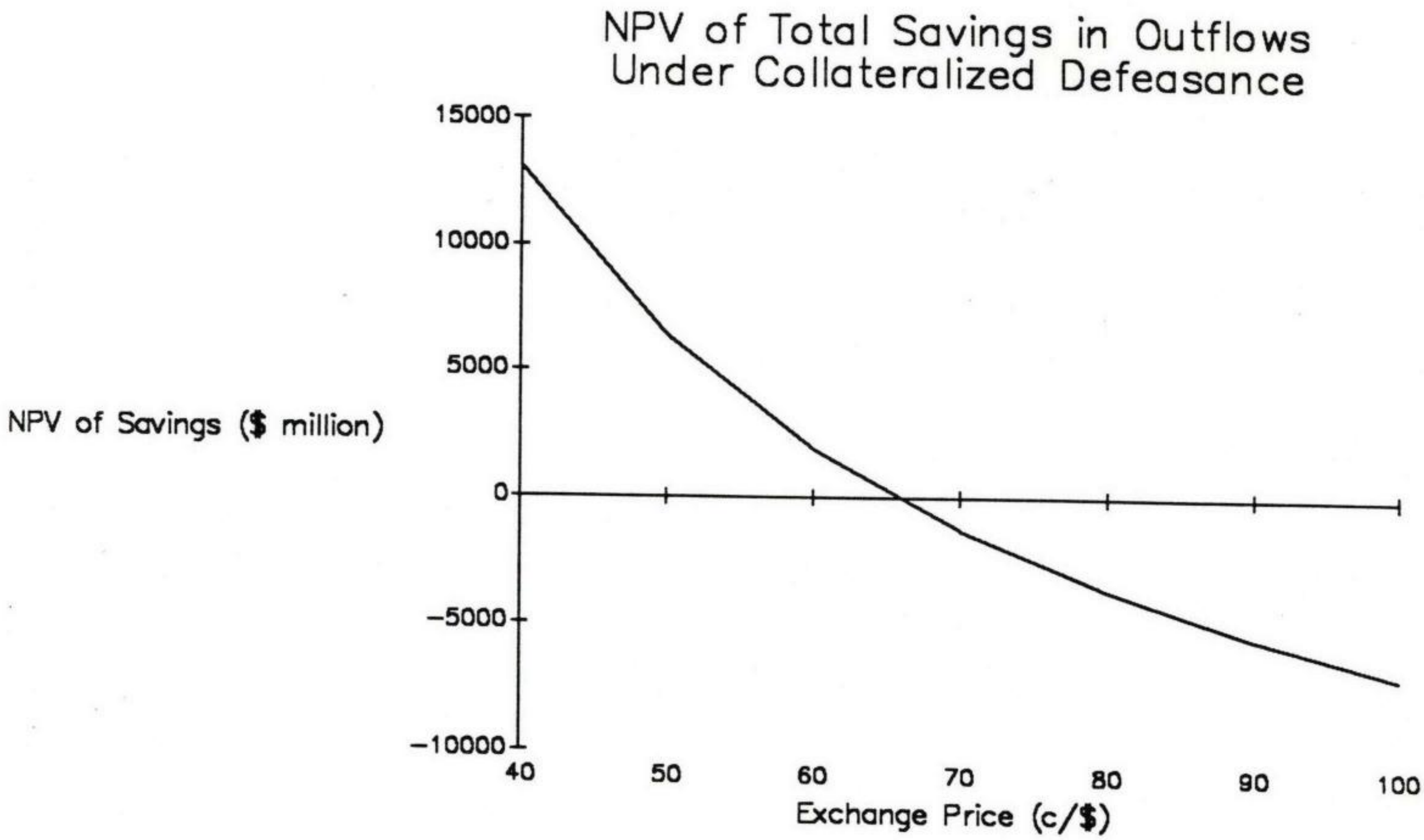
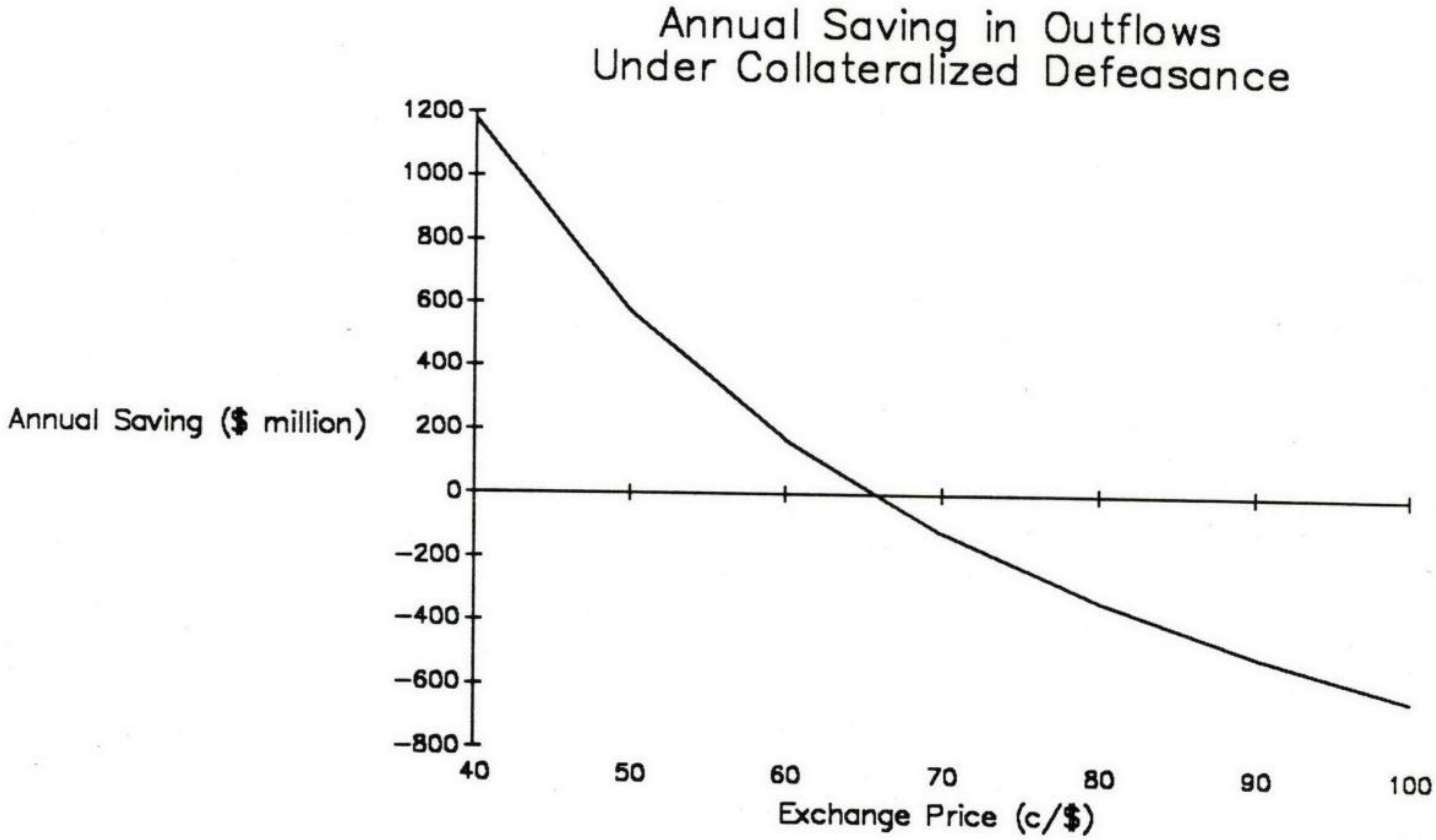

NPV of Total Savings in Outflows
Under Collateralized Defeasance
15000
10000
5000
0
-5000
-10000
NPV of Savings ($ million)
40
50
60
70
80
90
100
Exchange Price (c/$)

Figure 2



Annual Saving in Outflows
Under Collateralized Defeasance
Annual Saving ($ million)
1200
1000
800
600
400
200
0
−200
−400
−600
−800
40
50
60
70
80
90
100
Exchange Price (c/$)

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

RECEIVED DATE : 87/03/17 DUE DATE : 00/00/00
LOG NUMBER : EXC870317015
SUBJECT : Mexico--Visit of MOF on 3/18

OFFICE ASSIGNED TO FOR ACTION : Mr. Barber Conable E1227

ACTION:

__________ APPROVED
__________ PLEASE HANDLE
__________ FOR YOUR INFORMATION
__________ FOR YOUR REVIEW AND RECOMMENDATION
__________ FOR THE FILES
__________ PLEASE DISCUSS WITH ____________________
__________ PLEASE PREPARE RESPONSE FOR _______________ SIGNATURE
__________ AS WE DISCUSSED
__________ RETURN TO ____________________

COMMENTS :

cc: ISAAC SAM

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
AUG 27 2013
WBG ARCHIVES

CONFIDENTIAL

DATE : March 17, 1987

TO : Mr. Barber B. Conable

FROM : Rainer B. Steckhan, Acting RVP, LAC

THROUGH : Mr. Ernest Stern, SVPOP

EXTENSION: 74621

SUBJECT : MEXICO: Visit of Finance Secretary Lic. Gustavo Petricioli On Wednesday, March 18, 11:30 a.m.

1. Secretary Petricioli will call on you before signing the Second Export Development Project at 12:00 a.m. the same day. He and his committee will be travelling to New York for the signing of Mexico's US$7.7 billion new money package with commercial banks, currently scheduled for March 20.

Commercial Financing Package

2. The commercial bank package, if signed as scheduled, would enable the Mexicans to draw down the first tranche of US$2.5 billion plus the US$1 billion transport sector cofinancing facility. The availability of further tranches will depend on the availability of drawdowns under the IMF program for 1987 and on progress in the processing of so-called link loans of the World Bank. A US$500 million growth facility, which is part of the package, is expected to be triggered after the first quarter of CY 1987. To meet our obligations in evaluating the specific investments without delay, it is essential that the Government formally submit to the Bank a list of proposed projects within the next two weeks, so that we can undertake a formal assessment as required by the term sheets. You should encourage the Mexicans to act promptly on this matter. We also need to agree on procedures for the release of funds and for auditing, as we have already done in the case of the $1 billion cofinancing facility.

IMF Discussions

3. The first two tranches of the IMF's current Standby for Mexico were drawn down in September and December 1986. The specific quarterly performance criteria for calendar 1987 are still being discussed. The main issue concerns the size of the public sector deficit. It is not clear whether an agreed program will emerge by next Friday, before the signing of the commercial bank financing package.

General Interest Rate Agreement (GIRA) Discussions

4. We have a number of serious and pressing problems with the Mexicans over GIRA. As a result of record inflation in 1986 (106% year-to-year, last December), the average cost of funds in Mexico, the index which is used to adjust interest rates under GIRA, reached an all-time high

at 97.2%. After some delay, Mexicans informed us that for socio-political reasons they were not in a position to make all of the rate adjustments due on January 1, 1987. They also made it clear that the GIRA in its present form has become the subject of intense political criticism in Mexico. Its high visibility and great precision with regard to timing and magnitude of rate adjustments is seen by some Mexicans as a political liability of GIRA. During 1986, interest rate subsidies rose (after several years of decline) to 3.7% of GDP. It is ironic that the Mexicans are prepared to fight heavy battles with the IMF over fiscal improvements amounting to only 0.5% or 1% of GDP while at the same time permitting heavy but unbudgetted losses on interest rate accounts that could easily outweigh potential fiscal gains.

5. As envisaged under the GIRA we have stopped disbursing on all credit lines in sectors that are wholly or partially out of compliance. We have indicated to the Mexicans that we would only be able to consider their request for a waiver after the GIRA consultations requested by them in January. We offered to send a consultation mission immediately but they preferred to delay substantive discussions until after the March 20 signing of the commercial bank package. The consultations are expected to start informally this week. The Mexicans may attempt to use this meeting to short circuit the consultation/negotiating process by pressing for special concessions from you personally. You should urge the Mexicans to make their own constructive proposals and to collaborate fully towards the formulation of GIRA amendments acceptable to both sides.

6. Three loans already negotiated, including in particular a US$400 million FIRA IX Agriculture Credit Loan--which is one of the link operations--depend on a resolution of the current GIRA problems. In addition, our disbursement performance on ongoing credit lines is, of course, adversely affected by the current disbursement stoppage. This will make it harder to reach the US$1.7 billion gross disbursements in 1986 and 1987 required for release of the 5th tranche of the commercial bank new money package. You should stress that a quick and economically sound resolution of the GIRA problem is essential for the transfer of Bank resources to Mexico in 1987, as well as the scheduled drawdown of Mexico's commercial new money package.

Main Lending Issues

7. The bulk of the Bank's lending in the remainder of the current presidential term through 1988 consists of quick disbursing policy based/ sector adjustment loans. To continue our support for trade liberalization, a Second Trade Policy Loan is expected to be appraised shortly, as are other critical sector adjustment operations for steel, agriculture, fertilizers, housing, power, and in the area of three industrial subsectors (auto parts, agro-industry and textiles). Appraisal of the steel project is starting next week. The Mexicans will be particularly anxious to hear

from you that you are willing to support the steel project in spite of American opposition. Whilst the processing of the huge Mexican lending program within the Bank is progressing with relatively few delays, it is uncertain how quickly the Mexicans can move on the complex policy issues addressed by the various policy loans. All of them, with the possible exception of the steel project which is relatively speaking less controversial, are the subject of heated debate and political controversy in Mexico. And there is a limit to what the Bank can do to promote consensus building between the various Secretariats and agencies involved in the preparation process.

8. You should stress to Secretary Petricioli that it is essential to keep the momentum of trade reform and to undertake commensurate domestic decontrol measures in the key sectors of the economy where we are working with them towards restructuring objectives. Without these measures, you should caution him, Mexico may lose the benefits of courageous measures which were introduced in the recent past for completion of the stablization process and a return to sustainable growth. Nor could we make satisfactory progress on our lending program for 1987-1988 which addresses all the critical issues of the Government's growth-oriented adjustment program.

Economic Report

9. A draft economic report reviewing Mexico's performance since the crisis of 1982 and medium term prospects was distributed in Mexico last week. You may wish to request the Secretary to set an early date for discussions so that we can incorporate the Government's comments and finalize this important report soon.

Photo Opportunity

10. At the end of the meeting, before the signing ceremony, there will be a photo opportunity for journalists.

11. From the Region, the meeting will be attended by Mr. Steckhan and Mr. Bottelier (Mexico Division Chief).

cc: Mr. Knox (o/r)
Mr. Picciotto (o/r)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

① IS
② JM } INFO
③ JV (ORIG.)
(follow file)

Photo opportunity - OK'd
JWS.

DATE: March 13, 1987

TO: J. Botafogo G VPE

FROM: F.Vogl IPA

EXTENSION: 72468

SUBJECT: Mexican Loan Signing

I. I gather that a major loan signing will take place in the Bank next Wednesday with the Mexican finance minister and other top officials and, almost certainly, the media. I gather Mr. Steckhan will be signing for the Bank. Moreover, the Mexican delegation will then go to New York for the signing of the deal with the commercial banks, which will attract great publicity and at which, I gather, Mr. Stern may represent the Bank.

2. It strikes me that there is possibly a major opportunity for us here to underline in the media the increasingly central role that we are playing in the debt crisis. To do this we need to alert the media to this event and to what, as they say in the White House, could be a " photo opportunity " that involves Mr. Conable. A brief press statement quoting Mr. Conable would also help.

3. Perhaps you could take up these suggestions with Mr. Steckhan and Mr. Conable.

CC: Messrs. Sison, Bahl

Frank,

Mr. Steckhan agrees with any suggestion we may make to him to use this opportunity to ensure a good media coverage.
He told me that just before the ceremony Mr. Petricciolli, Finance Minister of Mexico, will be paying a visit to Mr. Conable.
#Photos could also be taken there.
He is going to ask Mr. Stern whether he wants to sign the loans but he does not believe Mr. Stern will want to do it.
Mr. Steckhan will designate a staff to contact Gizo monday morning for working out the details.

3-13-87

P-1866

TAMSA CONTINUOUS CASTING STEEL SHOP

As is well known, since 1976 exploration efforts made by Petroleos Mexicanos were highly successful. New oil fields were discovered and Mexico's proven oil and gas reserves increased from 5,773 million barrels at the end of 1964 to 40,192 million barrels at the end of 1978; they further increased steadily to 72,500 million barrels at the end of 1983.

Mexico was able to stop importing oil and became a world-class oil exporter. In this way it generated a substantial new source of foreign exchange (until then the most important limiting factor of the country's development efforts). The increased Mexican oil output contributed substantially to reduce the American Continent's dependence upon oil from the Middle East, an area which will probably continue being unstable in the foreseeable future. As a result of such favorable developments, the oil, petrochemical and also the capital goods industry related to the oil industry,became a key factor in the new long-term growth strategy of the country. Vital inputs for the oil industry as are the seamless steel pipe for drilling, casing, and other, placed Tubos de Acero de Mexico squarely in the same situation.

Up to 1977, TAMSA's production from its old plant could satisfy Pemex's demands of seamless steel pipe. However,starting in 1978, as a natural result of the accelerated growth of its exploration and production activities, Pemex progressively increased its consumption of seamless steel pipe. Such demands exceeded by important amounts the installed capacity of TAMSA's old plant; therefore, it was necessary for Mexico to spend large amounts of foreign exchange in the purchase of imported seamless steel pipe.

In the light of the world scarcity of seamless steel pipe that forced Pemex to buy abroad and store large amounts of steel pipe, it was only natural that the Mexican Government would request TAMSA to expand as fast as possible its productive capacity, in order to place the Mexican oil industry on a less risky footing insuring it from unreliable foreign supplies.

Responding to that request, TAMSA started its long-delayed expansion program. It was considered necessary not only to duplicate the company's productive capacity, but also to do it through a completely new plant representing the highly needed technological upgrading, in the melting as well as in the milling and finishing production facilities.

In short, the purposes of the project were the following:

1. To increase TAMSA's seamless pipe productive capacity in order to meet the additional requirements originated by the already known substantially enlarged oil reserves. Such new reserves actually positioned the country as a very important oil producer and exporter for many years to come, including the first decades of the Twenty-first Century.

2. To install a modern and "state of the art" production facility, capable of producing the high-specification steel pipe demanded by the modern and more demanding oil drilling and producing needs and conditions. In this way the necessary steps would be taken in time for the substitution of the old plant which was rapidly becoming obsolete and insufficient to meet the normal needs of Pemex.

3. To shield the oil industry from shortages of its most needed input -- seamless steel pipe. Oil is a vital activity for the Mexican economy: it is the only one that is and will be able, in the foreseeable medium-term future, to generate the foreign exchange necessary to pay for imports and to service the very large foreign debt. At the present time roughly 60% of the annual foreign exchange income of Mexico comes from exports of oil and oil-related products.

4. To improve Mexico's balance of payments, eliminating a drainage of foreign exchange through steel pipe imports and, in turn, converting the country into an exporter of this product whenever the production of TAMSA exceeded purchases from Pemex (United States has for many years been a large importer of seamless steel pipe; many other countries are also buyers).

TAMSA's planned investment for the construction of the new plant was US$700 million and included: a heat-treatment and cold finishing installation; the world's most modern continuous rolling mill (of retained mandrel) with an annual capacity of 450,000 tons of pipe; and finally, a continuous casting steel shop to produce the specialty bars of the size and type required by the rolling mill.

TAMSA has already completed the construction and is operating the above-mentioned installations, with the exception of the continuous casting steel shop. The steel shop has a projected production capacity of 500,000 annual tons of specialty bars of the precise type to feed the new rolling mill. The building of this steel shop, which is the final and essential element of the expansion program, requires an approximate investment of US$150 million. It must be mentioned that the economic and financial viability of all the investments already made by TAMSA, and the reliability of the supply of seamless steel pipe to Pemex in the years to come, depends very much on the construction of the steel shop, the reasons being:

a. Specialty steel bars in sufficient quantities to supply the new rolling mill cannot be obtained in Mexico. On the other hand, the external supply has already proven to be insufficient in volume and not very reliable, two facts that are critical for the normal operation of the new rolling mill and that affect very much the cost of production.

b. Such specialty steel bars bought abroad are more expensive than the ones TAMSA could produce with its projected steel shop. Only in this year such excess cost is estimated at US$28 million and it will increase to not less than US$40 million from 1985 on.

c. The projected savings in foreign exchange for the country which were expected to be achieved with the investment program are nullified to a large extent by such imports of specialty steel bars.

Such important considerations have driven TAMSA to advance negotiations for the necessary funding of the construction of the steel shop on the following bases:

-	Financing from Exim Bank at 8-3/4%	US$ 49 million
-	A syndicated loan with foreign banks led by the International Finance Corporation	" 50 "
-	An increase in the share capital to be placed both in the U.S. and in the Mexican markets with the participation and support of IFC	" 30 "
-	Internal funds	" 23 "
	Total	US$152 million

The Investment Committee of IFC, after considering the paramount importance of TAMSA's steel shop for the company and for Mexico, approved in principle, in December, 1983, its participation in the project including the capital and the credit packages. This position of IFC was known and gave rise to a favorable reaction by the international banks that had already stated their interest in the financing. Recently, however, the Credit Analysis Department of IFC has requested a series of additional conditions, practically impossible for TAMSA to meet, which indicate an unexpected different position regarding the operation mentioned above.

The resulting withdrawal of IFC would mean actually, the abstention of all international banks from the financing and also of other potential equity subscribers. In fact, TAMSA and Mexico would be in a position of not being able to make the physical investment, notwithstanding the important part it plays in the long-term economic strategy of the country. In addition, it would also create a very difficult financial situation for TAMSA,-the only Mexican private company with shares traded in the U.S. stock market--since the new production facility would remain unfinished and operating therefore at higher costs.

TAMSA's investment project is very sound and is related to the medium and long term needs of Mexico's oil industry. We believe that the additional conditions requested by the IFC are based mainly on concerns valid for a short term situation. Such concerns are mostly related to the temporary effects on the presently limited demand of TAMSA's products by Pemex and to the temporary distortion caused by the three-year economic adjustment program being applied by Mexico in order to meet the challenges of its foreign debt crisis.

TAMSA deems it reasonable to request that IFC may give enough weight to the strategic aspects of TAMSA's investments for Mexico's petroleum industry and for its foreign exchange earnings. The changes that may be brought about in the situation of the company and in its production costs may also be very relevant in a review that IFC could make of its position.

The Mexican Government gives a high priority to this private project. It will be very much appreciated if the IFC position regarding this project could be re-examined. From the result of this reconsideration depends the feasibility of TAMSA's project,essential to Mexico's oil industry. It would also contribute to a healthy and needed recovery of private investment at the present time.

5/30/84

2/87

Mexico
Steel

MEXICO - STEEL RESTRUCTURING PROJECT

1. The proposed US$375 million Bank loan to assist the Mexican steel industry is scheduled for appraisal in March 1987, and Board presentation in October 1987. The loan would: (a) improve performance of the steel sector by liberalizing the market environment, eliminating Government controls, and reducing and eventually eliminating subsidies; and (b) restructure the industry physically, organizationally and financially, so that it becomes more competitive and more market responsive. The loan would also support the further development of a long-term strategy for the steel sector. Effects of this strategy would be a net reduction in production capacity, a substantial change in the product mix, and an improved supply of higher quality and lower cost products in the market place.

2. Under the restructuring program, Mexican steel capacity will be reduced by about two million tons from its 1985 level of 8.2 million tons of finished steel products. A first step in this direction took place in mid-1986 when the public sector SIDERMEX shut down its Fundidora de Monterrey subsidiary and associated mines. As part of the proposed Bank project, it is expected that a further one million tons will be eliminated at the Altos Hornos subsidiary of SIDERMEX, plus 0.6 million tons should SICARTSA II be completed.

3. During the past seven years SIDERMEX has been constructing a two million ton facility, SICARTSA II, which is nearly complete through semi-finished steel production. This project is being supported by substantial Japanese and British technical and financial assistance. Its completion through finished products is now being delayed, at Bank insistence, until the long-term strategy is developed and the most rational product mix for the country identified. A summary of steel capacity, exports and imports before and after the proposed Bank loan is presented below:

Millions of Tons of Finished Products

	1985	1989	1992
Capacity on Stream	8.20	6.30	7.70
Exports	0.35	0.10	0.15
Imports	0.49	0.65	0.55

4. The proposed Bank loan would include: (a) a quick disbursing policy component to finance imports of steel products and raw materials. Trade barriers to steel would be reduced and price controls eliminated to allow market forces, domestic and international, help shape the long-term direction and content of the sector; (b) assist SIDERMEX to improve the quality of its products and further reduce costs through increased expenditures for maintenance and rehabilitation of the remaining capacity. Already 12,000 direct jobs have been eliminated and a further cut of 4,000 is expected. A major reorganization is also underway. Twenty four

non-steel subsidiaries have been or are being sold or liquidated, and the SIDERMEX steel distribution system may also be privatized; and (c) support the reorganization and help finance the market and technical studies required for development of a long-term steel strategy.

5. As important, the long-term strategy will help clarify and strengthen the important role of the private sector, and the policy measures will result in higher, trade regulated domestic steel prices. The higher prices will improve the private sector's financial condition, so that it too can rehabilitate its capacity and increase the currently insufficient servicing of its over US$1.5 billion of debt, mostly to U.S. commercial banks. Bank financial support for private sector investment is expected to take place through existing and future Bank loans to Mexican financial intermediaries.

6. The overall impact of the program will be an increased availability of higher quality and lower cost steel products, the elimination of resource mis-allocation, and an immediate reduction and eventual elimination of direct subsidies. Indirect subsidies have already been substantially eliminated through adoption of realistic pricing of basic energy inputs, i.e., electricity and natural gas. The maintenance and rehabilitation program will also help improve utilization of the remaining capacity. Because of better capacity utilization, we expect that in the next year or two Mexico's steel trade deficit will increase only to just over one-half million tons of finished steel.

7. Another important result of the restructuring will be the shift in the mix of products traded and its effect on international markets. The production and export of lower grade products should go down substantially, if not eliminated altogether, because it is in those products that capacity would be eliminated. The lower grade products compete solely on price, which makes them the most disruptive to international markets. The net effect of the restructuring will then be an increase in the level of imports, and a decrease or elimination of the disruptive effects of any Mexican exports that remain.

Industry Department
February 1987

January 27, 1987

MEXICO

BRIEFING FOR MR. BARBER B. CONABLE
FOR MEETING WITH SECRETARY OF FINANCE AND PUBLIC CREDIT,
LIC. GUSTAVO PETRICIOLI ITURBIDE
Wednesday, January 28, 1987 at 12:00 p.m.

1. Secretary Petricioli is visiting Washington for the annual bilateral discussions between Mexico and U.S. authorities. A main agenda item for this year's discussions is the 1986/87 financial package, particularly with respect to the delays experienced in finalizing the commercial bank component. We have been informed by the Mexican Embassy that the purpose of Secretary Petricioli's visit to Mr. Conable is to inform the Bank on the status of the financial package and to request the Bank's continued support. Lic. Jose Angel Gurria Trevino, Director General for Public Credit in the Secretariat of Finance, who is just returning from Europe, will accompany Secretary Petricioli. Mr. Luis Nava, Nacional Financiera's Resident Representative in Washington, will also attend.

Commercial Bank Financing Package

2. The Commercial Bank package has not yet been finalized. As of today, the US$7.7 billion package (including the contingency facilities) was about 95% subscribed, with some 200 regional and smaller banks still withholding their support. Many of these banks may have already reduced their Mexican portfolios through selling and/or writing-off their loans, whereas banks' contributions to the financing package are based on their exposures as of August 23, 1982. Further, the rather healthy Mexican balance-of-payments and reserve position for 1986 may have also led these banks into thinking that the size of the financing package is no longer justified. We feel that Secretary Petricioli is in Washington to get the support of the U.S. Administration, as well as of the Bank and the Fund, in urging the banking community to finalize the financing package.

3. Meanwhile, with the recent rise in world oil prices, it is now highly unlikely that the IMF Oil Mechanism and the Commercial Bank Investment Support Facility will trigger at all. In fact, higher oil prices may lead to reductions in undrawn commitments of the Parallel New Money Facility. The Growth Facility (related to index of industrial production and not to oil price) of US$0.5 billion, however, is expected to trigger at the end of March 1987.

Other

4. Mr. Petricioli is well informed of the forthcoming semi-annual Country Programming and Implementation Review in Mexico later this week. His Deputy, Under Secretary Francisco Suarez Davila, will be chairing the meetings. A Bank delegation, including Messrs. Steckhan and Picciotto, has just arrived in Mexico.

5. Mr. Marko Voljc, the Bank's first Resident Representative to Mexico, began work last week.

6. On January 20, the Executive Directors approved a US$250 million loan for the Second Export Development Project.

LC1MX

BBC

You might want to have a look at this before your meeting with Gus.

Pls return to me.

E

Mr. Stern

The World Bank
Washington D.C. 20433
U.S.A.

December 16, 1986

Lic. Gustavo Petricioli
Secretary of Finance and Public Credit
Secretariat of Finance and Public Credit
Palacio Nacional, 3er Piso
Mexico, D.F., Mexico

Dear Gustavo:

I am once again reporting to you on the status of projects in our lending program for calendar years 1986-88, and am attaching a table to reflect the changes in processing schedules that have been made since last month.

Export Development Project II

We have received the Government's policy statement on export development. I understand that all other conditions for Board presentation have also been met. Board presentation has now been scheduled for January 13, 1987.

Procedural not broad issues

Ninth Agricultural Credit

Trust Fund under Banco Rural

During negotiations, which started on November 17, we failed to reach agreement on two major issues: the achievement of financial self-sustainability of FIRA and FICART within a reasonable timeframe, say five years, and terms of reference for an agricultural financial subsector review. As you know, FIRA and FICART have both suffered severe decapitalization, particularly in 1982 and 1983 when inflation soared while subloans were made at fixed interest rates that were highly negative in real terms. The position has improved since 1984, mainly as a result of increased returns from higher and variable interest rates introduced by Government under the General Interest Rate Agreement (GIRA). But, as you know, interest rates are not the only vehicle for channeling financial subsidies to farmers. One of the objectives of GIRA was to implement a national system of accounting, budgeting, and control of all financial subsidies including, for example, excessive arrearages and Government sponsored credit insurance schemes. Under such a system, it will be possible to measure and control for target rates of cost and equity recovery on the part of the financial agencies responsible for the various agricultural credit programs supported by the Bank. The objective is to improve the capacity of these agencies to contribute to their own maintenance and expansion. We hope to reach agreement soon with the Government on a specific target for achieving self-sustainability and on the terms of reference for a study that could help to define a monitorable action program.

Trust for Dev. Agric under Bank of Mex

We are pleased to learn that the 50% reduction of subsidies for low income farmers will be achieved through an increase of PBI interest rates to 90% of CPP beginning January 1987.

Average Cost of funds (uses CPP to measure interest

low income farmers

Fertilizer Restructuring Project

Since my last letter, little progress has been made in resolving some of the remaining key issues, especially future pricing policy and import liberalization for fertilizers and the PEMEX/FERTIMEX relationship for ammonia/urea production. On some other important issues, agreement in principle has been reached. Perhaps the most important outstanding issue is the one on pricing. We feel that the adoption of a pricing formula linking domestic to prevailing international price levels - even if the actual production costs of FERTIMEX should be higher - is essential to achieve the objectives of this important restructuring project. I agreed with Secretary del Mazo at a meeting in Washington on November 19 that we would continue our preparatory work while Government is considering options for pricing policy reform and institutional adjustments. A follow-up meeting was held in Mexico City on December 3 between Bank staff and i.a. Undersecretaries Suarez Davila (SHCP), Paramo (SPP), Arroyo (SEMIP) and Mr. Davila (FERTIMEX). We understand that decisions regarding remaining key policy and institutional issues will be made shortly and we hope that those decisions will permit us to proceed with the appraisal of a first stage fertilizer sector restructuring project.

A second stage fertilizer project could focus on the investment requirements for the proposed two new urea plants. Unfortunately, our preparatory work on this has been handicapped by a lack of full access to all relevant information regarding the production by PEMEX and cost of ammonia. Full cooperation by PEMEX will be essential for the appraisal by the Bank of a fertilizer investment project.

Industrial Restructuring Project and Industrial Sector Loan

An identification/preparation mission in November focussed in particular on the critical need to develop a coordinated approach to the physical and financial restructuring needs arising out of the trade liberalization process. The restructuring needs of three major industries dominated by private sector participation - textiles, automotive parts, agroprocessing - have been studied in detail with the help of Mexican and foreign consultants. Their reports are being reviewed and discussed by Government and industry representatives with the active participation of Mexican development and commercial banks as well as World Bank staff. Other industries will be similarly analyzed and jointly reviewed next year. These reviews are proving to be very helpful in the formulation of an Industrial Restructuring Project aimed at meeting real industry needs, including financial restructuring. The project would also aim at assisting the Government in redressing specific regulatory and import or export restrictions that inhibit or retard meaningful restructuring at the firm level. We hope to be able to preappraise this project early next year.

We are simultaneously working, jointly with Government officials, on the formulation of a quick disbursing Industrial Sector Loan that would address further domestic regulatory and policy adjustments needed to complement the external trade liberalization process. We are hopeful that a project of this nature will be ready for appraisal during 1987.

Steel Restructuring Project

The draft sector report is being discussed in Mexico this week. We hope this will lead to a consensus on the policy and institutional issues that need to be addressed, a project definition suitable for Bank financing, and appraisal in early 1987. Because of the inevitable long term nature of a meaningful steel sector restructuring program, we would be willing to consider the feasibility of a multi-stage project approach, separating sector policy and institutional objectives from longer term investment requirements.

Power Sector Loan

The exploratory mission which visited Mexico in October made significant progress in its discussions with CFE. We are now working towards the preparation of a project to be ready for preappraisal early next year, pending agreement on a program of real tariff increases, a realistic least cost investment program, certain institutional development measures and acceptable procurement arrangements.

In the course of our efforts to place this project in a suitable energy sector context, it has become evident to us that there are a number of important broader energy sector issues that appear to require urgent study by the Government. Such issues include for example the need for conservation, overall demand management, the pricing of fuel oil and the future role of natural gas and coal as energy sources. We propose to discuss these issues with the relevant authorities and stress the need for a thorough evaluation of long term energy sector strategy options.

Agricultural Sector Loan

Sec. of Agric

A preparatory mission which visited Mexico in November had constructive discussions with key officials in SARH and other relevant Government agencies. Before we can firmly schedule appraisal, we need to discuss the Government's overall medium-term development strategy for the sector combined with an approximate timetable for the principal policy actions that are being planned, for example with regard to the further reduction of food subsidies to consumers and of input subsidies to farmers, the improved targetting of remaining subsidies, the removal of restrictions on domestic and foreign agricultural trade (including price controls), rationalization of the sugar industry, the organization of SARH and the public sector investment and expenditure program for agriculture.

Trade Policy Loans (TPL) I and II

As you know, TPL I became effective on November 18 and the first tranche of US$300.0 million has already been disbursed. All conditions for the second tranche were met on November 25, and the Bank has authorized the release of the second tranche in the amount of US$189.0 million. The remaining US$11.0 million in the loan account will be available to finance the establishment of a modernized trade information and antidumping system as well as economic and technical studies to support further trade policy rationalization and regulatory adjustments, as provided in the loan agreement. We hope to agree on the terms of reference for these study components by the time of the Country Programming Implementation Review meeting in January.

Continued successful implementation of Mexico's crucially important program to gradually open up the economy should permit us to process TPL II, as scheduled, for Board presentation in September 1987. Preparation of this follow-up loan has already started and appraisal is scheduled for March 1987. In this connection, I would like to bring to your attention an issue that will need to be addressed under TPL II. We note that the recently announced fiscal program for 1987 includes a special 5 percent uniform tax on imports, in addition to the basic import tariff. We would support a minimum tariff of 5 or even 10 percent, to reduce the overall dispersion of tariffs and effective protection and to generate increased revenue. But such a measure will need to be harmonized with the 1986-88 tariff calendar that was agreed under TPL I, so as to maintain the same overall maximum tariff ceilings.

Housing Finance Project II

In accordance with a recent request from Secretary Camacho we are trying to accelerate the processing schedule of this project. Unfortunately, despite general agreements on overall project objectives, our preappraisal mission which visited Mexico in November was unable to secure suitable understandings on the cost recovery issue which is fundamental to this project. Under the FOVI housing program, which would be supported under the proposed second Housing Finance Project, it should be possible to achieve full cost recovery within a relatively short timeframe. We trust that a satisfactory solution for this issue can be found soon so that appraisal of the second Housing Finance Project can be firmly scheduled.

Other Projects

As you know, there also are other, relatively smaller investment projects under preparation. Most of them are related to one or more of the larger policy oriented loans. They are included in the attached table where reasons for processing schedule changes, if any, are indicated in summary form.

Disbursements

Disbursements on Bank loans to Mexico for October and November totalled US$86.78 million and US$350.23 million respectively. The November figure includes US$300 million for the first tranche of TPL I. The disbursement total for projects approved through June 30, 1986, stands at US$552 million as of the end of November compared to our original target of US$800 million for the year as a whole for this group of projects. It is now very unlikely that this original target will be achieved. Including TPL I disbursements, we expect that 1986 year total disbursements from all effective loan accounts will be of the order of US$1.1 billion, about US$200 million below the aggregate target level that I discussed with you in August. The shortfall is mainly due to the slow processing of withdrawal applications by Government agencies, in particular with respect to the Earthquake Reconstruction loan.

Country Programming Implementation Review

As was recently agreed with your officials, we will hold a joint Country Programming Implementation Review (CPIR) meeting on January 26 and 27, 1987 in Mexico. I propose that the meeting focus on the major policy issues to be addressed under the policy and sector loans currently under preparation. We will submit a discussion paper to you shortly to explain our perspective on the objectives of the various proposed projects concerned, including TPL II, the Agricultural Sector Loan, the Industrial Restructuring Project, the Industrial Sector Loan, the Fertilizer Project, the Steel Project, the Power Project and the second Housing Finance Project. The role of other, relatively smaller projects in the overall lending program, will be reviewed as well. In addition we would like to review major project implementation problems which continue to hinder the effective execution of several of our ongoing projects.

The main objective of the discussion paper to which I referred would be to promote a common understanding of the policy objectives and inter-relationships between the various project proposals. Mr. Rainer Steckhan will lead the Bank's team and the delegation will also include Mr. Picciotto, who succeeded Mr. van der Meer as Regional Projects Director a few months ago, Mr. Bottelier, and other key staff working on the Mexico program.

Future Periodic Reviews of Lending Program

I propose that we henceforward keep you advised of the progress and major issues that need to be resolved on a quarterly basis. Mr. Knox or I will be in touch with you more frequently if required by the circumstances.

Sincerely,

(Signed) Ernest Stern

Ernest Stern
Senior Vice President
Operations

Attachment

cc: Lic. Francisco Suarez Davila, Undersecretary, SHCP
Lic. Jose Angel Gurria, Director General for Public Credit, SHCP
Lic. Jose Luis Flores, Director for International Financial Organizations, SHCP
Lic. Timoteo Harris, EDS

Cleared with and cc: Messrs. Steckhan, LCIDR
Picciotto/Jennings, LCPDR

cc: Messrs. Knox, LCNVP
Golan, INDDR
Wessels/Aguirre-Sacasa/Finzi, LCPDR
Landau, LCIDR
Thornley/Knudsen, LCPAC
Schultz/Page/von Loehneysen/Saadat/Prasad, LCPI2
Alber-Glanstaetten, LCPI2
Raghavan, INDD2
Rowat, INDD3
Sood/Lieberman, INDRE
R. Stern, INDD4
Thint, LCPUR
Moscote, LCPEN
LCIMX staff

MEXICO

PROCESSING SCHEDULE FOR PROPOSED OPERATIONS CY1986-88

	Previous Schedule				Revised Schedule				Reason for Important Changes in Major Operations
	Appraisal	Negot.	Board	Effect.	Appraisal	Negot.	Board	Effect.	
I. 1986 COMMITMENTS									
A. Major Operations									
Trade Policy Ln. I	Completed	Completed	Completed	11/86	Completed	Completed	Completed	Completed	
EDP II	Completed	Completed	11/86	02/87	Completed	Completed	01/87	04/87	Delay in receipt of Government Exp Development Policy Statement (now received).
FIRA IX	Completed	11/86	12/86	03/87	Completed	11/86	02/87	05/87	Recess in negotiations pending resolution by Government of self-sustainability issue.
B. Other Operations									
Industrial Recovery	Completed	Completed	Completed	11/86	Completed	Completed	Completed	Completed	
Technology Development	Completed	Completed	Completed	Completed	Completed	Completed	Completed	Completed	
Tropical Agriculture	Completed	Completed	Completed	Completed	Completed	Completed	Completed	Completed	
Emergency Reconstruction	Completed	Completed	Completed	Completed	Completed	Completed	Completed	Completed	
Municipal Development	Completed	Completed	Completed	Completed	Completed	Completed	Completed	Completed	
Solid Waste Pilot	Completed	Completed	Completed	Completed	Completed	Completed	Completed	Completed	
II. 1987 COMMITMENTS									
A. Major Operations									
Small/Med. Industry IV	Completed	01/87	05/87	08/87	Completed	02/87	05/87	08/87	
Fertilizer Restructuring	02/87	07/87	09/87	12/87	02/87	07/87	09/87	12/87	Tentative. To be reviewed again on receipt of Government restructuring plan.
Agric. Sector Ln. I	01/87	06/87	07/87	10/87	01/87	06/87	07/87	10/87	
Trade Policy Ln. II	03/87	07/87	09/87	12/87	03/87	07/87	09/87	12/87	
Ind. Restructuring	02/87	06/87	08/87	11/87	04/87	08/87	10/87	01/88	As agreed during the identification preparation mission last month, preappraisal mission would take pla in February 1987.
Steel Restructuring	02/87	07/87	10/87	01/88	02/87	07/87	10/87	01/88	Tentative. To be firmed-up after December review of sector report.
B. Other Operations									
Agric. Extension	Completed	03/87	06/87	09/87	Completed	03/87	06/87	09/87	
Agro-Industries	01/87	05/87	07/87	10/87	03/87	08/87	10/87	01/88	
Dairy Development	01/87	06/87	08/87	11/87	06/87	10/87	12/87	03/88	Assuming the preparation report establishes the project's economic and technical feasibility, a preappraisal could go out in January 1987. Project preparation report not yet received.
Highway Maintenance	10/86	03/87	07/87	10/87	Completed	04/87	07/87	10/87	
Ports IV	11/86	06/87	08/87	11/87	Completed	06/87	08/87	11/87	
Manpower Training & Dev.	01/87	06/87	09/87	12/87	02/87	06/87	09/87	12/87	
Urban Transport	Completed	01/87	02/87	05/87	Completed	01/87	02/87	05/87	
III. 1988 COMMITMENTS									
A. Major Operations									
Power I	06/87	11/87	01/88	04/88	06/87	11/87	01/88	04/88	
Industrial Sector	01/88	05/88	07/88	10/88	01/88	05/88	07/88	10/88	
Agric. Sector Ln. II	03/88	07/88	10/88	12/88	03/88	07/88	10/88	12/88	
Trade Policy III	02/88	05/88	07/88	10/88	02/88	05/88	07/88	10/88	
B. Other Operations									
Irrigation Rehabilitation	04/87	09/87	01/88	04/88	06/87	10/87	10/88	04/88	
Forestry	07/87	12/87	02/88	05/88	11/87	03/88	05/88	08/88	Final feasibility report would not be completed until June 1987 as discussed with the Government and FAO. Preappraisal scheduled in July 1987.
Health	09/87	01/88	[illegible]	10/88	09/87	05/88	07/88	10/88	
Housing Dev. II	03/87	10/87	[illegible]	02/88	03/87	10/87	11/87	02/88	
Fed. District Water, Sewerage	09/87	01/88	07/88	10/88	09/87	01/88	07/88	10/88	
FIFAPA IV (Water)	09/87	03/88	07/88	10/88	01/88	05/88	07/88	10/88	Delay in implementation of FIFAPA III precludes start of preparation for FIFAPA IV.

LCIMX
December 16, 1986

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

RECEIVED DATE : 87/01/30 DUE DATE : 00/00/00
LOG NUMBER : EXC870130009
SUBJECT : (VNERCISSIANTZ) MEXICO: MR. CONABLE'S MEETING WITH SEC. GUSTAVO PETRICIOLO ON 1/28/87.
OFFICE ASSIGNED TO FOR ACTION : MR. BARBER CONABLE E1227

ACTION:

- ____ APPROVED
- ____ PLEASE HANDLE
- ✓ FOR YOUR INFORMATION
- ____ FOR YOUR REVIEW AND RECOMMENDATION
- ____ FOR THE FILES
- ____ PLEASE DISCUSS WITH ________
- ____ PLEASE PREPARE RESPONSE FOR ________ SIGNATURE
- ____ AS WE DISCUSSED
- ____ RETURN TO ________

COMMENTS : Copy given to Isaac.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
AUG 2 7 2013
WBG ARCHIVES

CONFIDENTIAL

DATE: January 29, 1987

TO: Memorandum for the Record

FROM: V. Nercissiantz, Acting Division Chief, LC1MX

EXTENSION: 72575

SUBJECT: MEXICO - Mr. Conable's Meeting with Secretary Gustavo Petricioli

1. On January 28, 1987, Mr. Conable met with Finance Secretary Gustavo Petricioli. Messrs. Jose Angel Gurria of the Finance Secretariat and Luis Nava of NAFIN accompanied the Secretary. Ms. Rubio (ED) and Messrs. Stern, Knox, Sam, and I also attended the meeting.

2. Referring to the 1986/87 financial package for Mexico, Secretary Petricioli expressed his deep concern with respect to the delays experienced in finalizing the commercial bank component. As of date, the $7.7 billion package was about 95% subscribed and many regional and smaller banks were still withholding their support. He said that without completion of the package, the Government will not be able to continue with policy reforms because, after substantial domestic sacrifices, the Mexican public expects the international financial community to come through with the financial package. He felt that this would be essential for rallying the psychological and political support needed for the Government to undertake further reforms towards opening the Mexican economy.

3. Secretary Petricioli emphasized that timing for completion of the financial package is now critical. Firstly, because extended delays would endanger the existing commitments (95% of the package) and, secondly, announcement of major policy reforms cannot be delayed beyond February or early March 1987 (presumably because of the forthcoming Presidential election campaign). He concluded that the financial package must be concluded this week or next in order to avoid the above risks. Secretary Petricioli then added that he will be meeting Chairman Volcker and Secretary Baker later in the afternoon to discuss the situation and seek their assistance in developing a strategy for completion of the financial package. Secretary Petricioli said that he would appreciate the Bank's continued support.

4. Messrs. Conable and Stern concurred with Secretary Petricioli's assessment regarding the urgency to conclude the financial package and offered continued Bank assistance to Mexico. Secretary Petricioli was asked to keep the Bank informed about the outcome of the discussions with Messrs. Volcker and Baker so that the Bank can determine how to assist.

5. Secretary Petricioli then expressed his concern about the low priority which he felt was now being given to the Mexican package by the international community. He thought that whereas a very high priority was given to the Mexican case last Fall, it seemed to have declined since then.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

RECEIVED

1987 JAN 30 PM 12:39

DECLASSIFIED
AUG 27 2013
WBG ARCHIVES

CONFIDENTIAL

DATE: January 29, 1987

TO: Memorandum for the Record

FROM: V. Nercessiantz, Acting Division Chief, LC1MX

EXTENSION: 72575

SUBJECT: MEXICO - Mr. Conable's Meeting with Secretary Gustavo Petricioli

1. On January 28, 1987, Mr. Conable met with Finance Secretary Gustavo Petricioli. Messrs. Jose Angel Gurria of the Finance Secretariat and Luis Nava of NAFIN accompanied the Secretary. Ms. Rubio (ED) and Messrs. Stern, Knox, Sam, and I also attended the meeting.

2. Referring to the 1986/87 financial package for Mexico, Secretary Petricioli expressed his deep concern with respect to the delays experienced in finalizing the commercial bank component. As of date, the $7.7 billion package was about 95% subscribed and many regional and smaller banks were still withholding their support. He said that without completion of the package, the Government will not be able to continue with policy reforms because, after substantial domestic sacrifices, the Mexican public expects the international financial community to come through with the financial package. He felt that this would be essential for rallying the psychological and political support needed for the Government to undertake further reforms towards opening the Mexican economy.

3. Secretary Petricioli emphasized that timing for completion of the financial package is now critical. Firstly, because extended delays would endanger the existing commitments (95% of the package) and, secondly, announcement of major policy reforms cannot be delayed beyond February or early March 1987 (presumably because of the forthcoming Presidential election campaign). He concluded that the financial package must be concluded this week or next in order to avoid the above risks. Secretary Petricioli then added that he will be meeting Chairman Volcker and Secretary Baker later in the afternoon to discuss the situation and seek their assistance in developing a strategy for completion of the financial package. Secretary Petricioli said that he would appreciate the Bank's continued support.

4. Messrs. Conable and Stern concurred with Secretary Petricioli's assessment regarding the urgency to conclude the financial package and offered continued Bank assistance to Mexico. Secretary Petricioli was asked to keep the Bank informed about the outcome of the discussions with Messrs. Volcker and Baker so that the Bank can determine how to assist.

5. Secretary Petricioli then expressed his concern about the low priority which he felt was now being given to the Mexican package by the international community. He thought that whereas a very high priority was given to the Mexican case last Fall, it seemed to have declined since then.

6. Mr. Stern explained that the priority was still very high for the Mexican package. The slow progress, however, was partly due to the fact that the commercial banks are split within the US and vis-a-vis European banks on financial packaging of the external debts of their major borrowers. Moreover, since Mexico was successful in negotiating a very favorable deal with the Steering Committee, and the amounts were so large, there had been considerable difficulties in persuading the smaller banks to subscribe. Furthermore, higher oil prices and a healthy Mexican balance of payments and reserve position may have also led some banks into thinking that their contribution may not be necessary. Mr. Stern then queried whether the Government is considering offering more attractive deals to those banks that are now outside the package in order to bring them around.

7. Responding to this latter point, Mr. Gurria said that this was very risky as it may lead to similar demands by participating banks under the existing package, and open the negotiations which in turn may cause the package to collapse altogether.

8. Mr. Knox said that if the Government sets a new deadline to close the deal and subsequently fails, then there must be a strategy for alternative ways of addressing the problem.

9. Mr. Stern asked whether it would help to invite the 12 US regional banks who are now outside the package to come to Washington for creditor/debtor discussions with a view to closing the deal; the Bank would, of course, assist through presentations or by whatever means possible. Mr. Stern added that, on the US side, participation of the 12 regional banks was critical and progress here could be the key towards completion of the entire package. Secretary Petricioli replied that this was a good idea to explore and he said he would discuss it with Messrs. Volcker and Baker and inform the Bank of the outcome.

10. Towards the end of the meeting, Secretary Petricioli expressed his support for the CPIR Meetings scheduled to take place later this week in Mexico and, once again, emphasized that the Government's ability to announce and implement the policy reforms sought in the CPIR discussions would very much depend on timely completion of the financial package.

Cleared with and cc: Mr. Sam, EXC

cc: Messrs Stern
Knox, LCNVP
Koenig, LC1 (Acting Director)
Steckhan, LC1DR (o/r)
Picciotto, LCPDR (o/r)
Bottelier, LC1MX (o/r)

VNercissiantz:ak

1/23.

MEXICO - Briefing Note for Mr. Barber Conable
for Meeting with Mr. Rodman Rockefeller

1. On Friday, January 23, 1987, at 10 a.m., you will meet with Mr. Rodman Rockefeller, Chairman of the U.S. Council of the Mexico-U.S. Business Committee and several members of the Advisory Group on Capital Development for Mexico. The main objective of the Advisory Group is to develop views on policies deemed most conducive to new private investment and growth in Mexico. This is being carried out in consultation with U.S. and Mexican Government officials, industrial and banking leaders of both countries, and the multilateral financing institutions. Mr. Rockefeller and his colleagues would like to discuss the World Bank role in the recovery and growth of Mexico and at the same time brief you on their recent trip to Mexico where they have already met with representatives of the Government and the private sector.

2. You may wish to start the discussion by providing an overview of Mexico's economic program and the make-up of the 1986-87 financing package that is proposed to be provided in support of this program. A fact sheet on the financing package is attached. As you know, the commercial Bank package has not yet been finalized.

Mexico's Economic Program

3. The World Bank has worked with the Government on the program of growth-oriented adjustment and structural reform, and is of the view that, if implemented effectively over the next several years, it constitutes a sound basis for Mexico to resume production and employment growth on a sustainable basis. Mexico's program is designed to improve the efficiency and competitiveness of the economy through significant trade liberalization and a reduction in the size and scope of the public sector. Trade liberalization measures already implemented include accession to the GATT, elimination of import restrictions on more than 60% of the total value of imports and reduction in import tariffs from a maximum of 100% to 45% at present. The Government's intention regarding further trade liberalization, including specific commitments to remove all import reference prices by end 1987 and to reduce tariffs to a range of 0-30% by end 1988, has been publicly announced. Structural change in the area of public expenditures is being carried out along two lines: through the selling, merging, closing, and/or transferring of non-strategic and non-priority firms and industrial reconversion. The latter will be supported by the Bank through two specific projects in fertilizers and steel, as well as industrial sector and restructuring loans.

Foreign Direct Investment

4. Rules concerning foreign investment have been selectively liberalized, especially for small and medium scale industries and in the areas relating to non-oil exports and the transfer of technology. The Government has also recently issued procedures for debt-equity swaps.

MIGA

5. Mexico had abstained from supporting the resolution adopted by the the Board of Governors during the Seoul meetings of 1985. Bank position had been to wait until Brazil and Argentina signed the agreement on MIGA before approaching Mexico. Bank may now reconsider this position in view of some positive signs coming out of Mexico recently.

World Bank Role

6. As part of the international financial package negotiated last year between Mexico and her commercial bank creditors, the World Bank is tentatively committed to a net disbursement total of US$2.3 billion during the two year period 1986/87. This amount includes the net present value (estimated at about US$200 million) of guarantees. A large portion of our lending will be made available to the private sector through a variety of credit programs in agriculture, industry, mining, and housing. In this regard, you may want to give special emphasis to our recent Trade Policy Loan, the Export Development Loan II (Board approval 1/20/87), as well as forthcoming industrial restructuring loans for fertilizer, steel, and private sector firms in a variety of subsectors. Finally, you may want to touch upon the linkages between World Bank loans and the commercial banks' financing (including aspects that relate to our guarantees, parallel and co-financing).

7. As Mr. Rockefeller and his colleagues may have special interest in the proposed Bank-assisted projects that relate to industrial reconversion/restructuring, a summary paragraph is provided below for each of these projects:

8. Industrial Restructuring Loan is intended to provide financing to (private) firms undertaking restructuring operations in subsectors or product lines that are being freed of non-tariff Barriers, price controls, domestic content requirements, and similar market restrictions. It is intended to help the (private) industrial sector to cope with increased competitive pressures and high indebtedness. The project will have components of policy reform, credit supply, equity mobilization and financial engineering.

9. Steel Sector Restructuring would support implementation of a strategy to restructure the steel sector. The project is not aimed at capacity expansion. We envisage the following main components of the project: (i) Implementation of policy adjustments including removal of domestic price controls, effective liberalization of imports, and development of a national steel policy clearly identifying the role of the public and private sectors and stimulating private investments; (ii) Restructuring of Sidermex, including its corporate reorganization and financial restructuring; and (iii) Technical assistance package to private sector steel firms.

10. Fertilizer Sector Restructuring would aim at establishing the sector on a sound competitive basis by: (i) closing uneconomic plants and reducing production inefficiencies; (ii) partial privatization of the distribution system; (iii) gradual elimination of subsidies; and (iv) corporate reorganization and financial restructuring of FERTIMEX.

Mr. Bottelier, Mexico Division Chief, will attend the meeting.

Cleared in substance with and cc: Mr. Steckhan, LC1DR

Mexico Division
January 21, 1987

ATTACHMENT

FACT SHEET ON THE MEXICAN EXTERNAL FINANCING PACKAGE

A. Commercial Banks	Amount (US$ Bns)	Maturity/ Grace (Years)	Interest
1. New Money			
(a) Direct Syndication	5.0 1/	12/5	LIBOR + 13/16
(b) World Bank Cofinancing 2/	1.0	15/9	LIBOR + 13/16
2. Contingency Facilities 3/			
(a) Investment Support Contingency	1.2	8/4	LIBOR + 13/16
(b) Growth Contingency 4/	0.5	12/7	LIBOR + 13/16
3. Modification in Payment Terms of Existing Debt			
(a) Pre-1983 Debt (Previously Restructured)	43.7	20/7	LIBOR + 13/16
(b) Debt Contracted in 1983/84	8.55	No Change	LIBOR + 13/16
4. Private Debt (FICORCA)	11.2	(To be restructured on terms comparable to the restructuring of public debt).	
5. Interbank Credit Lines	5.2	(The minimum level to be maintained until June 30, 1989)	
B. Other 1986/87 Financing			
1. IMF			
Stand-by Facility (18 months)	SDR 1.4 (about US$1.7 bn)		
Oil Price Contingency	SDR 0.6 (about US$0.7 bn)		
2. World Bank 5/	2.3		
3. IDB	0.4		
4. Japan 6/	1.0		
5. Paris Club 7/	1.8	10/5	
6. CCC	0.6		

Note: Total net additional resources to be made available to Mexico under the package (including Paris Club rescheduling and contingencies) for 1986/87 amount to about US$16.2 billion.

1/ To be reduced by amount saved by Mexico in 1987 as a result of lower spreads on old debt and shift from Prime to LIBOR, negotiated as part of the overall package (estimated at about US$300 million).

2/ B-Loan cofinancing with World Bank transport sector loans. A non-accelerable World Bank guarantee for US$500 million is being negotiated.

3/ In lieu of oil price contingency proposed by IMF.

4/ Has US$250 million in World Bank guarantees.

5/ Includes net present value (NPV) of the two World Bank guarantees of about US$180 million (face value of US$750 million).

6/ US$240 million in cofinancing with the Export Development Loan II, US$260 million for steel projects and US$500 million for the Pacific Petroleum Project.

7/ Rescheduling of 100% of the principal falling due through the first quarter of 1988 and 60% of the interest payments falling due through the end of 1987. Interest on rescheduled debt to be fixed bilaterally on the basis of "appropriate market rates."

THE WORLD BANK
Washington, D. C. 20433
U.S.A.

A.W. CLAUSEN
President

June 20, 1986

Dear Chucho:

It is with great regret that all of us here at The World Bank received the word of your resignation from the Cabinet. It is our hope and wish that the enormous effort and sacrifices made by you and your team during the past several years will bear fruit for the benefit of Mexico and the world as a whole. On behalf of my colleagues, let me also express our thanks to you for the trust you have placed in The World Bank in spite of our occasional differences. Over the years, we have greatly benefited from our intensive and candid dialogue with you on critical Mexican and global development policy issues.

More personally, Chucho, I want you to know how much I respect and admire you as a statesman and public servant of Mexico. You have done an outstanding job in a difficult political and economic climate. And there are still great things awaiting you and you have so much yet to contribute to your country.

Please be assured of the value I place on our friendship of many, many years and the support you have always given me. As you know, my term here at The World Bank finishes on June 30 but I will be staying in Washington for a bit, so if you come this way, be sure to get in touch. I'm enclosing a card with my new address and phone number.

Warm regards.

Sincerely,

Lic. Jesus Silva Herzog
Cerro de Xico No. 44
Colonia Oxtopulco Universidad
Coyoacan
04310 Mexico, D. F., Mexico

BC: D. Knox
R. Steckhan
P. Bottelier

Fact Sheet on the Mexican Financial Package

	Amount (US$Bn)	Maturity/ Grace Years	Interest
A. Commercial Banks			
1. New Money			
(a) Direct Syndication	5.0 1/	12/5	LIBOR + 13/16
(b) World Bank Co-financing 2/	1.0	15/9	LIBOR + 13/16
2. Contingency Facilities 3/			
(a) Investment Support Contingency	1.2	8/4	LIBOR + 13/16
(b) Growth Contingency 4/	0.5	12/7	LIBOR + 13/16
3. Modification in Payment Terms of Existing Debt			
(a) Pre-1983 Debt (Previously Restructured)	43.7	20/7	LIBOR + 13/16
(b) Debt Contracted in 1983/84	8.55	No Change	LIBOR + 13/16
4. Private Debt (FICORCA)	11.2	(To be restructured on terms comparable to the restructuring of public debt).	
5. Interbank Credit Lines	5.2	(The minimum level to be maintained until June 30, 1989)	
B. Other 1986/87 Financing			
1. IMF			
Stand-by Facility (18 months)	SDR 1.4 (about $1.7 bn)		
Oil Price Contingency	SDR 0.6 (about $0.7 bn)		
2. World Bank 5/	2.3		
3. IDB	0.4		
4. Japan 6/	1.0		
5. Paris Club 7/	1.8	10/5	
6. CCC	0.6		

Note: Total net additional resources to be made available to Mexico under the package (including Paris Club rescheduling and contingencies) for 1986/87 amount to about $16.2 billion.

THE WORLD BANK

Office of the President

October 31, 1986

Mr. Conable:

MEXICO

You had enquired about progress towards achieving the $6 billion commercial banks contribution to the Mexican package.

As of last night, commitments received amounted to 40% or $2.4 billion. The deadline is today, but I suspect that the IMF will keep the door open beyond the end of the day if by then commitments for the full $6 billion have not been received.

Mr. Rainer Steckhan will keep you informed.

Isaac

Isaac

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Mexico - Country Files - Correspondence - Volume 1	1779794

Document Date	Document Type
Aug 13, 1986	Letter

Correspondents / Participants
Mr. Barber Conable

Mr. R.T. McNamar

Subject / Title
The 1986 Mexican Program

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☑ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

Reason for Removal
Information Provided by Member Countries or Third Parties in Confidence

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	Aug 27, 2013

CONFIDENTIAL

August 5, 1986

Mr. Barber B. Conable
(through Mr. Willi Wapenhans, Acting SVPOP)

Re.: Mexico - Commercial Debt Rescheduling

I just called Bill Rhodes, Chairman of the Mexico Advisory Committtee, to see how things were going. Bill says:

a) He has spent all weekend working on the bridging loan and there are still problems since--as he put it--the public sector did not coordinate well (as you know, we are not a partner to these negotiations. However, the "public sector" hopes to get reimbursed out of the World Bank disbursements to Mexico and Legal Department and Treasury are in touch on this aspect).

b) The only problem he sees with the World Bank at present is our position on the $500 million additional investment program in case the first quarter of 1987 shows no growth in Mexico (we had told the Advisory Committee that we would be happy to assess the soundness of a $500 million additional investment program, but would not normally participate in its financing).

c) The Economic Subcommittee is presently working with the Mexican authorities in Mexico City on the projections and will report back to the full Advisory Committee next Monday. Thereafter Bill Rhodes will get in touch with us.

d) As far as the price of oil is concerned, he hopes it will stay up so that the banks are not asked to put additional funds (which is foreseen in the standby letter if the price of oil drops below $9 per barrel).

e) He has just written you a letter on "cofinancing" between commercial banks and the World Bank in situations such as Mexico, and is looking forward to your answer (I do not think the letter has arrived yet).

f) He asked me again about the status of the Earthquake Reconstruction Loan and I replied that, according to our latest information, a Mexican official is travelling to Washington tomorrow with the necessary documents. I added that we had to examine these documents--which could be done quickly--to see whether they conform to our effectiveness conditions. I shall advise him as soon as this loan can be disbursed.

After checking with the IMF, my impression is that the commercial banks are beginning to put the heat on the Managing Director because of the tight schedule (the Managing Director would like an IMF Board meeting on September 8, which means the critical mass--something like 90 percent of all commercial banks agreeing to a deal--would have to be in September 5. It also means that the Advisory Committee would have to have a deal and send out messages by August 18 to all 500 member banks. At that time, they would also need messages from the IMF, World Bank, and IDB supporting whatever deal was negotiated by them. All this is obviously an extremely tight schedule indeed).

I will talk to the Mexican authorities later this afternoon and will keep you advised as necessary.

RBS
Rainer B. Steckhan

cc. Mr. Knox (o/r)
Mr. Bottelier, LC1MC (o/r)
Mr. Bock, FPADR
Mr. Vibert, VPCAU
Mr. Morais, LEGVP

February 12, 1986

Dear Chucho:

I want you to know how much I appreciate the special effort which Mexico has made in denominating its IDA7 contribution in Special Drawing Rights (SDRs). This decision not only increases the resources available to IDA, which are vitally needed to assist our low-income member countries, but also sets an example which I hope other donors will follow.

It is especially laudable that your government has taken the decision to implement its pledge to IDA7 in this way despite the extreme economic and financial difficulties which Mexico is facing.

Let me thank you also for your expression of confidence in IDA's effectiveness and in its key role in concessional assistance. We, of course, share your hope that the developed countries will increase their efforts for the transfer of concessional resources, especially through a substantial replenishment of IDA8. I trust we can continue to count on Mexico's support during the course of the IDA8 negotiations.

Warm regards.

Sincerely,

A. W. Clausen

His Excellency
Jesus Silva-Herzog
Minister of Finance and
Public Credit
Palacio Nacional, 3er Piso
Mexico City 1, D. F., Mexico

bcc: Ms. Filardo de Gonzales
Messrs. Qureshi
Bock

FORM NO. 89
(2–83)

THE WORLD BANK

ROUTING SLIP	Date Feb. 3, 1986

OFFICE OF THE PRESIDENT

Name	Room No.
Mr. Qureshi	E-1241

	To Handle		Note and File
	Appropriate Disposition	XX	Prepare Reply
	Approval		Per Our Conversation
	Information		Recommendation

Remarks

Would you please prepare a reply for Mr. Clausen's signature by February 10?

Roy Southworth

From

18920
02/03/86
①
cc Mr Mistry
cc: [illegible]

G.H.1

127

ESTADOS UNIDOS MEXICANOS

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

SECRETARIA DE HACIENDA Y CREDITO PÚBLICO.

Of. No. 305. III. 1207.

México, D. F., a 21 de enero de 1986.

MR. A W. CLAUSEN
President
World Bank Group
1818 H. Street N. W.
Washington, D. C. 20433.

I am pleased to inform you that we have recieved Congressional approval to denominate our IDA-7 contribution in Special Drawing Rights (SDRs). As your are aware, this will enable us to effectively contribute the 15.0 million dollars pledged.

We are convinced of IDA's effectiveness in promoting the development of the poorest countries and of its key role in transfering concessional aid. For these reasons we have supported IDA in the past and will continue to do so in the future within the limits of our possibilities. However, we believe that the transfer of concessional resources is to a very great extent in the realm of the developed countries and we would therefore expect them to increase their efforts in this connection.

Best regards,

Jesús Silva-Herzog F.

THH/mcai.

RECEIVED

1986 JAN 30 PM 5:57

OFFICE OF THE PRESIDENT

The World Bank
Washington, D.C. 20433
U.S.A.

ERNEST STERN
Senior Vice President, Operations

October 31, 1986

Mr. Conable

done ✓

Barber:

American Security and Trust has advised the Steering Committee that it will not participate in the Mexico financing. I would recommend that you call the Chairman, Mr. Daniel J. Callahan, III, Tel: 624-4077 and make the following two points:

a) AS&T has a long standing but also quite profitable relationship with the World Bank. They handle a lot of our financial transactions and we provide them on-site offices (at a rental of course). However, we prefer to be associated with a bank which takes a broader view of its responsibilities towards the national and international financial system than is evidenced by their refusal to participate.

b) All the banks on the Steering Committee are aware of the special relationship between AS&T and the World Bank and their non-participation is a direct source of embarrassment to us.

You should, therefore, recommend to Mr. Callahan that he reconsider his decision, hopefully today, and so advise the Steering Committee.

Ernie

pg. 2 is taken
from your speech
on Mexico

Myra - pls. file

WORLD BANK NEWS

Vol. V, No. 41 October 16, 1986

This Week

Lending

Bahamas, Indonesia, Senegal and Sri Lanka borrow $88.5 million from World Bank, IDA

IFC News

Corporation helps to organize textile company in Senegal

Urban problems

Officials from Sri Lanka, Nepal to discuss practical approaches to coping with urban management problems

Mexico's recovery program

The World Bank's role in Mexico's move towards a more open and competitive economy

Lending

BAHAMAS, INDONESIA, SENEGAL AND SRI LANKA BORROW $88.5 MILLION FROM WORLD BANK, IDA

THE BAHAMAS. More than 120,000 people will benefit from an eight-year project to improve the quality of water and its supply in New Providence, The Bahamas. The World Bank is supporting the project with a loan of $10 million.

The project, whose total cost is $33.5 million, will also rehabilitate deteriorating sewerage facilities. It will contribute to a cleaner environment and help prevent waterborne diseases.

The Caribbean Development Bank, European Investment Bank and the National Insurance Board of The Bahamas will provide cofinancing for the project.

INDONESIA. A technical assistance project to be supported with a World Bank loan of $14.5 million will help improve the overall efficiency of Indonesia's telecommunications network, particularly PERUMTEL, the General Telephone Company.

The project is designed to improve PERUMTEL's systems and procedures for planning, procurement, project implementation and supervision, and its organizational structure. PERUMTEL staff will undergo training in new technology, management, and finance.

The three-year project is expected to cost $17.9 million overall. PERUMTEL will provide financing of $3.4 million.

SENEGAL is launching a $19.6 million project that will improve the quality of primary education and increase enrollments. The International Development Association (IDA), the World Bank's affiliate for concessionary lending, is supporting the project with a credit of SDR 10.2 million ($12 million).

The eight-year project will focus on the regions of Louga, Diourbel, and Fatick in the west. These regions account for 25 percent of the country's population and have the lowest primary enrollment rates, an average of 33 percent compared to the national average of 54 percent.

This is the first IDA-financed project in Senegal in support of educational reform.

It is expected to increase primary school enrollments by about 32 percent, or 180,000 additional students, by the 1994/95 school year without increasing the share of education in the government's budget from its level in 1985/86. The construction program will reduce unit costs by about 35 percent.

The government is contributing $2.28 million towards the cost of the project. The African Development Bank is providing financing of $5.33 million.

SRI LANKA. A $108 million project in Sri Lanka will get underway soon to improve the quality of electric power supply and to make it more reliable. IDA is supporting the project with a credit of SDR 43.2 million ($52 million).

The project also seeks to reduce power distribution losses and to expand the distribution system to meet future demand. It is a four-year part of the investment program of the Ceylon Electricity Board (CEB).

Other financing for the project will come from CEB which will provide $43 million. The Government of Sri Lanka has approached the Overseas Development Administration of the United Kingdom for a grant of $13 million. The project is expected to be completed by mid-1991.

IFC News

IFC HELPS TO MODERNIZE SENEGALESE TEXTILE PRODUCTION. The International Finance Corporation is providing an 18 million French franc loan ($2.25 million) to Societe de Teinture, Blanchiment, Apprets et d'Impressions Africaine (SOTIBA-SIMPAFRIC) of Senegal to support a $7.5 million modernization program of the company, the only producer of textile prints in the country.

IFC is an affiliate of the World Bank that provides loans and equity financing to private enterprises in developing countries.

The project, which will be completed at the end of 1988, is a part of a revitalization effort to modernize SOTIBA-SIMPAFRIC's plant and enable the company to strengthen its existing position in the local and regional markets by improving the quality of its printed cloth and by reducing operating costs. Production is expected to increase from 32 million meters of cloth a year to 37 million meters by 1990. About 63 percent of production is sold on the local market while the balance is exported to neighboring West African countries.

SOTIBA's modernization program is IFC's first project with a company in which the majority (96 percent) is owned by private Senegalese nationals.

What's Ahead

HOW TO COPE WITH URBAN PROBLEMS. Senior urban officials from Sri Lanka and Nepal will discuss practical approaches to solving urban management problems in developing countries at a seminar scheduled for 9:30 a.m.-12 noon, on Wednesday, October 22, in World Bank Room E-1244.

R. Paskaralingam, Secretary, Ministry of Local Government, Sri Lanka, and M.P. Kafle, Secretary, Ministry of Panchayat and Local Development, Nepal, will speak at the seminar, "Municipal Management: The Practitioner's Viewpoint."

With support from the International Development Association (IDA) and the United Nations Development Programme, Nepal and Sri Lanka are carrying out projects which include the development of innovative approaches to improving urban finance, management, and operations. IDA is the World Bank's affiliate for concessionary assistance.

Consultants involved in the projects also will participate in the seminar which is open to the press.

Feature

MEXICO AND THE WORLD BANK

In early October 1986 Mexico's creditors agreed on a $12 billion refinancing package to help revive the economy of that country.

The overall financing package includes about $6 billion, plus two contingency lending facilities, from commercial banks; an IMF stand-by of about $1.7 billion; net disbursements from the World Bank of about $2.3 billion, including the net present value of its guarantees; and commitments from bilateral official sources. In addition, agreement was reached on a proposed rescheduling of Mexico's outstanding debt. Two weeks earlier, Mexico reached agreement with the Paris Club on a rescheduling of its official debt.

World Bank President Barber Conable has called Mexico's program of fundamental policy changes and the associated financing package "a milestone in the world-wide effort to find constructive and negotiated solutions to the developing countries' debt problem." Without these policy changes, designed to move Mexico towards a more open and competitive economy, it would not be possible to achieve growth, increase private investment, and gradually restore creditworthiness.

Medium-term program

The need for structural change was recognized in 1983-85, but it has been made more urgent by the dramatic fall in oil prices. The program that is now being implemented by the government is a sound program that will enable Mexico to resume growth and to sustain it, in a more stable environment. It is a difficult program, being carried out in adverse internal and external circumstances, and there are many uncertainties and risks. But, these risks seem manageable, when viewed against the government's commitment to reform and the measures already undertaken.

The most fundamental policy reform that is being undertaken is the shift from inward-directed growth towards a more outward-oriented development strategy based on gradually declining protection to improve the efficiency and export competitiveness of the economy.

To make this strategy effective and successful, it must be accompanied by appropriate exchange rate and other policies, to facilitate the adjustment to a more open economy. The actions already taken by the government to reduce trade barriers and to bring about these complementary adjustments are impressive.

The program of reducing barriers to trade -- which is being supported by the World Bank through a recently signed $500 million Trade Policy Loan -- has already started. The government has eliminated import restrictions on more than half of the total value of imports. Import tariffs have been reduced from a maximum of 100 percent to 45 percent at present, and the government has made public a calendar which calls for a further lowering of tariffs to a maximum of 30 percent by October 1988. The purpose of making public such a calendar is to enable firms to anticipate and adjust to declining levels of protection.

Mexico's trade liberalization measures are key to the long-term strengthening of the economy and its ability to achieve the objectives of increased domestic income, employment, and external creditworthiness.

But import liberalization by itself -- to encourage greater domestic efficiency and export capability -- would run the risk of inundating the economy with imports. To protect against this risk, the government has devalued the Mexican peso by nearly 50 percent in real terms over the past 12 months. As a result, through the first half of this year, imports have actually declined by about 10 percent and non-oil exports have jumped 30 percent.

Other reforms

To further complement its strategy of moving toward fuller participation in world trade, Mexico has undertaken a series of important structural reforms in industry, agriculture, and the public sector. The World Bank intends to continue to work with the government on further action in these areas, and to support these efforts with additional quick-disbursing loans.

A second fundamental change is the decision to reduce the size of the public sector, improve the efficiency of public sector firms, and cut back on subsidies throughout the economy.

Public sector expenditure has been reduced from a peak of 35 percent of the gross domestic product to 27 percent by 1985, and is expectd to fall below 25 percent in 1986. This is a reduction of nearly one-third in the size of the public sector.

Agriculture, too, should become a major beneficiary of a more open economy development strategy. Protectionist policies in the past were directed towards promoting industry at the expense of agriculture, and so naturally resources were induced to move away from agriculture towards industry. This had many adverse consequences: Excessive urban concentration, depressed rural productivity and income, a deteriorating agricultural trade balance, and a slowing of employment in what was historically a very labor-intensive sector. To offset these negative trends, ever-rising subsidies had to be pumped into agriculture -- both to producers and to consumers. These subsidies created an untenable fiscal drain.

The government has moved impressively to reduce agricultural subsidies and to create employment opportunities through agro-industrial exports, partly through the promotion of more joint ventures between Mexico's private sector and foreign investors.

In parallel, the World Bank's lending program will finance increases in credit to the private sector, through industrial, agricultural, housing, mining, and housing credit programs supported by World Bank loans. And the Bank will work with the government on the restructuring of enterprises and industrial sectors where necessary.

Role of the World Bank

The World Bank is supporting the government's program of structural change through the expansion of conventional project lending, and through loans in support of specific policy reforms.

The Bank has been working closely with Mexico since the crisis of 1982 began, to help in the analysis of the issues which had to be faced if Mexico was to change its development strategy.

The World Bank expects to commit $2 billion annually in the next two years compared to a historical lending level of about $500 million. Net disbursements will be about $2.1 billion over 1986 and 1987. This is a large expansion of outstanding exposure -- about a 50 percent increase in two years.

Since 1985, commercial bank exposure in Mexico has declined, while World Bank exposure has grown. In fact, the World Bank has been Mexico's principal source of long-term capital over this period. This cannot continue. An effective program in Mexico requires the support of all its creditors. And ultimately, private sector confidence, both in Mexico and abroad, is vital to the success of the government's reform program and to the financing package that is being designed in support of that program.

Prospects for recovery

Mexico's prospects for future recovery are based on numerous factors. First, Mexico has a rich natural and human resource base, and close proximity to the world's largest market. Second, the drastic fall in the terms of trade is unlikely to continue, and should begin to turn around on even conservative assumptions about the future of world price of oil -- any improvement in the terms of trade will have significantly salutary effects on fiscal, financial, and balance of payments performance, as well as directly on growth, investment, and hence, employment. Third, the 30-40 percent drop in real wages since 1982 appears to have brought Mexican unit labor costs to internationally competitive levels, even below those of Southeast Asia.

Mexico's reform program will face uncertainties and risks. And it can only succeed if adequately supported by external capital. The World Bank's commitment to disburse $2.1 billion and its offer to guarantee 50 percent of $1.5 billion of new commercial bank funds is a vote of confidence in Mexico's program. But it also is contingent on the participation of all commercial bank creditors in their share of the package. Without the participation of the commercial banks, World Bank funds, and those of the IMF, would not suffice to support Mexico's efforts in 1986 and 1987, and the program would be doomed from the outset.

World Bank News (ISSN 0254 6353) is published once a week about 50 times a year in English, French, German, and Spanish by The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A. Editor: Hugh Blackman (202) 477-5328; Assistant Editor: Leandro V. Coronel (202) 477-5423.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED CONFIDENTIAL
AUG 27 2013
WBG ARCHIVES

DATE: : May 20, 1986

TO : Mr. A. W. Clausen
(through Mr. W. David Hopper, Acting SVPOP)

FROM : A. David Knox, RVP, LAC

EXTENSION : 75901

SUBJECT : Brief for Your Meeting with Mexico's Undersecretary for Finance Lic. Francisco Suarez Davila, on Wednesday, May 21, 1986 at 11:30 a.m.

1. We understand that Mr. Suarez has four items on his agenda:

(i) to brief top management on recent progress in the formulation and implementation of structural adjustment policies;

(ii) to discuss how we can finalize quickly negotiations on the proposed $500 million trade loan;

(iii) to complain about Bank imposed linkages between the trade loan and the timing of Board presentation of a $150 million Industrial Recovery Loan to FONEI; and a $250 million follow-up Export Development Project (EDP II);

(iv) to present a Government request for a large "Industrial Reconversion" loan to facilitate adjustment to trade liberalization by private and public enterprises in several industrial subsectors.

2. With regard to the trade loan, I recommend that you take note of the Government's position. Negotiations are in a delicate stage as explained in paras. 4-6 below. I also suggest that you use the opportunity of Lic. Suarez's visit to be fully briefed by him on the Mexico situation, including ongoing negotiations with the IMF and their plans for approaching the commercial banks.

3. Re (i): there is movement in the right direction on a fairly broad front now. I was briefed on this by Secretaries Silva Herzog and Carlos Salinas (Budget and Planning) during my recent visit to Mexico (May 6-9). A summary of recent policy initiatives is attached in Mr. Varallyay's memo to Files (Annex I). I recommend that you congratulate the Mexican Government on the policy initiatives that we are now beginning to see.

4. Re (ii): There are two main issues that remain to be resolved: the further removal of quantitative import restrictions (QRs) and the use of official reference prices (ORPs). In an effort to break a deadlock in negotiations during my recent visit, I offered to forego our requirement of a firm quantitative end-1988 (end of de la Madrid administration) target for

the removal of QRs in exchange for a qualitative statement on trade policy intentions (satisfactory to the Bank) and a further substantial reduction of QRs as a condition for second tranche release. The Government has not so far responded to this compromise proposal. With regard to ORPs, there is agreement on the target date for their complete removal - end 1987 - but we have not yet agreed on a quantitative interim target for the second tranche. There is complete agreement on targets for tariff rates. An end-1988 target range of 10-30% and some important immediate reductions were announced during GATT entry negotiations in Geneva on April 30.

5. The main problem in completing negotiations appears to be a refusal by the Secretary for Trade and Industry, Hector Hernandez, to make any commitments on further trade liberalization beyond what has already been decided by the Government and publicly announced. He takes the view, which is shared by many in the Mexican Government, that the QR reductions that were implemented on July 25, 1985, combined with the tariff policy targets announced in Geneva on April 30, provide ample justification for a $500 million Bank loan, without tranching and without any further conditionality or up-front action. I expect that Lic. Suarez will come to present his Government's latest thinking on this. We believe that the July 1985 measures (a reduction in QR coverage of domestic production from 95-55%) are historically very important but do not by themselves constitute viable trade liberalization unless a clear perspective on completion of the process (removal of all or most QRs) is set. We have indicated to the Mexicans that the Bank would be willing to make two or three follow-up trade loans to support implementation of the entire process.

6. There is one other issue that may come up in your discussion on the trade loan. During my visit, Secretary Silva Herzog and others argued that the Bank should disburse the loan at once, irrespective of any follow-up action by the commercial banks. We are not sure that we have completely succeeded in persuading the Secretary to accept that the Bank needs "satisfactory assurances" that the commercial banks will follow with an adequate package for 1986 (Mexico is now seeking $3.5 billion from the commercial banks out of a total of $6.5 billion) as a condition of loan effectiveness. This approach would give us leverage over the commercial banks that we would otherwise not have. It is possible that our willingness to take an active leadership role in helping Mexico with its very difficult current problems will again be questioned by Lic. Suarez. Our reply has been that our willingness to take risks and assume a leadership role is demonstrated by our preparedness to present this loan to our Board, if necessary before there is an IMF agreement. (IMF negotiations on a new Standby for 24 months, from mid-1986 through mid-1988, are ongoing but we understand that progress is slow.)

7. Re (iii): The Mexicans are upset by our decision to delay Board presentation of a $150 million Industrial Recovery loan to FONEI (negotiated in January) until we have successfully negotiated the trade loan. They are also concerned that EDP II (appraised but not yet negotiated) may be delayed for the same reason. Our position is explained in Mr. Stern's letter of April 16 (Annex II).

8. Re (iv): We are in the process of preparing a Technical Assistance loan to assist in parastatal restructuring and in the financing of sub-sectoral adjustment studies (steel, capital goods, textiles, automotive parts, agro-industries and in-bond industries) that could form the basis for one or more "Industrial Reconversion" loans. We are simultaneously also discussing the possibility of a loan for fertilizer sector restructuring. A Bank diagnostic study on this subject was recently completed. The first time the idea of an umbrella "Industrial Reconversion" project came up was at the end of a conference in Oaxaca in April that was organized by the Government to discuss a joint Bank/Mexico study on public sector investment and parastatal management problems. We recommend that you welcome Lic. Suarez's request and ask him to spell out broadly what he has in mind and how the Bank can help.

Attachments

LC1MX
May 20, 1986

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 19, 1986

TO: The Files

FROM: Julius Varallyay, Senior Loan Officer, LC1MX

EXTENSION: 72562

SUBJECT: MEXICO - Some Recent Economic Adjustment Measures

Actions Taken Recently

2. On April 30, the Government announced a multiyear calendar for the reduction of import tariffs, whereby maximum tariffs of 100% would be reduced to 45% or 50% immediately, with further reductions following over a 30-month period to lower tariffs to a range of 0-30%. This was reported in greater detail in connection with the status of negotiations for the Mexico Trade Policy Loan. Measures are also being adopted to promote non-oil exports, including the introduction of a "single window" facility in the Secretariat of Agriculture (SARH) to approve all agricultural exports, which previously required the clearance of four or five different Government institutions. In Mr. Knox's meetings with industrialists in Monterrey, it was revealed that, as a result of the trade liberalization process, administrative procedures have also been simplified, and that it is now actually easier to import than to export in Mexico.

3. The Government continued its program of industrial restructuring. The iron- and steelmaking facility of FUNDIDORA of Monterrey, the nation's second largest plant and a parastatal that was acquired by the Government more than 10 years ago, will be shut down shortly. The decision was published on May 8, 1986, and will directly affect at least 6,000 workers in this plant, which has a total capacity of 1.5 million tons/year. The enterprise has been bankrupt since 1983. This unprecedented decision was termed as politically the most difficult one that the present Administration has taken so far. It also shows the Government's commitment to parastatal restructuring.

./...

4. The Government has also decided to gradually sell off its interest in the textile sector, and the sale of the first company, NUNATEXT, took place during the week of May 5, 1986. This plant was taken over by the social sector (trade unions). In the sugar sector, eight refineries are being closed as part of the Government's program for restructuring four industrial sectors in 1986, as per the 1986 budget that was approved by Congress in December 1985. The recently reported withdrawal of subsidies for different staple food items traded by CONASUPO is also being implemented. Action in this area was initiated at the time of the Public Sector Management Seminar held at Oaxaca last month. Further details are not yet available, but an agricultural sector mission, scheduled for next June, will have an opportunity to make a full assessment of the CONASUPO reforms.

5. As a result of the 1986 austerity budget, and subsequent budget cuts introduced by the Secretariat of Programming and Budgetting (SPP) during this year, public sector expenditures net of debt service payments have dropped from 32% of GDP in 1982 to 17% currently. Public investments are down to about 3% of GDP in 1986.

6. Since 1985, the Government has reassigned some 16,000 public servants from the Mexico City Metropolitan Area to other locations in the country as part of a major descentralization plan, which has been implemented with renewed vigor since the September 1985 earthquake.

7. Considerable progress has been made recently on debt-equity swaps beyond the first four operations, which amounted to some US$75 million. Because of the significant discount on debt papers (currently some sources quote sales at 55%-58% of face value), debt-equity swaps can be quite attractive to potential investors in Mexico. Although there is no central clearinghouse for these operations, some financial experts estimated that the Mexican Government is working on a total of 150 deals, representing several hundreds of millions of dollars.

Additional Government Measures

8. Further Government actions can be expected in the forthcoming months in several key areas, such as:

a) The privatization of 123 additional parastatal enterprises, including, among others, such companies as Mexicana de Aviacion;

b) Publication of a special document on foreign investments, termed a "libro blanco," which would explain the Government's record on foreign investment and introduce automatic approval of foreign investment applications for exporters, unless a specific rejection is delivered within 30 days after the date of application;

c) Preparation and submission to the Congress by September 1986 of a comprehensive taxation package, which would overhaul

Mexico's fiscal system to a greater extent than any fiscal legislation in the past two decades--corporate taxes would have to be paid on the basis of estimates during the tax year, to compensate for the so-called "Tanzi effect;" and

d) Additional descentralization measures to reassign a total of 70,000 public servants away from the Mexico City Metropolitan Area to regional and state administrations, thus bringing the total of people moving away from Mexico City to about 350,000.

9. An impression emerged from Mr. Knox's meetings that, while the Mexican authorities see fully well the urgency of increasingly difficult reform measures, they are--perhaps for the very same reasons--more and more cautious in publicizing any actions taken and, in some instances, implementation arrangements are given low visibility. Because of this, it is essential that in the framework of Economic Sector Work and macroeconomic work, we look into the measures already taken and make an independent assessment of the adequacy of the implementation arrangements. That would enable the Bank to make a realistic assessment of the likely impact of the measures on economic performance and expectations. Arrangements with the Mexican authorities for expanded and intensified sector work in industry, agriculture, and urban services are fully satisfactory, and are expected to provide an opportunity for the required reviews within the next two to four months.

JVarallyay/slc

The World Bank
Washington, D.C. 20433
U.S.A.

April 16, 1986

Dear Mr. Secretary:

Thank you for your kind words on the Reconstruction Loan in your letter of April 11. I am happy that the loan was signed soon after its approval by the Board. I noted your concerns about the processing of the proposed Industrial Recovery Project of FONEI, and would like to explain our thinking on that.

I believe that a joint presentation to our Executive Directors of the Trade Adjustment and the Industrial Recovery Loans would demonstrate the Bank's massive support for your Government's comprehensive adjustment effort since late 1985. Therefore, I would prefer to wait until the negotiations of the Trade Adjustment Loan are concluded and that loan too is ready for Board consideration. In this manner, we would avoid any premature discussion in our Board of sensitive macroeconomic issues while your negotiations on trade adjustment with the Bank and on a stabilization program with the Fund are in progress.

I am pleased to inform you that last March our Board approved a modification to the Capital Goods Industries Development Project (Ln. 2142-ME), which now allows FONEI to finance the general equipment and working capital requirements of its customers under that loan. Up to about US$80 million would be available for the purpose, providing adequate bridge financing through the third quarter of 1986, when the new FONEI loan is expected to be signed. The legal amendments formalizing this change in the project's design were forwarded to Mexico on April 16, 1986.

I look forward to progress on the pending negotiation issues and want to assure you of my personal attention to these matters, so as to schedule a joint Board presentation for our two loans at the earliest possible date.

Sincerely,

Ernest Stern
Senior Vice-President
Operations

Mr. Jesus Silva Herzog Flores
Secretary of Finance and Public Credit
Secretariat of Finance and Public Credit
Palacio Nacional, 3er Piso
Mexico, D.F., Mexico

April 11, 1986

Mr. Ernest Stern
Executive Vicepresident
International Bank for
Reconstruction and Development

Dear Mr. Stern:

Just a brief line to express our appreciation for the fast negotiation and processing of the reconstruction loan. As you know, it was signed Wednesday.

I am also pleased about the resumption of negotiations on the Trade DPL next week, after a rather hesitant take-off in Mexico last week.

I would like to register my concern, however, about the processing and approval by the Board of the FONEI loan. As you know, it has been negotiated since January and it is sitting there waiting for something we ignore. I assume it is waiting for further progress on the DPL, although I think this form of linkage is not at all constructive. The issues pending on the DPL have their own dimension, and the FONEI loan should not be held up. Besides, FONEI is your model borrower and it has run out of money.

I will appreciate your intervention to help expedite and present to the Board the FONEI loan as early as possible.

Best regards,

Jesús Silva Herzog
Minister of Finance
and Public Credit
of Mexico

cc David Knox
Rainer Steckhan
Pieter Bottelier
Angel Gurria

Lic. Jesús Silva-Herzog F.
SECRETARIO DE HACIENDA Y CREDITO PUBLICO

R/

al

13 de enero de 1986.

SR. A. W. CLAUSEN
President of the World Bank

Dear Tom:

Thank you very much for the copy of your statement at the Central Bank of Buenos Aires. I certanly find it, as usual, most interesting.

Best wishes for 1986.

Sincerely yours,

RECEIVED

1986 JAN 28 PM 2: 14

OFFICE OF THE PRESIDENT

January 2, 1986

Dear Chucho:

As promised, enclosed is a copy of my address at the Central Bank in Buenos Aires last mmnth. I hope you will find it of interest.

It was good seeing you again. Best wishes for 1986.

Sincerely,

Enclosure

His Excellency Jesus Silva Herzog
Minister of Finance and Public
Credit
Palacio Nacional
3er Piso
Mexico City 1, D.F.
Mexico

Los Pinos, Mexico City,
September 23, 1985

Mr. A. W. Clausen
President
The World Bank

Dear Mr. Clausen:

I extend my thanks to you and your colleagues, for your note expressing solidarity with the Mexican people after the earthquake that affected this country.

In reference to your technical and additional financial assistance to be applied to reconstruction and infrastructure of basic needs, I am pleased to inform you that I have given the necessary instructions to analyze your kind proposal.

Miguel de la Madrid
President of Mexico

cc: Mr Stern (o/r)
Mr. von der Meer
10/23

MIGUEL DE LA MADRID H.

PRESIDENTE CONSTITUCIONAL
DE LOS ESTADOS UNIDOS MEXICANOS

Los Pinos, D. F., septiembre 23 de 1985.

SEÑOR
A.W. CLAUSEN
Presidente del Banco Mundial
Washington, D.C.

Myra,
Mr. Clausen
has background
of this, copy
of telex to
Mexico

1425

Estimado señor Clausen:

Agradezco a usted y a sus colegas, la amable manifestación de solidaridad con el pueblo de México, que tuvieron la gentileza de - expresarnos con relación al sismo que afectó a este país.

Referente a su atento ofrecimiento de ayuda técnica y financiera adicional, para aplicarse a la recontrucción de la infraestructura y los servicios básicos, le comunico que he girado las instrucciones correspondientes para analizar su amable propuesta.

RECEIVED
1985 OCT 21 PM 7: 10
OFFICE OF THE PRESIDENT

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 2, 1985

TO: Mr. A. W. Clausen

THROUGH: S. Shahid Husain, Acting SVPOP

FROM: A. David Knox

EXTENSION: 75901

SUBJECT: Brief for your meeting with Mr. Alfredo Phillips Olmedo, Director General, Banco Mexicano de Comercio Exterior (BANCOMEXT), Tuesday, December 3, 1985 at 2:45 p.m.

1. We have not been advised of the purpose of Mr. Phillips Olmedo's visit. The following topics may come up in the conversation:

Mexico's Political and Economic Situation

2. The political situation is very tense and economic prospects for 1986 are uncertain. The first half of the year will be very difficult. But, if the Government successfully implements the ambitiously austere budget just presented to Parliament and confidence gradually returns, economic improvement in the second half of the year is possible. The growth spurt of 1984 and early 1985 has come to a halt. It was based on a premature relaxation of demand management combined with continued high levels of protection. Confidence in the Government and its policies is low as is reflected, i.a. in the fact that the so-called free exchange rate (at almost 500 Peso to the dollar) has again run away from the official controlled rate which, at 330 Peso to the dollar, is about right from a purchasing power parity point of view. The earthquakes of 19 and 20 September have also weakened the Government politically because of widespread allegations of tampering with building codes, inspection standards, and also because of the subsequent nationalization of real estate in downtown Mexico.

The 1983 Export Development Loan and possible follow-up project

3. The US$350 million Export Development Project (Ln. 2331-ME) was made to BANCOMEXT in FY83 in the context of policy-based lending, designed to help Mexico in its effort to recover from the 1982 crisis. The Bank's principal objective has been to assist the Government in formulating and implementing the first stage of a comprehensive export development strategy, including major policy reforms to reduce the existing anti-export bias, improvements in administrative procedures affecting exports and imports, strengthening of the institutional infrastructure and delivery mechanisms for financial and non-financial services for exporters, and a substantial program of studies to define specific measures to be included in the subsequent phases of the export development strategy. The project provides financing for imported inputs as well as for fixed investments required by exporters.

4. The project has met most of its policy reform goals and has been instrumental in bringing about several key administrative and institutional improvements. Initial commitments and disbursements, however, were slow as a result of several project-specific conditions. Nevertheless, subsequent

improvements of operating regulations, modifications of lending terms for pre-export financing, and, especially, a more effective promotion of the credit line resulted in a substantial increase in the use of loan funds (some US$220 million committed, over US$100 million disbursed as of October 1985). We are currently appraising a follow-up Export Development Project that is scheduled for Board presentation in early FY87. One of the main objectives of this follow-up loan would be to extend the credit facilities to indirect exporters.

Trade Development Policy Loan (DPL)

5. We are currently appraising a DPL in support of the trade liberalization measures announced by President de la Madrid at the end of July. One of the main difficulties we have encountered in the appraisal process is that the Government has extended the use of protective devices, primarily reference prices (for the calculation of duty purposes) which have had the effect of partially rolling back the trade liberalization measures announced by the President in July. There is intense debate going on in Mexico at the present time on trade policy implementation and the phasing of future import liberalization. A further factor which may delay processing of a major Trade DPL or threaten its feasibility is that the macro-economic policy environment is, at present, less than fully supportive of the announced trade policy objectives. We are, in particular, concerned about the continuance of Mexico's dual exchange rate system and the fact that the margin between the two rates is so wide. The appraisal process has not yet been completed and it would be best to stay clear of a detailed discussion of this proposed operation.

World Bank Support for Earthquake Rehabilitation

6. We are presently reviewing, within the context of the Bank's earthquake reconstruction efforts in Mexico, a BANCOMEXT proposal to finance (out of Ln. 2331-ME) about US$30 million worth of long-distance telephone facilities for TELMEX, which were destroyed during the earthquake. No decisions have been made on this subject as yet; the Reconstruction Project appraisal team has only just returned to Washington. The mission will recommend a loan of US$400 million, mostly for the rehabilitation or reconstruction of housing, community facilities, schools, hospitals, markets, etc. We are also in the process of amending a number of on-going loans with a view to reallocate funds for earthquake reconstruction work.

7. A few weeks ago we declined a Government request for the financing of earthquake-related hotel reconstruction under the Export Development Project at preferential interest rates. Interest rates on subloans for hotels and other export-oriented fixed investment financing under the Export Development Project are governed by our General Interest Rate Agreement (GIRA) with Mexico (signed in August 1984). Since one of the main objectives of GIRA is to reduce interest rate subsidies in Mexico, we considered it unwise to agree to new subsidies. Mexico's fiscal situation requires, if anything, accelerated reduction in remaining subsidies. It is possible that Mr. Phillips may wish to reopen this issue in his meeting with you.

8. Pieter Bottelier, Division Chief for Mexico will attend your meeting with Mr. Phillips.

GSchultz:PBottelier/ya:db

ZCZC DIST3851 RCA9976
EXC
REF : TCP HC

cc: Mr. Stern
Mr. van der Meer
10/23

RCA9976
248423 WORLDBANK
1776397 SHDPME

SECRETARIA DE HACIENDA Y CREDTO PUBLICO
SECRETARIA PARTICULA

1397

248423 WORLDBANK
1776397 SHDPME

SECRETARIA DE HACIENDA Y CREDITO PUBLICO
SECRETARIA PARTICULAR

T E L E X MEXICO, D.F., 15 OCTUBRE DE 1985

MR. A. W. CLAUSEN
PRESIDENT
INTBAFRAD
WORLD BANK

DEAR MR. CLAUSEN:

THANK YOU VERY MUCH INDEED FOR YOUR KIND MESSAGE OF SYMPATHY. UNFORTUNATELY, THE EARTHQUAKE THAT STRUCK OUR COUNTRY BROUGHT TERRIBLE DAMAGE, SUFFERING, AND LOSS OF HUMAN LIFE. HOWEVER, THE EXTRAORDINARY RESPONSE OF OUR OWN PEOPLE AND THE EXITING SUPPORT OF OUR FRIENDS FROM ABROAD EWILL INDEED CONTRIBUTE TO THE RECONSTRUC

TION OF OUR NATION.

WITH APPRECIATION AND GRATITUDE,

JESUS SILVA-HERZOG F.
MINISTER OF FINANCE AND
PUBLICI CREDIT

248423 WORLDBANK
1776397 SHDPME

=10151956

=10160503

ALT RTD FROM:EXCM

NNNN

September 26, 1985

Mr. A. W. Clausen
Washington, D.C.

On behalf of the President of Mexico, Lic. Miguel de la Madrid, it is a pleasure to acknowledge with great appreciation your telex of September 20, offering your generous assistance to our government after the tragedy of the earthquake occurred on Sept. 19 and 20. We thank you for your valuable collaboration.

Sincerely,

Lic. Manuel Bartlett Diaz
Secretary of State

R1

ZCZC DIST0158 JWS0214
EXC
REF : TCP MET

cc: Mr. Stern
Mr. van der Meer (Acting)
9/30

JWS0214 ZJR305 IN 27/21:27 OUT 27/21:30
1774376 SGOBME

SEPTIEMBRE 26, 1985.

A. W. CLAUSEN
WASHINGTON D. C.

1332

ME ES GRATO DEJAR TESTIMONIO DEL PROFUNDO AGRADECIMIENTO DEL SE OR PRESIDENTE CONSTITUCIONAL DE LOS ESTADOS UNIDOS MEXICANOS, LICEN-- CIADO MIGUEL DE LA MADRID Y MIO PROPIO, POR EL ATENTO TELEX QUE HI- CIERA LLEGAR EL DIA 20 DE LOS CORRIENTES, EN EL QUE MANIFIESTA PREO- CUPACION POR LA TRAGEDIA OCURRIDA LOS DIAS 19 Y 20 DEL MES EN CURSO Y GENEROSAMENTE BRINDA SU AYUDA Y SOLIDARIDAD AL PUEBLO DE MEXICO.

CON NUESTRO RECONOCIMIENTO POR SU VALIOSA COLABORACION, RECIBA UN FRATERNAL ABRAZO.

EL SECRETARIO DE GOBERNACION

LIC. MANUEL BARTLETT DIAZ.

BUCARELI NO. 99 PRIMER PISO
COL. JUAREZ
MEXICO, D. F.
1

=09280805

ALT RTD FROM:EXCM

NNNN

ZCZC DIST0158 JWS0214
EXC
REF : TCP MET

cc: Mr. Stern
Mr. van der Meer (Acting)
9/30

JWS0214 ZJR305 IN 27/21:27 OUT 27/21:30
1774376 SG0BME

SEPTIEMBRE 26, 1985.

A. W. CLAUSEN
WASHINGTON D. C.

1337

ME ES GRATO DEJAR TESTIMONIO DEL PROFUNDO AGRADECIMIENTO DEL SE OR PRESIDENTE CONSTITUCIONAL DE LOS ESTADOS UNIDOS MEXICANOS, LICEN-- CIADO MIGUEL DE LA MADRID Y MIO PROPIO, POR EL ATENTO TELEX QUE HI- CIERA LLEGAR EL DIA 20 DE LOS CORRIENTES, EN EL QUE MANIFIESTA PREO- CUPACION POR LA TRAGEDIA OCURRIDA LOS DIAS 19 Y 20 DEL MES EN CURSO Y GENEROSAMENTE BRINDA SU AYUDA Y SOLIDARIDAD AL PUEBLO DE MEXICO.

CON NUESTRO RECONOCIMIENTO POR SU VALIOSA COLABORACION, RECIBA UN FRATERNAL ABRAZO.

EL SECRETARIO DE GOBERNACION

LIC. MANUEL BARTLETT DIAZ.

BUCARELI NO. 99 PRIMER PISO
COL. JUAREZ
MEXICO, D. F.
1

=09280805

ALT RTD FROM:EXCM

NNNN

1985 SEP 30 PM 2:19

FORM NO 27 OCR (3/82)
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: ______

PAGE ____ OF ____

9/20/85

START HERE

WDIAL

.LC1MX

OINFO

-SUBJECT: MEXICO - EARTHQUAKE EMERGENCY

-DRAFTED BY: SUZANA AUGUSTO, LC1MX EXT: 72545

-AUTHORIZED BY: A. W. CLAUSEN, PRESIDENT, WORLD BANK

-CC: STERN, SVPOP; KNOX, LCNVP; BOTAFOGO, VPE; STECKHAN, LC1DR;

- BOTTELIER, LC1MX O/R; VAN DER MEER, LCPDR O/R; VAN GIGCH,

- LCPDR; H.E. AMB. ESPINOSA DE LOS REYES; MRS. FILARDO DE

- GONZALEZ, EDS

----

383 170985 =

-H.E. LIC. MIGUEL DE LA MADRID HURTADO

-PRESIDENTE DE LA REPUBLICA

-ESTADOS UNIDOS MEXICANOS

-MEXICO, D.F., MEXICO

383 1777552 =

-LIC. CARLOS SALINAS DE GORTARI

END OF TEXT

-SECRETARIO DE PROGRAMACION Y PRESUPUESTO

SIGNATURES:

DRAFTED BY: ______

AUTHORIZED BY: ______

READY FOR TRANSMISSION: ______
(Inputter's Initials)

TRANSMITTED BY: ______

DATE: ______

DELIVERY NOTICES RECEIVED? ______

FORM NO 27 OCR
(3/82)
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: ____________

PAGE ______ OF ______

START HERE

-SECRETARIA DE PROGRAMACION Y PRESUPUESTO
-MEXICO, D.F., MEXICO
383 1774375 =
-LIC. MANUEL BARTLETT DIAZ
-SECRETARIO DE GOBERNACION
-SECRETARIA DE GOBERNACION
-MEXICO, D.F., MEXICO
383 1774300 =
-LIC. JESUS SILVA HERZOG
-SECRETARIO DE HACIENDA Y CREDITO PUBLICO
-SECRETARIA DE HACIENDA Y CREDITO PUBLICO
-MEXICO, D.F., MEXICO
383 1774300 =
-LIC. JOSE LUIS FLORES HERNANDEZ
-DIRECTOR, ORGANISMOS FINANCIEROS INTERNACIONALES
-SECRETARIA DE HACIENDA Y CREDITO PUBLICO
-MEXICO, D.F., MEXICO
BT
WASHINGTON DC - 20-SEP-85

IN MY NAME AND THAT OF MY COLLEAGUES IN THE WORLD BANK, I WISH TO EXTEND OUR HEARTFELT SYMPATHIES OVER THE TRAGEDY THAT THE

END OF TEXT

SIGNATURES:

DRAFTED BY: ____________

AUTHORIZED BY: ____________

READY FOR TRANSMISSION: ____________
(Inputter's Initials)

TRANSMITTED BY: ____________

DATE: ____________

DELIVERY NOTICES RECEIVED? ______

FORM NO 27 OCR (3/82)
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: ______

PAGE ____ OF ____

START HERE

MEXICAN PEOPLE SUFFERED YESTERDAY. I WOULD LIKE YOU TO KNOW THAT WE ARE PREPARED TO ASSIST YOUR GOVERNMENT WITH ADDITIONAL FINANCIAL SUPPORT, AND TECHNICALLY, IN DEALING WITH THE DEVASTATION CAUSED BY THE EARTHQUAKE. I HAVE ASKED MY STAFF TO CONTACT YOUR OFFICIALS TO DISCUSS IN WHICH WAY WE CAN BEST HELP IN THE EXPEDITIOUS RECONSTRUCTION OF BASIC SERVICES AND INFRASTRUCTURE. I HOPE THAT THE EXTRAORDINARY RESCUE EFFORTS WHICH YOU HAVE MOUNTED WILL BE SUCCESSFUL IN MINIMIZING THE LOSS OF LIFE AND FURTHER DESTRUCTION. WITH WARM REGARDS, A.W. CLAUSEN, PRESIDENT, INTBAFRAD.

END OF TEXT

SIGNATURES:

DRAFTED BY: ______

AUTHORIZED BY: ______

READY FOR TRANSMISSION: ______
(Inputter's Initials)

TRANSMITTED BY: ______

DATE: ______

DELIVERY NOTICES RECEIVED? ______

June 4, 1985

Dear Mr. De Pedro:

Just a note to thank you for passing along the report on Mexico's program for rural development from Secretary Eduardo Pesqueira. Please convey to Mr. Pesqueira my appreciation and let him know that we in the Bank look forward to the opportunity to study the report.

Sincerely,

A. W. Clausen

Mr. Alejandro De Pedro C.
Advisor to the Executive
Director
Room F-1315

bcc: Mr. D. Knox (w/incoming to handle)

VRS:sbp

(Log # 688)

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

688

May 29, 1985

Mr.
A. W. Clausen
President
World Bank
Washington, D.C.

Dear Mr. Clausen:

On his recent visit to Washington, Mr. Eduardo Pesqueira, Mexican Secretary of Agriculture and Hydraulic Resources, on May 22 and 23, he expressed his interest to bring to your attention the "National Program for Rural Development 1985-1988", prepared by the government of President Miguel de la Madrid with the purpose for it to be known by the World Bank.

Mr. Pesqueira requested I send a copy of this document to you.

Very truly yours,

Alejandro De Pedro C.
Advisor to the Executive Director

Enclosure

Mexico, May 20, 1985

Mr. A. W. Clausen
President
The World Bank

It is a pleasure to deliver a copy of "National Program for Integral Rural Develop ment 1985 - 1988". Such document was approved by the President of Mexico last May 16.

This program puts together the objectives and goals toward social well being, agrarian reform, production, employment and income in the rural areas, The instruments of this document considers the active participation of the federal entities, state and municipal governments as well as the organizations of producers from the social and private sector.

Cordially,

Lic. Eduardo Pesqueira
Secretary of Agriculture

FORMA 110 - 1

SECRETARIA DE AGRICULTURA
Y RECURSOS HIDRAULICOS

SECRETARIA PARTICULAR

100.200.-

México, D.F., mayo 20 de 1985.

688

SR. A.W. CLAUSEN
PRESIDENTE DEL BANCO MUNDIAL
WASHINGTON, D.C.
U. S. A.

Me es grato hacerle entrega de un ejemplar del "PROGRAMA NACIONAL DE DESARROLLO RURAL INTEGRAL 1985-1988", documento que fue aprobado por el Presidente Constitucional de los Estados Unidos Mexicanos, el pasado 16 de mayo.

Este Programa conjuga los objetivos y metas de bienestar social, reforma agraria, producción, empleo e ingreso en el medio rural, y su instrumentación considera la participación activa de las dependencias federales, gobiernos estatales y municipales, así como los productores organizados de los sectores social y privado.

P. A.

A T E N T A M E N T E
SUFRAGIO EFECTIVO. NO REELECCION
EL SECRETARIO

LIC. EDUARDO PESQUEIRA

Anexo: (1)

c.c.p.- C. Lic. Narciso Acevedo Valenzuela - Subsecretario de Planeación - Pte.-

T. G. N.-

FORM NO 27 OCR
(3/82)
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: MEXICO

START HERE

WDIAL

.LC1DR

OINFO

-SUBJECT: MEXICO

-DRAFTED BY: FBERGER/RBSTECKHAN:vob EXT:74621

-AUTHORIZED BY: BARBER B. CONABLE

-CC: MESSRS. WAPENHANS, KNOX (O/R), BOTTELIER, LC1MX

-

----

383 1774500 =

-HIS EXCELLENCY PRESIDENT MIGUEL DE LA MADRID

-PRESIDENCIA DE LA REPUBLICA

-MEXICO CITY, MEXICO

BT

WASHINGTON DC 29-JUL-86

I AM MOST PLEASED TO REPORT TO YOU THAT THE BOARD OF DIRECTORS OF THE WORLD BANK THIS MORNING APPROVED THREE LOANS TO MEXICO, FOR A TOTAL COMMITMENT OF US$698 MILLION.

END OF TEXT

SIGNATURES:

DRAFTED BY: ____________

AUTHORIZED BY: ____________

READY FOR TRANSMISSION: ____________
(Inputter's Initials)

TRANSMITTED BY: ____________

DATE: ____________

DELIVERY NOTICES RECEIVED? ____________

FORM NO 27 OCR (3/82)
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: MEXICO

START HERE

THE MOST IMPORTANT OF THESE LOANS WAS THE FIRST TRADE POLICY LOAN, IN THE AMOUNT OF US$500 MILLION, TO SUPPORT YOUR GOVERNMENT'S PROGRAM OF TRADE LIBERALIZATION OVER THE PERIOD 1986-1988.

I HOPE THIS WILL OPEN UP A NEW CHAPTER IN THE LONG AND FRUITFUL RELATIONSHIP BETWEEN MEXICO AND THE BANK. AS WE WORK OUT MUTUALLY SATISFACTORY ARRANGEMENTS FOR FUTURE FAST-DISBURSING POLICY LOANS, FOR EXAMPLE IN AGRICULTURE AND INDUSTRIAL RECONVERSION, I AM SURE THAT WE CAN BOTH LOOK FORWARD TO A SIZEABLE INCREASE IN BANK LENDING. THIS WOULD ALSO SERVE THE PURPOSE OF HELPING TO MOBILIZE ADDITIONAL EXTERNAL RESOURCES IN SUPPORT OF A SOUND RECOVERY PROGRAM.

I LOOK FORWARD TO THE OPPORTUNITY OF MEETING YOU IN WASHINGTON AT A DINNER, ON AUGUST 13, TO WHICH YOU SO KINDLY INVITED ME. MY BEST REGARDS. BARBER B. CONABLE, PRESIDENT, WORLD BANK.

INTBAFRAD

END OF TEXT

SIGNATURES:

DRAFTED BY: FBerger/RBSteckhan:vob

AUTHORIZED BY: Barber B. Conable

READY FOR TRANSMISSION: ____________
(Inputter's Initials)

TRANSMITTED BY: ____________

DATE: ____________

DELIVERY NOTICES RECEIVED? ____________

FORM NO. 27 OCR (Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

Mr. Clausen

TEXTNAME: Tel-Clausen

PAGE 1 OF 2

START HERE

WDIAL

.LC1MX

OINFO

-SUBJECT: MEXICO - APPOINTMENT SHCP

-DRAFTED BY: PBOTTELIER/SLC EXT: 72562

-AUTHORIZED BY: A. W. CLAUSEN, PRESIDENT

-CC: KNOX, LCNVP; STECKHAN, LC1DR; BOTTELIER, LC1MX

---

383 1762130 =

-LIC. GUSTAVO PETRICCIOLI

-SECRETARIO DE HACIENDA Y CREDITO PUBLICO

-SECRETARIA DE HACIENDA Y CREDITO PUBLICO

-MEXICO, D.F., MEXICO

BT

WASHINGTON DC - 19-JUNE-86

I WOULD LIKE TO CONGRATULATE YOU ON YOUR APPOINTMENT AS MEXICO'S SECRETARY OF FINANCE AND PUBLIC CREDIT. YOUR LONG AND DISTINGUISHED CAREER IN MEXICO, AND THE BROAD INTERNATIONAL EXPERIENCE THAT YOU ARE BRINGING TO THIS CRITICAL POST AT THIS

END OF TEXT

SIGNATURES:

DRAFTED BY: PB

AUTHORIZED BY: [signature]

Cleared by Steckhan

READY FOR TRANSMISSION: M (Inputter's Initials)

TRANSMITTED BY: J. Hillman

DATE: 6 20 86

DELIVERY NOTICES RECEIVED? ✓

FORM NO 77 OCR
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: Tel-Clausen

START HERE

CRITICAL JUNCTURE, UNDERLIE OUR HOPE AND CONFIDENCE THAT SOLUTIONS WILL BE FOUND FOR MEXICO'S EXTREMELY PRESSING FINANCIAL PROBLEMS. I WOULD LIKE TO ASSURE YOU OF OUR CONTINUED DESIRE AND COMMITMENT TO WORK CONSTRUCTIVELY WITH YOUR GOVERNMENT TOWARDS THE REALIZATION OF YOUR COUNTRY'S ENORMOUS DEVELOPMENT POTENTIAL. MY STAFF IS LOOKING FORWARD TO AN EARLY OPPORTUNITY TO DISCUSS WITH YOU HOW WE CAN BE OF GREATEST ASSISTANCE TO YOU. MEANWHILE, I AM SENDING YOU MY BEST WISHES FOR SUCCESS IN YOUR NEW ASSIGNMENT. WITH WARM PERSONAL REGARDS, A.W. CLAUSEN, PRESIDENT, INTBAFRAD.

END OF TEXT

SIGNATURES:

DRAFTED BY:

AUTHORIZED BY: A Clausen

READY FOR TRANSMISSION: (Inputter's Initials)

TRANSMITTED BY:

DATE:

DELIVERY NOTICES RECEIVED?

IBAFIN
INSTITUTO DE BANCA Y FINANZAS A.C.

R/

cc: Mr. Knox
Mr. Nercissiantz
11/07

1257

October 24, 1984

Mr. A. W. Clausen
President
The World Bank
1818 H Street, N. W.
Washington, D. C. 20433

Dear Tom:

On behalf of our Deputy President, Dr. Luis Rubio, and of myself, we would like to thank you for the cordial reception that you granted us during our brief visit to your good Institution.

I trust that next time you are in Mexico you will give us the opportunity of reciprocating your attentions.

Should anything develop, we will be in touch with you through your Senior Loan Officer, Mr. Vahram Nercissiantz.

Kindest personal regards.

Alejandro Medina Mora
President

J.Balmes 11, Edif. B-6° Piso - 11510 México, D. F.

CONFIDENTIAL

DATE: October 17, 1984

TO: Memorandum for the Record

FROM: V. Nercissiantz, Acting Division Chief, LC1MX

EXTENSION: 72575

SUBJECT: Mr. Clausen's Meeting with Messrs. Mora and Rubio of IBAFIN

1. On Tuesday, October 16, 1984, Messrs. Alejandro Medina Mora and Luis Rubio, Director General and Executive Director of the Institute of Banking and Finance (IBAFIN) of Mexico, made a courtesy call on Mr. Clausen. I was present.

2. Mr. Medina Mora gave a brief history of IBAFIN and its evolution over the years. He explained that IBAFIN is a private and independent institute serving the business community through provision of post graduate training in financial management and research. For example, Mr. Mora referred to the last round of GATT discussions and said that IBAFIN had provided a great deal of research and training to the Mexican officials to help Mexico join GATT. However, due to political reasons, Mexico was not able to do so. Responding to the latter point, Mr. Clausen said that he hoped Mexico would find a way to join GATT because it has much to gain in doing so. Mr. Mora indicated interest in receiving EDI assistance in course preparation and said that IBAFIN staff would like to visit the Bank for a full discussion of the ways that such assistance could be obtained.

3. Referring to the financial difficulties of the Latin American countries, Mr. Mora queried about Bank-IMF coordination in economic assistance. Mr. Clausen explained various initiatives of the Bank such as SALs, and the Special Action Program and added that other measures are currently under review in close coordination with IMF.

4. Mr. Mora expressed some reservations concerning the past agricultural policies in Mexico, which had encouraged inefficiency in agricultural production, and asked whether the Bank is assisting the country in improving the situation. Mr. Clausen responded that the present Government is efficiency conscious and, in fact, it has already taken several initiatives in adjusting producer prices and elimination of subsidies. Through preparation and discussion of economic and sector analyses with the Government and careful selection and implementation of development projects, the Bank continues to assist the Government to implement policies for improved agricultural productivity and production.

cc: Messrs. Knox (o/r)
van der Meer, Actg. RVP, LAC
Steckhan, LC1 (o/r)
Eigen, Actg. Director, LC1
Willoughby, EDIDR (o/r)
Bottelier, LC1MX (o/r)

cc: Mr. Southworth, EXC

VNercissiantz:sk

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
~~CONFIDENTIAL~~
AUG 27 2013
WBG ARCHIVES

DATE: October 17, 1984

TO: Memorandum for the Record

FROM: V. Nercissiantz, Acting Division Chief, LC1MX

EXTENSION: 72575

SUBJECT: Mr. Clausen's Meeting with Messrs. Mora and Rubio of IBAFIN

1. On Tuesday, October 16, 1984, Messrs. Alejandro Medina Mora and Luis Rubio, Director General and Executive Director of the Institute of Banking and Finance (IBAFIN) of Mexico, made a courtesy call on Mr. Clausen. I was present.

2. Mr. Medina Mora gave a brief history of IBAFIN and its evolution over the years. He explained that IBAFIN is a private and independent institute serving the business community through provision of post graduate training in financial management and research. For example, Mr. Mora referred to the last round of GATT discussions and said that IBAFIN had provided a great deal of research and training to the Mexican officials to help Mexico join GATT. However, due to political reasons, Mexico was not able to do so. Responding to the latter point, Mr. Clausen said that he hoped Mexico would find a way to join GATT because it has much to gain in doing so. Mr. Mora indicated interest in receiving EDI assistance in course preparation and said that IBAFIN staff would like to visit the Bank for a full discussion of the ways that such assistance could be obtained.

3. Referring to the financial difficulties of the Latin American countries, Mr. Mora queried about Bank-IMF coordination in economic assistance. Mr. Clausen explained various initiatives of the Bank such as SALs, and the Special Action Program and added that other measures are currently under review in close coordination with IMF.

4. Mr. Mora expressed some reservations concerning the past agricultural policies in Mexico, which had encouraged inefficiency in agricultural production, and asked whether the Bank is assisting the country in improving the situation. Mr. Clausen responded that the present Government is efficiency conscious and, in fact, it has already taken several initiatives in adjusting producer prices and elimination of subsidies. Through preparation and discussion of economic and sector analyses with the Government and careful selection and implementation of development projects, the Bank continues to assist the Government to implement policies for improved agricultural productivity and production.

cc: Messrs. Knox (o/r)
van der Meer, Actg. RVP, LAC
Steckhan, LC1 (o/r)
Eigen, Actg. Director, LC1
Willoughby, ED1DR (o/r)
Bottelier, LC1MX (o/r)

cc: Mr. Southworth, EXC

VNercissiantz:ak

P-1867

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1984

TO: Mr. A. W. Clausen
(through Mr. Ernest Stern)

FROM: Rainer B. Steckhan, Director, LAC I Steckhan

EXT.: 7 4621

SUBJECT: MEXICO - Briefing Note for Mr. Clausen's Meeting October 16, 2:30 p.m. with Messrs. Mora and Rubio of the Institute of Banking and Finance of Mexico

The visitors are Messrs. Alejandro Medina Mora and Luis Rubio, President and Vice President of IBAFIN (Institute of Banking and Finance) of Mexico. IBAFIN is a high-quality think tank set up some years ago by the then privately owned commercial banks of Mexico. The Chairman of IBAFIN continues to be Agustin Legorreta, former Chairman and principal shareholder of BANAMEX, the largest commercial bank in Mexico. We have no operational relations with IBAFIN.

Recent Developments in Mexican Banking

Until early 1984, the Government was locked in an internal debate over whether and how far to reprivatize the banks and their non-bank subsidiaries. The private sector, and many legal scholars, argued that the nationalization was unconstitutional. President de la Madrid decided that it was politically irrevocable insofar as the commercial banks themselves were concerned, but together with Secretary Silva Herzog and others overrode strong opposition within the Government and the PRI to the reprivatization of the subsidiary non-banking firms. By mid-1984, the Government had reprivatized about 95% of the non-banking firms, including quasi-banking firms such as brokerage houses and insurance. Previous owners received priority rights to bid, and it is our understanding that many of these assets were reacquired by their original owners.

Possible World Bank Assistance

A major legislative reform of the banking system is being worked on and is expected to be issued in late 1984. The Bank has not become involved in this process for the time being. The Mexican delegation at the Annual Meeting informally probed our reaction to a possible Development Policy Loan, to support financial sector reform and recapitalization, probably of the development banking system. This matter is very delicate, and we know little about the thinking within the Government. You may wish to discuss what reforms are likely, what types of reforms IBAFIN would like to see, and what role the Bank might play, if any.

cc: Messrs. Knox (o/r), van der Meer, LCPDR, Bottelier, LC1MX (o/r)

FBerger/VNercissiantz/mtr

K1

Embajador de México
Washington

1162

October 1, 1984.

cc: Mr. Knox
Mr. Stockham
10/15

Mr. A.W. Clausen
President of the World Bank
1818 H Street
Room # E-1227
Washington, D.C. 20433

Dear Mr. Clausen:

I am very pleased to send herewith a letter addressed to you by the President of Mexico, Miguel de la Madrid Hurtado.

I avail myself of this opportunity to renew to you, dear Mr. Clausen, the assurances of my highest consideration.

Jorge Espinosa de los Reyes

1 Enc.

(quick translation)

THE WORLD BANK

Office of the President

Los Pinos, D.F. (Mexico City)
September 11, 1984

Mr. A. W. Clausen
President
The World Bank

Dear Mr. Clausen:

It was a pleasure to receive your note of August 15 and I am glad to know that you had a pleasant stay in my country.

I agree with you that through the dialogue between Mexico and The World Bank we will be able to establish important programs that will benefit both parties, and I join you in the desire of colaboration and negotiation, coupled with mutual respect.

Receive my cordial regards.

Miguel de la Madrid
President of Mexico

1163

R1

MIGUEL DE LA MADRID H.

PRESIDENTE CONSTITUCIONAL

DE LOS ESTADOS UNIDOS MEXICANOS

Los Pinos, D. F., a 11
de Septiembre de 1984.

SR.
A. W. CLAUSEN.
Presidente del Banco Mundial.
Presente:

Estimado señor Clausen:

Recibí con agrado su atenta comunicación del pasado 15 de agosto, por medio de la cual me comenta el haber tenido una agradable estancia, durante su visita a mi País.

Coincido con usted en que a través del diálogo entre México y el Banco Mundial, se podrán establecer importantes programas que beneficien a las dos partes, por tal motivo me uno a sus deseos de colaboración y negociación, apegados al respeto mutuo.

Le envío un cordial saludo.

RECEIVED
1984 OCT 10 PM 1:49
OFFICE OF THE PRESIDENT

CONFIDENTIAL

DATE : September 21, 1984

TO : Memorandum for the Record

FROM : Pieter Bottelier, Division Chief, LC1A

EXT : 72543

SUBJECT : MEXICO: Meeting between Mr. Clausen and Minister Pesqueira

On Monday, September 17, 1984 at 3:00 p.m., Mr. Pesqueira, Mexico's newly appointed Minister for Agriculture and Livestock came to see Mr. Clausen for a courtesy visit. Messrs. Stern, Knox and myself also attended the meeting. The Minister wished to continue the good working relationships between the World Bank and his Ministry and asked support for projects in the following areas:

1. Agro industries, (all kinds of processing including small scale);

2. Forestry development;

3. Dry land agriculture;

4. Livestock development;

5. Small rural infrastructure to enhance farm efficiency.

We explained to the Minister that a Bank mission was visiting Mexico to explore the possibility of an agro-industrial project, that we will consider the possibility of a forestry project, that dry land agricultural development was already being supported through the ongoing PLANAT and PRODERITH projects and that further support was envisaged through a proposed seeds project and a proposed extension project.

When Mr. Knox added that we were also hoping to assist in regional development, starting with Chiapas, the Minister indicated that he had some reservations about the present project design which, he feared, might aggravate existing income inequalities between various social groups in the region, and thus create a political problem. We explained that this potential problem had been clearly recognized during project appraisal and had been the subject of much discussion with Mexican officials and within the Bank. We had, however, concluded that development of the coastal lowlands and the central valley through irrigation and drainage works combined with infrastructure (rural roads) and some tree crop development in the "Altos" (the central moutainous part of Chiapas State where most of the State's lowest income group -- the Indians -- lives) was in our judgment the best that could be done in the first stage of the Government's 10-year development plan for Chiapas. The first stage (supported by the proposed Bank loans for integrated agricultural and transport sector development) would create many additional employment opportunities for the low income population and provide for the identification and preparation of more substantial investment plans for the "Altos." The Minister did not seem to be altogether convinced by this and said that he would like to study the project a little closer, before giving the green light. Mr. Stern mentioned that the Bank would not wish to proceed with the project unless it had the Minister's full support.

Referring to last year's agricultural sector report on Mexico, Mr. Stern reminded the Minister of the importance of appropriate producer pricing policies as a powerful tool to increase output and avoid distortions in resource allocation. The Minister mentioned that considerable progress towards border pricing had already been made in the recent past.

NOTE:

In a subsequent meeting on Chiapas between the Minister and officials of Mexico's Finance Ministry later that same day, Minister Pesqueira is reported to have said that the project should not be delayed and that negotiations should proceed as scheduled. This remains to be confirmed officially.

cc: Messrs. Clausen
Stern
Knox
Steckhan, LC1
van der Meer, LCPDR
Jennings,LCPDR
van Gigch, LCPDR
Otten, LCPAC
Newman, LCPT2
Downing, LCPAC
Nercissiantz, LC1MX

this and said that he would like to study the project a little closer, before giving the green light. Mr. Stern mentioned that the Bank would not wish to proceed with the project unless it had the Minister's full support.

Referring to last year's agricultural sector report on Mexico, Mr. Stern reminded the Minister of the importance of appropriate producer pricing policies as a powerful tool to increase output and avoid distortions in resource allocation. The Minister mentioned that considerable progress towards border pricing had already been made in the recent past.

NOTE:

In a subsequent meeting on Chiapas between the Minister and officials of Mexico's Finance Ministry later that same day, Minister Pesqueira is reported to have said that the project should not be delayed and that negotiations should proceed as scheduled. This remains to be confirmed officially.

9

cc: Messrs. Clausen
Stern
Knox
Steckhan, LCI
van der Meer, LCPDR
Jennings,LCPDR
van Gigch, LCPDR
Otten, LCPAC
Newman, LCPT2
Downing, LCPAC
Nercissiantz, LCIMX

333

DATE : September 21, 1984

TO : Memorandum for the Record

FROM : Pieter Bottelier, Division Chief, LC1A

EXT : 72543

SUBJECT : MEXICO: Meeting of Mr. Clausen with Mexican Delegation to 1984 Annual Meeting

Delegation

1. Mr. Jesus Silva Herzog, Secretary of Finance and Public Credit
2. Mr. Gustavo Petricioli, Director General, Nacional Financiera, S.A.
3. Mr. Jose Angel Gurria, Director General of Public Credit
4. Mr. Victor Navarrete, Director General, Banco Nacional Pesquero Y Portuario, S.A.
5. Mr. Jose Luis Flores, Director of International Financial Institutions
6. Mr. Patricio Ayala-Gonzalez, Executive Director

Bank

1. Mr. Clausen
2. Mr. Stern
3. Mr. Husain
4. Mr. Knox
5. Mr. Steckhan, LC1
6. Mr. Bottelier, LC1MX

1. On September 21, 1984 at 11:00 a.m., the Mexican delegation to the Annual Meeting met with Mr. Clausen in his office for about forty-five minutes. Mr. Clausen started the meeting by congratulating the Mexican Government on the recent successes in negotiating a very significant restructuring of Mexico's external debt. He said that this had broken the logjam and had raised, naturally, the expectations of other countries in Latin America. Secretary Silva Herzog confirmed that the debt restructuring was indeed a big step in the right direction and that Mexico could now begin to focus again on its long term development objectives. In reviewing Mexico's economic performance during 1984, he noted that most objectives were likely to be met with minor deviations. The budgetary deficit as a percentage of GDP was expected to be 6.5 percent instead of the target level of 5.5%. Inflation was down to 2.8% in August, the lowest figure in 32 months. For the year as a whole he expected inflation to be 50-52% on a point to point basis. The current account surplus was now estimated to be \$3-4 billion for the year as a whole. However, this good result was no longer primarily the result of a shrinkage of imports (imports were beginning to rise again) but of a healthy performance of non-oil exports. GDP growth was also expected to be 2-2.5%, slightly better than originally expected.

2. In response to a question from Mr. Stern, Secretary Silva Herzog replied that there was evidence of a beginning of return of private sector confidence in the Mexican economy. He put emphasis on the fact that all non-banking assets of the nationalized private banks had been offered for sale and that 88% had now been sold. He was confident that the remaining 12% would also be taken up by private sector interests shortly. Although the overall macroeconomic indicators were by and large favorable, he did stress the fact that social pressures in the country were beginning to mount. Real wages had dropped by 25-30% since 1981, which had created a very tough situation for the Government. Fortunately, good weather had helped agriculture in both 1983 and 1984. In conclusion, he said that Mexico had made a firm political decision that there will be no change of course until the economy had been stabilized. The Government's confidence in pursuing the goals was reinforced by a comfortable cushion of external reserves which had increased to the current level of about $7 billion compared to almost nothing at the end of 1982. $1 billion out of the $5 billion syndicated loan of 1984 will be prepaid in 1985 as part of the debt restructuring package.

3. Shifting the discussion to relations between Mexico and the Bank, Secretary Silva Herzog singled out two points on which he wanted his officials to concentrate in the months ahead: disbursements and project pipeline. He noted that disbursements in calendar 1984 would probably exceed $700 million which would be a very good achievement. But concern was expressed that much of this was due to the Bank's Special Action Program and that there might not be a continuation of this good performance in the years ahead without an additional effort to strengthen the pipeline of Bank supported projects. The Secretary said that they were looking forward to the forthcoming December programming discussions with the Bank which he hoped would lead to agreements on strengthening the project pipeline for the next several years.

4. Then the Secretary turned to the question of domestic interest rates and the Agreement which had recently been signed with the World Bank. He stressed that, while inflation was now really coming down in Mexico, it was extremely difficult politically for him and his colleagues to raise nominal rates even by a few points, particularly in the agricultural sector. He asked Mr. Clausen for continued flexibility to accommodate these very special and very difficult Mexican conditions during the next 3-6 months. He did reaffirm the Government's commitment to the dual objective of narrowing the range between lending rates and of moving towards positive real rates. In response to the Secretary's remarks on the Interest Rate Agreement, Mr. Stern said that failure to adjust the rates in October would make subsequent adjustments more difficult. We should not lose sight of the real purpose of the agreement which remains, as the Secretary had said, a narrowing of the range in lending rates and movement towards positive real rates. He said he would be looking forward to the Government's counterproposals. In response to this, the Secretary once again pleaded for an understanding of Mexico's special circumstances and the special pressures on the Cabinet to avoid nominal rate increases at this time.

5. Mr. Stern also mentioned that he welcomed the Secretary's commitment to a strengthening of the project pipeline because he feared that the commitment level in FY85 would be even lower than in FY84 which itself was already too low for Mexico. He furthermore stressed that new commitments

this year and next will drive disbursements in 1986, 1987 and beyond, which would be critical years for Mexico's balance of payments. A high level of Bank disbursements in those years would be good for Mexico. Mr. Knox stressed the importance of possible development policy loans to strengthen the lending program relatively quickly with the prospect of high disbursements in nearby years. The Secretary reaffirmed his interest in DPL's, as he called them (with a smile), and said that they would be working on it.

6. The meeting took place in a most cordial and constructive atmosphere.

cc: Messrs. Clausen, Stern, Husain, Knox, Steckhan, LC1, van der Meer, LCP, Jennings, LCP, Glaessner, LCP, Finzi, LCP (o/r), van Gigch, LCP, Pfeffermann, LCNVP, Otten, LCP, Newman, LCP, Schultz, LCP, Thint, LCP, Moscote, LCP, Yepes, LCP, Keare, LCP, Mexico Division

Record Removal Notice

The World Bank Group Archives & Records Management

File Title Mexico - Country Files - Correspondence - Volume 1	**Barcode No.** 1779794

Document Date Sep 18, 1984	**Document Type** Memorandum

Correspondents / Participants
members of the Managing Committee

I.F.I. Shihata, Vice President and General Counsel

Subject / Title
Mexico : Restructuring of Mexican Public Sector Debt to Commercial Banks Maturing 1985 to 1990

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☑ 4 ☐ 5 ☐ 6 ☐ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

Reason for Removal
Attorney - Client Privilege

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	Aug 27, 2013

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

9-74
9/14/84

DATE : September 14, 1984

TO : Mr. A.W. Clausen, President

THROUGH : Mr. Ernest Stern, SVPOP

FROM : Pieter Bottelier, Division Chief, LC1MX

PBottelier

EXTENSION : 72543

SUBJECT : Brief for your meeting with Mr. Eduardo Pesqueira Olea, Secretary of Agriculture (Mexico), Monday, September 17, 1984, 3:00 p.m.

1. The meeting has been arranged at the request of the Mexicans, as a courtesy call. Messrs. Steckhan and/or Bottelier will also be present. We have not been advised of any specific points that Mr. Pesqueira may wish to raise. From our side, we suggest the following topic for discussion:

Chiapas Regional Development Project (agricultural component). After almost three years of preparation/appraisal work by the Bank, there is now a possibility of further delay. We understand that Mr. Pesqueira is in the process of redefining agricultural sector investment and policy priorities and that there may be a request for reappraisal of an amended project concept. We are concerned about this possibility and have informally suggested to Government officials that the present project concept (which is a time-slice of a ten-year agricultural development program) be respected and that possible shifts in priorities be reflected in a follow-up project.

2. We do not suggest that you initiate any discussion on the following topic, but in case it is raised by Mr. Pesqueira, the following is presented as essential background:

Agricultural Interest Rates: On October 1, 1984, the first scheduled adjustment of all onlending rates under Bank-financed credit projects and credit components falls due in accordance with the recently signed (August 7) General Agreement on Interest Rates. Mr. Pesqueira strongly opposed the agreement but was overruled by the Finance Minister. Because inflation in Mexico has declined more slowly than was anticipated at the time we negotiated the General Agreement on Interest Rates, the cost of fund index (to which all onlending rates will hence forward be linked) has also declined less than expected. Consequently, several small upward rate adjustments are likely to be required, including in particular for credit to small farmers. We expect that any upward adjustment of nominal interest rates will be strongly opposed by Mr. Pesqueira and some other members of Government. President de la Madrid recently announced a temporary price freeze on many public goods and services (until the end of the year) to reduce inflationary expectations. The Mexicans may ask us during the Annual Meetings to agree to freeze current interest rates until the next adjustment is due, December 31,

1984. The Agreement does provide a framework for consultations on interest rate adjustments and if the Mexicans raise the matter we should be willing to discuss it. If the matter is not resolved before October 1, 1984, the Agreement provides for an automatic suspension of disbursements on all loans in sectors where non-compliance occurs.

Attachment: Biographical Sketch of Mr. Pesqueira

cc: Messrs. Knox; Eigen, LC1; Steckhan (o/r), LC1; Berger, LC1MX;
Nercissiantz, (o/r) LC1MX

BSzaszkiewicz/PBottelier:cac

Attachment

Biographical Sketch of Mr. Pesqueira

Mr. Pesqueira Olea (47) became Secretary of Agriculture in July 1984. A law graduate from the Autonomous University of Mexico (UNAM), he has been associated with the Mexican public sector since 1962, mostly with the Ministry of Finance where he held several positions in the Directorate General of Credit. After a brief absence in 1977-78, as Executive Director for Mexico in the World Bank, he joined the Ministry of Programming and Budgeting in 1979 as General Coordinator of State Governments, with vice-ministerial rank, until his appointment as Director General of the Agriculture Credit Bank (BANRURAL) in December 1982, a post he held until June 1984.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
CONFIDENTIAL
AUG 27 2013
WBG ARCHIVES

M R WBG/ARCHIVES

DATE: August 29, 1984

TO: Mr. Ernest Stern, SVPOP
THROUGH: Mr. David Knox, LCNVP AML

FROM: Rainer B. Steckhan, Director, LC1 Steckhan

EXTENSION: 74621

SUBJECT: MEXICO - External Debt Rescheduling Negotiations - Provisional Report

Status of Negotiations

1. After 18 consecutive days, negotiations on the restructuring of Mexico's commercial bank debt were provisionally concluded in New York late Sunday evening, August 26, 1984. The Mexican delegation was led by Mr. Jose Angel Gurria, Director-General of External Credit; the Banks' Advisory Group was led by Mr. Rhodes, Senior Vice-President of CITIBANK. Discussions of the Advisory Group, to iron out remaining differences between participating banks, are expected to resume and be concluded in New York early next week. An outline of the draft restructuring agreement was leaked to the press and reported in a somewhat confused way by the Washington Post and the New York Times yesterday. The final outcome of negotiations depends on the resolution of reservations expressed by some banks. We have, unofficially and confidentially, learned of two outstanding issues. First, the British banks would like to make the restructuring agreement contingent on arrangements with the Paris Club on the restructuring of export credits. The Mexicans feel that this is unnecessary, since an arrangement with the United States--the biggest source of such credit--has been negotiated and the amounts outstanding from other countries are relatively small. Second, and potentially more serious, is the extreme reluctance of the French banks to agree to any restructuring of amortization payments falling due beyond the next three years. Mr. Rhodes is at present visiting Paris and London, presumably trying to resolve the remaining problems.

Terms of Restructuring

2. The draft debt restructuring proposals as they stand at present cover a total of over $47 billion in amortization payments falling due during the period 1985-90. It may well be the largest debt rescheduling deal in history. Under the proposals, commercial bank debt falling due during 1985-90 which has not been rescheduled already, estimated at US$20.1 billion, will be amortized over 14 years, including one year of grace. The amortization of commercial bank debt that was rescheduled in 1983 is also

./...

20.1
11.5
11.5
4.0
#47!

being stretched out as follows: Payments due in 1987 and 1988, amounting to $11.5 billion, will be repaid in 12 years, without grace; payments falling due in 1989 and 1990, amounting to another $11.5 billion, will be repaid in 10 years, also without grace. The Mexicans also succeeded in improving the terms of part of the $5 billion jumbo loan made by the commercial banks in 1983, as part of the IMF rescue package. On condition that Mexico prepays $1 billion of that loan in 1985, the banks will agree to apply to the remaining $4 billion of that loan, the same terms as the $3.8 billion commercial bank syndication that was arranged in 1984 (viz. 10 years, including 5-1/2 years of grace). Under the new proposals, all commercial bank debt currently outstanding would thus be fully paid off by 1999. The bulk of all Mexican public and private external debt (except World Bank/IDB/IMF debt) that was outstanding in early 1983, will have been rescheduled once the new deal is completed, and no further rescheduling is expected.

3. Under the new proposals LIBOR will be accepted as the reference rate for all outstanding commercial bank debt. The weighted average premium over LIBOR for all such debt would be 1-1/8%. (The actual premium would be based on a "step-up" formula, starting with 7/8% in the early years.) The banks would not charge front-end fees or other commissions. The draft agreement also provides for currency switching, i.e., non-American banks may choose to be repaid in their national currency, provided they so indicate to the Mexican authorities by a specified date.

Performance Monitoring

4. We have learned that the rescheduling agreement will be legally binding only through December 1987 (two years after the expiration of the current EFF agreement with the IMF). The formula proposed for the monitoring and review by the commercial banks of Mexico's performance is very interesting. Banks accounting for 33% or more of the commitments that were made in the $5 billion 1983 jumbo loan, may force a vote on Mexico's performance by all participating banks during the last quarter of 1987. If banks accounting for 55% or more of the 1983 commitments vote that Mexico's performance has not been adequate, the rescheduling agreement terminates on December 31, 1987 and all original maturity schedules, etc. will be reinstated. M

5. We understand that the IMF has agreed, after having shown much initial reluctance and a week of tough negotiations, to continue monitoring Mexico's performance under an "enhanced Article IV" formula. The details of this proposed side agreement with the IMF are not yet available to us, but its main characteristics appear to be as follows: After expiry of the current EFF agreement, the Mexican Government itself will prepare annual financial plans for approval by the national Legislature. The IMF will comment on these plans at the Government's request. It will continue to monitor performance under Article IV and submit its reports, as usual, to the Government. It will then be up to the Government to make the IMF reports available to the commercial banks.

6. We have been (unofficially) informed that during the recent negotiations in New York, serious consideration was given by the commercial banks to the possibility of also asking the World Bank to serve as an official monitor of Mexico's economic performance for the purpose of implementing the proposed debt restructuring agreement. (Earlier, both the Mexican Government and the commercial banks had expressed sincere appreciation to us for a staff presentation made in New York in July for a closed-door session of the Advisory Group, together with Central Bank representation, on World Bank views on Mexico's economic situation and prospects.) After debate on this option, it was decided not to pursue it on the grounds that World Bank conditionality, as understood by the commercial banks, was generally of a project or sector nature, and not sufficiently broad for their purpose.

New Money

7. As far as we know, the draft proposals do not contain any commitments by the commercial banks to provide new loans. There should be no need for such commitments, since the deal, once signed, should substantially restore Mexico's creditworthiness for commercial bank borrowing. The IMF monitoring role, combined with Mexico's commitment to prepare its own annual financial plans, will effectively introduce external borrowing ceilings that will be publicly known. It is our understanding that the draft debt restructuring proposals are based on the assumption that Mexico's gross new borrowing requirements from the commercial banks will be $1.2 billion in 1985 and $3 billion in 1986.

8. Further information and comments on the draft debt restructuring proposals and the ultimate agreement will be prepared when a more complete picture emerges. After resolution of the remaining issues with British and French banks (as mentioned in para. 1), the next step (expected to be reached by the middle of next week) will be to formally propose the agreement by telex to all 500+ participating banks.

cc: Messrs. Woods, FPBVP
Rotberg, TREVP
Bock, FPADR
Baneth, EPDDR
Pfeffermann, LCNVP
Hope, EPD(ED)
Landau, LC1
LC1MX

PBottelier:IulHaque/slc

THE WORLD BANK
Washington, D. C. 20433
U. S. A.

A. W. CLAUSEN
President

July 30, 1984

Dear Jack:

On my return from the Grove today, I learned of your thoughtful invitation to Peggy and me to stay at the Embassy while we are in Mexico City. I am sure you know we appreciate your offer of hospitality but, unfortunately, we cannot take you up on it.

Our people already have made reservations for us at the Camino Real since I will have to touch base with them periodically and, logistically, the hotel proves to be the best spot. Additionally, Jack, in my present position as head of an international organization, I think it best that I not stay at Embassies for obvious reasons which I am sure you understand.

Though our days in Mexico City are going to be rather hectic, I hope there will be some opportunity for us to have a little visit in any event.

Meantime, Peggy and I send our best to you and Constance.

Sincerely,

The Honorable
John A. Gavin
American Ambassador
Mexico City, Mexico D.F.

- R1

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

July 12, 1984

Lic. Carlos Salinas de Gortari
Secretario
Secretaria de Programacion y Presupuesto
Palacio Nacional, 4º piso
Patio de Honor
Mexico, D.F., Mexico

Dear Lic. Salinas:

In the absence of Mr. Clausen, I wish to acknowledge receipt of your letter of May 25, 1984, and a copy of the presentation which you made at the Wilson Center of the Smithsonian Institution. May I say that I found your speech both lucid and thought-provoking. Many of the themes of your speech, such as the need for promotion of non-oil exports, real interest rates, adjustment of public prices, productivity of investment, debt restructuring, etc. have also been highlighted in our Economic Report of May 1984, and we hope we can further broaden our economic dialog with the Mexican authorities. In addition, the availability of foreign finance is of critical importance and we hope to substantially expand our lending program for Mexico in support of policy changes and institutional strengthening.

In this connection, I shall be visiting Mexico in the week of July 16 to discuss in what way the Bank can most usefully contribute to your Government's efforts to promote "growth under conditions of greater equity and efficiency" as you put it. I am obviously at the disposal of yourself and your associates.

With best wishes.

Sincerely,

Rainer B. Steckhan

Rainer B. Steckhan
Director
Country Programs Department
Latin America and the Caribbean
Regional Office

bcc: Messrs. Knox
Southworth
Bottelier (o/r)

#637

Rec. 7/11

637

CARLOS SALINAS
SECRETARIO DE PROGRAMACION Y PRESUPUESTO

México, D.F.,May 25th., 1984.

ALDEN. W. CLAUSEN
President of the World Bank
1818 H. Street N.W.
Washington, D.C. 20433, USA

Mr. Clausen:

I am enclosing a talk which I recently gave at the Wilson Center of the Smithsonian Institution.

As you know, Mexico's economy is achieving an important recovery. We have controlled the economic crisis. Nevertheless, higher interest rates and restrictions on world trade and financial flows are putting severe strains on the economies of developing nations.

I would apreciate hearing your viewpoints on these topics in a near future.

Sincerely yours,

Carlos Salinas

Enclosure

RECEIVED

1984 JUN 27 PM 6: 54

OFFICE OF THE PRESIDENT

N O T E

To: Mr. Roy Southworth

Supplementary Data

MEXICO: Banca Confia

Small commercial bank, established in 1932. Prior to the nationalization of all Mexican banks in September 1982 Banca Confia was controlled by the Saenz family (sugar interests) and had a reputation as a conservative well run organization.

After the nationalization the Mexican Government named Ezekiel Padilla Couttolenc as Banca Confia's Managing Director; however the day to day management of the bank is handled by Rolando Veiga Saenz, a relative of the former controlling family.

Banca Confia continues to enjoy the same sound reputation as before the nationalization, and Ezekiel Padilla is given credit for having been able to retain the strong management team.

Ezekiel Padilla, a former businessman with no previous banking experience (he was a Y.P. in the Bank for a few months between October 1967 and July 1968), was recently introduced to IFC by Bernardo Quintana A., the President of Empresas Tolteca de Mexico, S.A. de C.V. to which IFC has recently extended an additional loan of US$68 million, of which US$15 million was for IFC's own account, and an equity investment of US$3.95 million.

The introduction has resulted in Banca Confia being most helpful to IFC, as well as in expressions of interest in providing Peso co-financing for IFC's future Mexican investments.

Whilst Banca Confia, like other Bancas Multiple in Mexico, has affiliates involved in such other activities as leasing, insurance and performance bonds, it is not known for any specific specialization.

Hugh Henry-May

Hugh Henry-May
IFC LAC I
2-13-84

Attached

1. Summary of the activities of Banca Confia
2. Biography of Mr. Ezekiel Padilla

SUMMARY OF THE ACTIVITIES OF BANCA CONFIA

Banca Confia was established in 1970 as a merger of financial groups dealing with the industrial and the sugar sectors. Prior to the nationalization of the Bank in September 1982, Banca Confia was a private institution. At the end of 1983, its total assets amounted to over 78 billion pesos, or about $525 million. Its credit portfolio amounted to almost $200 million at the end of 1983 and deposits held from the public amounted to over $450 million. Banca Confia employs almost 3,500 people and has 122 offices throughout the country. The only relationship with the World Bank of Banca Confia is its participation in the Small and Medium Industry projects through NAFINSA.

The curriculum vitae of Mr. Ezequiel Padilla, President and Chief Executive Officer, who will meet with Mr. Clausen on February 14, 1984 is attached. We understand that the objective of Mr. Padilla's visit is to inquire on possible cooperation between Banca Confia and the International Finance Corporation.

BIOGRAPHY

MR. EZEQUIEL PADILLA

President and Chief Executive Officer
Banca Confia

Born March 19, 1942, Mexico City. Graduate in Economics from National School of Economics in Mexico. Received Masters Degree in Public Administration from Harvard University. Also completed studies in International Finance and International Trade at Harvard (1965-1967).

Financial positions held include:

- Economist, Interamerican Development Bank (1966)
- Technical Advisor to Exec. Dir. of International Monetary Fund (1967)
- Member, Technical Staff of the World Bank (1967)
- Advisor to Exec. Pres. of Nacional Financiera, S.A. (1968-1970)
- Advisor to Undersecretary of Ministry of Finance (1969-1976)
- Executive Vice President, Union Nacional de Productores de Azucar (1973-1974)
- Advisor to Exec. VP of PEMEX (1974-1975)
- Vice President, Televisa (1976-1982)

Assumed present position as President and CEO of Banca Confia in January 1983.

ALFONSO MAZA
EXECUTIVE VICE PRESIDENT

BANCA CONFIA

SOCIEDAD NACIONAL DE CREDITO

BALDERAS 36 MEZANINE **MEXICO 1, D. F.** **597-47-88**

Not sure if Mr. Maza is coming or not.

BANCA CONFIA
SOCIEDAD NACIONAL DE CREDITO

BIOGRAPHY

ALFONSO MAZA
Executive Vice President

Mr. Maza is Executive Vice President in charge of Corporate Banking Group and International Division of Banca Confia.

Mr. Maza joined Banca Confia in January 1980 as Senior Vice President in charge of the International Division and in September also took the charge of Corporate Banking Group. He was promoted Executive Vice President in October 1983. During his professional career he has been in charge of several financial positions including those of Chief of Branch Operations of the Banco Comercial Mexicano (1971-1972) and promoted to Branch Manager (1972-1973), Finance Specialist of the Instituto Mexicano de Comercio Exterior (1973-1974), Account Manager of Citibank, N.A. (Mexico) (December 1974-July-1977), Manager of Foreign Credit Operations of the Ministry of Finance (july 1977-February 1978), Assistant Director of Foreign Credit Operations of the Ministry of Finance (February 1978-January 1979) and Account Manager in charge of the Public Sector of Banco Nacional de México (February 1979-December 1979).

Mr. Maza was born on October 23, 1948, he is native of Mexico City, and graduated in Business Administration from the Universidad Nacional Autónoma de México in 1971.

JANUARY, 1984

Mexico: Balance of Payments, 1985-87

(In billions of U.S. dollars)

orderly restructuring and internal reform —

	1985	1986	1987	Cumulative 1986-87
Current account	0.5	-3.5	-2.9	-6.4
Exports	23.1	15.5	17.3	32.8
Oil	14.8	5.6	6.0	11.6
Other	8.4	9.9	11.3	21.2
Imports	-13.5	-12.0	-14.3	-26.3
Interest payments	-9.9	-8.6	-8.1	-16.7
Other	0.7	1.6	2.2	3.8
Official capital	0.4	5.5	5.1	10.6
Commercial banks	0.2	3.5	2.5	6.0
Drawings	1.3	5.0	6.0	11.0
Amortization	-1.1	-1.5	-3.5 1/	-5.0
Multilaterals	0.7	1.1	1.6	2.7
Drawings	1.2	1.6	2.1	3.7
Amortization	-0.5	-0.5	-0.5	-1.0
Bilaterals and suppliers	0.3	0.5	1.0	1.5
Drawings	1.1	1.5	2.0	3.5
Amortization	-0.8	-1.0	-1.0	-2.0
CCC	-0.3	0.2	0.5	0.7
Drawings	0.3	0.8	0.8	1.6
Amortization	-0.6	-0.6	-0.3	-0.9
Other and short-term	-0.5	-0.3	-0.5	-0.8
Drawings	1.2	0.8	0.7	1.5
Amortization	-1.7	-1.1	-1.2	-2.3
Interest rebate	--	0.5	--	0.5
Private capital (net)	-4.3	-1.5	-1.3	-2.8
Interest earnings abroad	-1.3	-1.2	-1.2	-2.4
Debt amortization	-1.1	-2.2	-1.3	-3.5
External credits	...	1.8	1.0	2.8
Direct investment	0.5	0.6	0.6	1.2
Other payments and errors and omissions	-2.4	-0.5	-0.4	-0.9
Net international reserves (increase -)	3.4	-0.5	-0.9	-1.4

Sources: Mexican authorities; and Fund staff estimates.

1/ Includes US$3 billion of PEMEX acceptance facilities.

Note: Exports of crude oil are calculated using the following assumptions: for 1986, on the basis of actual exports in January-June 1986, assuming prices of US$9 per barrel and volumes of 1.2 mbd for the third quarter, and prices of US$11 per barrel and volumes of 1.2 mbd for the fourth quarter; and for 1987, assuming prices of US$11.0 per barrel and volumes of 1.3 mbd.

SPP
programación y presupuesto

CONFERENCE GIVEN BY MR.

CARLOS SALINAS DE GORTARI,

SECRETARY OF PLANNING AND BUDGET
OF MEXICO, AT THE WILSON CENTER OF
THE SMITHSONIAN INSTITUTION

May 11, 1984

CONFERENCE GIVEN BY MR.

CARLOS SALINAS DE GORTARI,

SECRETARY OF PLANNING AND BUDGET OF MEXICO, AT THE WILSON CENTER OF THE SMITHSONIAN INSTITUTION

May 11, 1984

Conference given by Mr. Carlos Salinas, Secretary of Planning and Budget of Mexico, at the Wilson Center of the Smithsonian Institution.
May 11, 1984

THE RESTRUCTURING OF THE MEXICAN ECONOMY

Mr. Prosser Gifford
Director of the Wilson Center;

Ladies and gentlemen:

I wish to thank the Wilson Center for its invitation to talk about Mexico's economic policies with such a distinguished group of scholars and observers of the Latin American situation.

Recently, there is ample news about Latin America and a renewed interest among the general public. Important events are altering the reality of the continent: democratic transitions in South America, the Central American quagmire, and the foreign debt problem which has resulted in an economic crisis, the depth and extent of which has no precedent since the Great Depression of the 1930's. During periods of great changes, the interrelationships between problems, ideas and countries increase. Mexico is not estranged from this dynamic.

As you know, Mexico has faced, since the beginning of 1982, a severe economic crisis. The Program for the Immediate Reordering of the Economy, which President Miguel de la Madrid introduced the same day he took office, December the first of 1982, is still being carried out and remains the policy framework for overcoming the crisis. Seventeen months of struggle to reorder the economy give us a firm base to state that we are carrying out the correct policies; we are attacking the roots of the crisis. These are the themes of my talk tonight.

To truly understand the present economic policy of Mexico —its goals and instruments— requires understanding both the country's long political tradition and its recent economic history.

The definition and execution of Mexico's economic and social programs are inseparable from the political project which guides the development and the modernization of the country. Mexico has a solid political regime, product of the first popular and nationalist revolution of this century. We constitute a Nation with a unique culture and strong social institutions. The Constitution of 1917, legal synthesis of Mexico's historic development, establishes the basis for an orderly and democratic social change. Thus, since the start of the century, we have built a mixed economy, where the public sector has promoted economic development and the private sector has played an important role in the industrialization and modernization of the country. The Constitution guarantees liberty of commerce, industry and career and, at the same time, establishes wide ranging social rights to protect and satisfy the basic needs of the population. The organized labor movement is a strong defender of the nation's political institutions.

The values which sustain our institutions and guide the country's development are nationalism, democracy, respect for liberty and a search for a just, sustained and balanced growth. The capacity which Mexico has demonstrated throughout its modern history to overcome problems and promote development is the result of these principles, which maintain the nation's unity and which give its institutions strength and flexibility. Thus, it is possible to execute a strong program to face the economic crisis, while maintaining democratic liberties and social peace.

As important as a correct economic policy, or perhaps even more, is the strength of the political system. In Mexico, the progress made in the fight against the economic crisis is due to:

— A clearly defined economic program.
— The government's will to carry it out.
— The institutional negotiations, through the political system, which allow its efficient execution.

This is how Mexico's political system allows the execution of the economic policy.

Being aware that the present crisis is a cleavage in Mexico's modern economic development forces us to recall, albeit briefly, the events that led up to it.

During more than fifteen years, from the mid nineteen fifties through the end of the seventies, the mexican economy was able to maintain strong economic growth together with stable prices and a fixed exchange rate. Internal financial savings increased considerably. The public deficit, as a portion of the GDP, was maintained at less than

2%. Real wages grew and foreign savings represented an average of 10% of total investment. The country was strengthened in all areas, incrementing its social and physical infrastructure and significantly expanding its industrial and agricultural capacity.

Nevertheless, during this period, structural disequilibriums appeared which would later limit the country's economic development. Personal income distribution did not improve significantly. Capital investment subsidies limited job creation. Prices and tariffs in the public sector lagged. Protectionist policies limited —as happened in most Latin American countries during this period— the possibilities of taking full advantage of the extraordinary boom in international trade that occured during the sixties. This prevented establishing a more efficient and competitive place in export markets and the world economy.

Throughout the seventies our development policy sought to overcome the economic and social structural deficiencies, especially through the creation of jobs at the same rate as population growth. Employment and welfare levels rose, but not enough attention was paid to maintaining the conditions of macroeconomic stability necessary to give permanence and strength to the social benefits of economic growth. Thus, the strong economic expansion programs, particularly those followed from 1978 to 1981, partly based on funds from petroleum and foreign debt, increased the economy's vulnerability with respect to the international environment. In this context, the two "shocks" in the early eighties —the excessive increase in interest rates and the fall in the price of oil— were the immediate causes of the crisis of 1982. Its magnitude was heightened due to the deferal of necessary economic adjustments.

The administration of President De la Madrid encountered, in december 1982, an increasingly deteriorating economic situation. The foreign exchange crisis and inflation were worsening, with negative effects on capital markets, public finance and production. Inflation, during the last quarter, was running at an annual rate of 125%; the public sector deficit reached 18% of the GDP and industrial production fell, during the second semester, at an annual rate of 10%. Foreign debt was 80 billion dollars, foreign credit was suspended and the international reserves of the Central Bank were almost depleted. Imports were drastically cut back. The banking system ceased obtaining foreign currency as a result of general exchange controls; the exchange market shifted over the border into the United States.

A deepening recesion —with a chain of bankruptcies, massive unemployment, hyperinflation and the corresponding indexation of some critical prices— constituted then, in a climate of uncertainty and lack of confidence, not only a real risk but also the most likely outcome. The existing dynamic would have led, had not firm actions been implemented, to economic chaos and grave social repercussions.

In his inaugural address, President De la Madrid announced the ten basic points of an economic program that faced the crisis directly:

— Reduce the rythm of growth of public sector expenditures.

— Protect employment.

— Continue selected public works.

— Establish strict standards to guarantee discipline, adecuate budgeting and honesty in public spending.

— Assist and provide incentives for producing, importing and distributing basic foodstuffs.

— Increase public revenues.

— Channel credit towards priorities.

— Reincorporate the exchange market under the monetary sovereignty of the State.

— Restructure the federal government administration.

— Strengthen the mixed economy regime.

These ten points synthesize the conception behind the economic reordering strategy which was designed throughout the presidential campaign, from the end of 1981 to mid 1982, while observing the country's reality daily, and was made more precise during the five months which separated the election from the inaugural. The presidential candidate listened to the citizens and, establishing a new style, publicly proposed a clear and basic strategy for dealing with the crisis, without hiding the difficulties of the situation or the measures necessary to face it. Afterwards, the president elect confronted the petitions and suggestions which were collected throughout the campaign with an updated diagnosis of the economic situation; this led to a precise series of actions. These stages were basic in setting a clear economic program based on the democratic mandate of the election.

After December the first, 1982, to base social change on the rule of law and to strengthen social harmony —which the crisis could have weakened— it was necessary to politically determine the economic relationship between the State and the society. This was the purpose of the constitutional reforms which defined the participation of the public, private and social sectors in the economy. Also, the reforms established a democratic and modern National Planning System, as an ordering principle for economic policy.

During the period in which the economic adjustment program was designed, some basic principles were established:

— The convenience of adopting a strategy to fight the crisis head on. It was necessary to mobilize the strength of the new government and of the majority of the population to correct the economic distortions, increase internal savings and reduce inflation. Gradual adjustments and general indexation were rejected as options because the medium and long term social costs of prolonging a crisis are considerable, as demonstrated by the experiences of many Latin American countries.

— The need —which proved to be true *a posteriori*— to correct the internal disequilibriums (that is to say, in public finances) so as to overcome the external disequilibriums in the balance of payments. Thus, the importance of internal factors was emphasized in the diagnosis of the crisis and the need for internal adjustment was underlined, with due attention to the delicate international environment.

— The conviction that it was necessary, both politically and economically, to avoid a merely orthodox stabilization strategy. An innovative set of measures, which sought to distribute the social costs of the adjustment and protect the productive manufacturing structure, was introduced. These measures would be the basis for a rapid recovery of economic activity and employment.

Thus, the program consisted of a series of innovative measures designed to face the economic problems while explicitly taking political and social factors into account. Actions were implemented immediately; day after day, during the first weeks of the present administration; the basic decisions of the new economic policy were executed, according to a precise calendar which had been drawn up previously. The congruence of the announced actions, the political will and the demonstrated capacity to act decisively modified the existing dynamic and led to a positive change in expectations.

The economic and social objectives were the following:

— To face the crisis within the framework of the mexican political system and through democratic methods.

— Maintain the productive manufacturing facilities and protect existing jobs.

— Adjust the growth of aggregate demand to the productive and financial bases of the economy so as to reduce inflation, foreign exchange instability and financial disintermediation; this meant, fundamentally, cutting the public sector's deficit as a percentage of GDP, from around 18% in 1982 to 8.5% in 1983. Without reducing the deficit, it would have been impossible to adjust other economic variables.

— Establish an adequate real exchange rate, which initially required undervaluing the peso, so as to jointly stabilize the dynamic of the foreign exchange market and induce, as desired, exports and efficient import substitution.

— Establish real interest rates which would foment savings in pesos.

— Reestablish, as soon as possible, financial and commercial relationships with the rest of the world.

The most important measures instrumented were the following:

1. *Reduction of the fiscal deficit through a selective adjustment of income and expenditure, introducing equity criteria*

The reduction in expenditures and the increase in income participated, on an equal basis, in the fiscal adjustment. A greater budgeting discipline increased the efficiency of expenditures; at the same time, the budget was reoriented towards the social sectors (education, health, social security) and towards labor intensive activities (agriculture and transport infrastructure); the budget cuts were concentrated in the industrial and energy sectors.

The increase in public income was based on redistributive criteria. A surtax of 10% was introduced for high income brakets, tax loopholes were reduced; the rate of the value added tax was increased from 10% to 15%, with the exception of medicines and basic foodstuffs which were taxed at a reduced rate of 6%. Most public prices were adjusted, specially gasoline; nevertheless, subsidies for basic foodstuffs were maintained and even increased in real terms.

Within the framework of budgetary austerity, a new job program for urban zones and depressed rural zones was established. The design and characteristics of this program are very innovative; the funds were channeled flexibly into works which directly benefited the community and which were labor intensive such as housing, drainage and roads. The program has been very successful in coping with social needs and in helping employ those who were entering the job market for the first time, which, given the population growth of the 60's, now reduced, means 800,000 new workers per year.

2. *The establishment of a dual exchange rate*

Exchange controls were maintained but simplified. The uncertainty and lack of confidence which existed initially would have made a free market volatile and vulnerable, while rigid and bureaucratic controls would have been unmanageable. The sliding exchange rate stabilized expectations during 1983. The controlled market operated normally, without shortages after the first semester, and overall the central bank's intervention in the free market was practically nil. The exchange stability allowed a discretional non-indexed adjustment of interest rates, which became positive, in real terms, during the second half of the year.

3. *The restructuring of foreign public and private debt*

The direct negotiations of the government with the international banking community allowed the restructuring of 18.8 billion dollars in principal payments due from August 1982 to December 1984. The restructuring of private debt was managed through an original mechanism, called FICORCA, which reduced the enormous short term load on the firms, without government subsidies on exchange or interest rates. This program was very successful and covered 11.6 billion dollars, almost the total private debt with foreign financial institutions.

4. *Moderate wage negotiations*

The adjustment of the minimum wage was tied to the expected rather than the observed inflation, looking forward rather than backwards. This broke the inertia of inflationary expectations and contributed decisively in protecting employment. A basket of basic consumer products was defined and the administration of price controls and subsidies was concentrated on the 18 items.

As a result of the preceding measures, the main objectives of the economic reordering program were attained during 1983. The internal adjustment of public finances was accomplished, the deficit was reduced as programed. Thus, the internal debt of the public sector was reduced 20% in real terms. The external adjustment of the balance of payments was larger than expected; the surplus in the balance of trade was 14 billion dollars and the current account showed, for the first time in more than 40 years, a surplus of 5.5 billion dollars which allowed a strong replenishment of the central bank's reserves.

Inflation was reduced from 100% in 1982 to 80.8% in 1983, and, more important, hyperinflation was avoided. If we observe the rate of inflation on a semestral basis, the reduction was much larger; from 120% in the second semester of 1982 to approximately 60% in the second semester of 1983.

The Gross Domestic Product fell 4.7% in real terms, although the various sectors of the economy behaved differentely. In general, those sectors open to international trade, and favored by the devaluation, reacted more dynamically. The severe drop in production, which began in mid 1982, was stopped by mid 1983 and there was a stable level of general activity during the last quarter of that year.

The 1982 crisis has imposed severe social costs on the mexican population. Nevertheless, the government's actions have controled the crisis and avoided even higher social costs. One of the most significant achievements of the Economic Reordering Program during 1983 was being able to avoid important bankruptcies in the manufacturing sector and maintaining practically constant rates of employment in the modern sector of the economy. This situation, together with a good agricultural year and the public employment programs, reduced the problems caused by unemployment and the pressures created by a growing labor force. All of this was accomplished while maintaining social peace.

On the basis of the results obtained during 1983, the main objective for the present year continues to be reducing inflation; the goal is to achieve an annual rate of 40% by the end of 1984, which will allow us to consolidate the economic recovery in a framework of reduced inflation. The reactivation of the economy has already started in a growing number of sectors, which makes it likely that the goal of 1% growth in GDP will be achieved during 1984. Savings in the banking system have continued to grow in real terms during the first months of the year, and both credit to the private sector and non petroleum exports have shown signs of a promising recovery. The crisis is under control. The economic policy is the correct one. We will persevere in its firm implementation.

Since his inaugural speech, President De la Madrid has emphasized the importance of being able to take advantage of the crisis as an opportunity for improvement. In implementing the economic adjustments, we have introduced important changes in the development process, which might have been inconvenient under easier circumstances, and which allow us not only to overcome the crisis but to avoid future reoccurrences. The objective is to establish structural conditions which assure a permanent congruence among social progress, macroeconomic stability and productive efficiency; we are establishing a new strategy which overcomes the limitations of the two stages of our recent economic history, where either financial stability without explicit social criteria was priviledged or social changes were sought without a solid productive base.

The National Development Plan 1983-1988, which was published close to a year ago, on the basis of a widespread gathering of public opinion, expresses the conviction that important changes in the nation's economic and social structures are required. It outlines a precise strategy, a series of regional and sectorial actions, to promote a different type of economic growth which will create more jobs and lower the foreign exchange component of investment, and which will allow improvements in the productive efficiency of agriculture, commerce and industry, thus leading to social progress.

We know that the internal adjustment effort which has been achieved, allows us to face the world wide uncertainty and instability during the second half of the decade with greater strength and under more favorable conditions than other nations which do not have, in the short run, bases for sustained growth. This is why we have decided to remain firm in confronting and overcoming the economic crisis we face today. However, the challenges Mexico faces in its future development are not easy, even though the country's potential —human, natural and institutional— gives us a base from which we can successfully deal with our problems.

The foreign debt of Mexico, and of other developing countries, has become a problem with its own dynamic, independent of internal adjustment variables and difficult to manage, if the fundamental parameters which govern its evolution do not change, specially the real rate of interest imposed by creditor nations and the growth in world trade.

As stated by President De la Madrid in his recent visit to South America, the possibility that developing nations can recommence sustained economic growth critically depends, after the necessary national efforts of internal adjustment, on the existence of a less adverse international environment. This requires lower interest rates, a renewal of financial flows and a reduction of protectionist barriers which reduce exports from developing countries towards the markets of industrialized nations, limiting, in consequence, the availability of enough foreign exchange to sustain internal growth and service the external debt.

This basic change in the international situation is necessary to strengthen the social stability and the democratic regimes in developing countries. The population is increasing and its demands multiply when they are not satisfied; economic stagnation means loss and retreat. On a political level, an indefinitely prolonged recession would, without a doubt, frustrate the democratic hopes and opportunities of many countries in the southern part of the continent. But a change in the international *milieu* is also necessary to consolidate the stability of the world economy and its financial system. An economic recovery in the industrialized nations can not be lasting if it is not also achieved, through dynamic trade flows, in developing countries. Latin America not only needs longer repayment calendars and lower interest costs on its debt but, above all, security in terms of greater access to the markets of the industrialized nations, so as to be able to generate the necessary foreign currency to reduce the accumulated debt burden. In today's interdependent world, stagnation in developing countries would jeopardize sustained growth in industrialized nations.

Because the circumstances of Mexico's independent life have never been easy, it is a country with a proud history and a tradition of successful struggle. In this process, the national strength has been forged based on: principles with a widespread social support, a clear determination to follow our own path, solid institutions which have shown resilience and flexibility, a strong executive with a democratic foundation, an adequate representation of each of the main sectors of society, and a political system with the capacity to recognize its weaknesses in time and to correct these for the good of the country. This institutional strength has allowed us, throughout our history, to coexist —in peace and respecting others sovereignty— with countries whose political regimes or ideological convictions differ from Mexico's.

Mexico's national strength depends on its integral development. We seek sustained growth under conditions of greater equity and efficiency. This is the essential tool for maintaining conditions of liberty, peace and social justice, within the rule of law established by our Constitution. Because of this, within the framework of our principles and on the basis of our political system, we persevere in confronting and overcoming the economic crisis we suffer. We remain alert to face, as we have throughout our history, both internal challenges and difficult international circumstances. We know that a responsible attitude of the industrialized nations in the implementation of their economic policy and a desire for a greater international economic cooperation will prevail because, otherwise, circumstances would revert against them.

We have not yet finished the process of reordering the economy but the progress accomplished confirms that President De la Madrid's government is following the correct path and that we will be able to achieve sustained growth on more permanent and equitable basis.

This present edition of the Conference
given by Mr. Carlos Salinas de Gortari,
was finally published on May, 1984 in
The Nations Graphic Workshops.
The edition was in charge of the
Secretary of Planning and Budget of
Mexico.

ISBN 968-809-903-1

R1

International Finance Corporation

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: CORINTFIN

June 29, 1984

His Excellency Jesús Silva-Herzog
Secretary of Finance and Public Credit
Secretaría de Hacienda y Crédito Público
Palacio Nacional
Mexico 1, D.F.

Dear Minister Silva-Herzog:

Further to my letter of June 7, 1984, regarding TAMSA, we have had the opportunity of reviewing the memorandum which you enclosed with your letter to Mr. Clausen dated May 31, 1984.

I wish to reiterate our appreciation for the interest expressed by President Miguel de la Madrid and yourself in obtaining IFC's financial support for TAMSA's project. To that end, IFC has devoted very substantial time and effort in processing this transaction. Details of our involvement and status of processing are contained in the attached note.

We have just completed a review of our work and involvement to date in the TAMSA project and have concluded that it would be very worthwhile to meet with the management of the Company and work together toward developing ways to overcome the obstacles which have arisen. In this regard, Giovanni Vacchelli, the Director of the IFC Department in charge of Mexico, will be travelling to Mexico at an early date to meet with TAMSA. IFC has already in the past provided its financial support to TAMSA, and I trust that it will be possible to develop a way of assisting its growth on this occasion.

Yesterday we had our last Board meeting of the 1984 Fiscal Year. The IFC Board approved a loan to Primex for its phthalic anhydride project, which joins previous approvals for Metalsa's restructuring and expansion in Monterrey and for Proteison's cottonseed flour/oil mill project in Sonora. We had worked to have TAMSA also approved in FY84, and hope that it will be possible to conclude our analysis and negotiations on that and several other projects in our pipeline during FY85.

I wish to express our thanks, on behalf of my colleagues in IFC and on my own, for all the support and collaboration which we have received in our operations and IFC's capital increase from you and your associates in the Secretaría de Hacienda and Banco de México, and in particular from Mexico's Executive Director in the World Bank/IFC, Lic. Patricio Ayala-González.

I look forward to seeing you soon.

Kind regards,

José M. Ruisanchez
Vice President
Latin America and the Caribbean

Note on Background and Status of IFC work on Processing the TAMSA Project

During September 1983, at TAMSA's request, IFC conducted a field appraisal of TAMSA's expansion program and the proposed US$150 million steelmaking facility. On December 21, 1983, IFC's Investment Committee authorized negotiations on a proposed IFC investment consisting of US$50 million in loans and US$7.5 million in equity. In the meantime, the timetable for raising the financing and implementing the project has slipped by several months while TAMSA and its commercial banks negotiated the restructuring of its existing foreign debt. Therefore, prior to going into syndication, IFC decided to update its original appraisal. This work took place during April 9-12, 1984, in Mexico.

As a result of this update, it became clear that, since IFC's Investment Committee meeting, several material changes had occurred. These changes include heightened uncertainties about the selling price adjustment mechanism in light of TAMSA's inadequate profit margins in 1983. TAMSA's 1983 sales volume to PEMEX fell substantially below original indications. Furthermore, a slower than anticipated growth has been identified in PEMEX's demand for oil country tubular goods (OCTG) and consequently, substantially higher export requirements will have to be achieved by TAMSA in the international OCTG industry dominated by persistently substantial excess capacity. The differential has recently widened between high domestic and low export selling prices which raises questions about the intrinsic economic costs/benefits of TAMSA's expansion. From the financial point of view, IFC was initially asked to consider subscribing to share capital to supplement the Mexican shareholders' resources. Subsequently, however, substantial resources became available from the Mexican shareholders, TAMSA discontinued negotiations with its prospective US market underwriters, but instead requested IFC to purchase the shares which were to be issued in the US market, thereby clouding IFC's role as an investor. With respect to the structuring of TAMSA's debt position, it was agreed that the existing short-term debt would be paid-off. It has instead been restructured, thereby considerably increasing the prospective debt service burden of the Company. These developments adversely affect TAMSA's financial and economic prospects which are now quite different from those presented to IFC's Investment Committee last December. In order to achieve adequate financial performance, it appears that TAMSA will need to operate at substantially higher production rates than initially foreseen.

IFC met with TAMSA on May 4, 1984, in Mexico City. At that meeting, IFC presented the above mentioned issues and concerns and suggested that TAMSA gather additional information and give assurances as follows:

(i) PEMEX's exploration and production program substantiating future seamless pipe requirements.

(ii) OCTG off-take arrangements between PEMEX and TAMSA.

(iii) TAMSA's detailed marketing programs substantiating higher export sales.

(iv) International OCTG industry data addressing likely future demand trends, capacity utilization levels and estimated international trading prices for the remainder of the 1980s.

(v) Revised TAMSA production programs substantiating higher output levels including material balances, costs and additional equipment requirements.

The above information is required for IFC to ascertain TAMSA's financial, commercial and economic viability in future years. Once such information is evaluated, IFC will be able to reintroduce the proposed project to IFC's Investment Committee, obtain renewed authorization to negotiate with TAMSA, initiate syndication efforts and proceed to its Board of Directors.

IFC has endeavored to maintain a constructive dialogue with TAMSA and has not withdrawn from the project. We look forward to early contacts with TAMSA and to working together with its management toward resolving these issues.

We appreciate the interest of the Government of Mexico in this project and look forward to continued cooperation in this and other matters.

YAntitch:mlb

6/8

After we talked about acknowledging this letter, I learned that Mr. Ruisanchez had received the letter directly from Mr. Ayala-Gonzalez and had acknowledged it (as attached).

MH

6-12-84

OK

B

FORM NO. 89
(2-83)

THE WORLD BANK

ROUTING SLIP	Date June 7

OFFICE OF THE PRESIDENT

Name	Room No.
Mr. Wuttke	I-12-100

XX	To Handle		Note and File
	Appropriate Disposition		Prepare Reply
	Approval		Per Our Conversation
	Information		Recommendation

Remarks

6-7-84

Please advise Mr.
Wuttke that I should
at least acknowledge
any [illegible] should reexamine
and [illegible] urgent
that Hans Wuttke
respond in
detail!

Roy Southworth

From

June 7, 1984

H.E. Jesus Silva-Herzog
Secretary of Finance and Public Credit
Secretaría de Hacienda y Crédito Público
Palacio Nacional
México 1, D. F.

Dear Minister Silva-Herzog:

On behalf of Messrs. Clausen and Wuttke, I wish to acknowledge and thank you for your letter of May 31, 1984 regarding Tubos de Acero de Mexico which was received through the courtesy of Mr. Ayala-Gonzalez.

IFC will be reviewing and following up on the memorandum which you enclosed with your letter.

Kind regards,

Jose M. Ruisanchez
Vice President
Latin America and the Caribbean

cc: Mr. Ayala-Gonzalez

JMR/zp

cc: Messrs. Clausen
Wuttke
Vacchelli
Schwartz/Antitch
Westmeier

Banco Mundial

1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

Con atendos saludos de

Patricio Ayala-González

Director Ejecutivo

RECEIVED
6 JUNE 84

Lic. Jesús Silva-Herzog F.

SECRETARIO DE HACIENDA Y CREDITO PUBLICO

May 31st. 1984.

MR. A.W. CLAUSEN
President
World Bank/I.F.C.
P r e s e n t

Dear Mr. Clausen:

On occasion of the visit to Washington, D.C. of President Miguel de la Madrid, I mentioned to you the great interest that the Mexican Government has in the financial support that the International Finance Corporation could give to the projected steel melt shop to be built by Tubos de Acero de México.

I am taking this opportunity to confirm in writing the relevance that the Mexican Government gives to this strategic project. At the same time. I enclose herewith a memorandum that explains in detail why we attach great importance to such an investment.

Yours very sincerly.

c.c. -Mr. Hans A. Wuttke

Enclosure.

TAMSA CONTINUOUS CASTING STEEL SHOP

As is well known, since 1976 exploration efforts made by Petroleos Mexicanos were highly successful. New oil fields were discovered and Mexico's proven oil and gas reserves increased from 5,773 million barrels at the end of 1964 to 40,192 million barrels at the end of 1978; they further increased steadily to 72,500 million barrels at the end of 1983.

Mexico was able to stop importing oil and became a world-class oil exporter. In this way it generated a substantial new source of foreign exchange (until then the most important limiting factor of the country's development efforts). The increased Mexican oil output contributed substantially to reduce the American Continent's dependence upon oil from the Middle East, an area which will probably continue being unstable in the foreseeable future. As a result of such favorable developments, the oil, petrochemical and also the capital goods industry related to the oil industry,became a key factor in the new long-term growth strategy of the country. Vital inputs for the oil industry as are the seamless steel pipe for drilling, casing, and other, placed Tubos de Acero de Mexico squarely in the same situation.

Up to 1977, TAMSA's production from its old plant could satisfy Pemex's demands of seamless steel pipe. However,starting in 1978, as a natural result of the accelerated growth of its exploration and production activities, Pemex progressively increased its consumption of seamless steel pipe. Such demands exceeded by important amounts the installed capacity of TAMSA's old plant; therefore, it was necessary for Mexico to spend large amounts of foreign exchange in the purchase of imported seamless steel pipe.

In the light of the world scarcity of seamless steel pipe that forced Pemex to buy abroad and store large amounts of steel pipe, it was only natural that the Mexican Government would request TAMSA to expand as fast as possible its productive capacity, in order to place the Mexican oil industry on a less risky footing insuring it from unreliable foreign supplies.

Responding to that request, TAMSA started its long-delayed expansion program. It was considered necessary not only to duplicate the company's productive capacity, but also to do it through a completely new plant representing the highly needed technological upgrading, in the melting as well as in the milling and finishing production facilities.

In short, the purposes of the project were the following:

1. To increase TAMSA's seamless pipe productive capacity in order to meet the additional requirements originated by the already known substantially enlarged oil reserves. Such new reserves actually positioned the country as a very important oil producer and exporter for many years to come, including the first decades of the Twenty-first Century.

2. To install a modern and "state of the art" production facility, capable of producing the high-specification steel pipe demanded by the modern and more demanding oil drilling and producing needs and conditions. In this way the necessary steps would be taken in time for the substitution of the old plant which was rapidly becoming obsolete and insufficient to meet the normal needs of Pemex.

3. To shield the oil industry from shortages of its most needed input -- seamless steel pipe. Oil is a vital activity for the Mexican economy: it is the only one that is and will be able, in the foreseeable medium-term future, to generate the foreign exchange necessary to pay for imports and to service the very large foreign debt. At the present time roughly 60% of the annual foreign exchange income of Mexico comes from exports of oil and oil-related products.

4. To improve Mexico's balance of payments, eliminating a drainage of foreign exchange through steel pipe imports and, in turn, converting the country into an exporter of this product whenever the production of TAMSA exceeded purchases from Pemex (United States has for many years been a large importer of seamless steel pipe; many other countries are also buyers).

TAMSA's planned investment for the construction of the new plant was US$700 million and included: a heat-treatment and cold finishing installation; the world's most modern continuous rolling mill (of retained mandrel) with an annual capacity of 450,000 tons of pipe; and finally, a continuous casting steel shop to produce the specialty bars of the size and type required by the rolling mill.

TAMSA has already completed the construction and is operating the above-mentioned installations, with the exception of the continuous casting steel shop. The steel shop has a projected production capacity of 500,000 annual tons of specialty bars of the precise type to feed the new rolling mill. The building of this steel shop, which is the final and essential element of the expansion program, requires an approximate investment of US$150 million. It must be mentioned that the economic and financial viability of all the investments already made by TAMSA, and the reliability of the supply of seamless steel pipe to Pemex in the years to come, depends very much on the construction of the steel shop, the reasons being:

a. Specialty steel bars in sufficient quantities to supply the new rolling mill cannot be obtained in Mexico. On the other hand, the external supply has already proven to be insufficient in volume and not very reliable, two facts that are critical for the normal operation of the new rolling mill and that affect very much the cost of production.

b. Such specialty steel bars bought abroad are more expensive than the ones TAMSA could produce with its projected steel shop. Only in this year such excess cost is estimated at US$28 million and it will increase to not less than US$40 million from 1985 on.

c. The projected savings in foreign exchange for the country which were expected to be achieved with the investment program are nullified to a large extent by such imports of specialty steel bars.

Such important considerations have driven TAMSA to advance negotiations for the necessary funding of the construction of the steel shop on the following bases:

- Financing from Exim Bank at 8-3/4%	US$ 49 million
- A syndicated loan with foreign banks led by the International Finance Corporation	" 50 "
- An increase in the share capital to be placed both in the U.S. and in the Mexican markets with the participation and support of IFC	" 30 "
- Internal funds	" 23 "
Total	US$152 million

The Investment Committee of IFC, after considering the paramount importance of TAMSA's steel shop for the company and for Mexico, approved in principle, in December, 1983, its participation in the project including the capital and the credit packages. This position of IFC was known and gave rise to a favorable reaction by the international banks that had already stated their interest in the financing. Recently, however, the Credit Analysis Department of IFC has requested a series of additional conditions, practically impossible for TAMSA to meet, which indicate an unexpected different position regarding the operation mentioned above.

The resulting withdrawal of IFC would mean actually, the abstention of all international banks from the financing and also of other potential equity subscribers. In fact, TAMSA and Mexico would be in a position of not being able to make the physical investment, notwithstanding the important part it plays in the long-term economic strategy of the country. In addition, it would also create a very difficult financial situation for TAMSA--the only Mexican private company with shares traded in the U.S. stock market--since the new production facility would remain unfinished and operating therefore at higher costs.

TAMSA's investment project is very sound and is related to the medium and long term needs of Mexico's oil industry. We believe that the additional conditions requested by the IFC are based mainly on concerns valid for a short term situation. Such concerns are mostly related to the temporary effects on the presently limited demand of TAMSA's products by Pemex and to the temporary distortion caused by the three-year economic adjustment program being applied by Mexico in order to meet the challenges of its foreign debt crisis.

TAMSA deems it reasonable to request that IFC may give enough weight to the strategic aspects of TAMSA's investments for Mexico's petroleum industry and for its foreign exchange earnings. The changes that may be brought about in the situation of the company and in its production costs may also be very relevant in a review that IFC could make of its position.

The Mexican Government gives a high priority to this private project. It will be very much appreciated if the IFC position regarding this project could be re-examined. From the result of this reconsideration depends the feasibility of TAMSA's project, essential to Mexico's oil industry. It would also contribute to a healthy and needed recovery of private investment at the present time.

5/30/84

R.I. cc. Mr. Wuttke

545

Lic. Jesús Silva-Herzog F.

SECRETARIO DE HACIENDA Y CREDITO PUBLICO

May 31st. 1984.

MR. A.W. CLAUSEN
President
World Bank/I.F.C.
P r e s e n t

Dear Mr. Clausen:

On occasion of the visit to Washington, D.C. of President Miguel de la Madrid, I mentioned to you the great interest that the Mexican Government has in the financial support that the International Finance Corporation could give to the projected steel melt shop to be built by Tubos de Acero de México.

I am taking this opportunity to confirm in writing the relevance that the Mexican Government gives to this strategic project. At the same time. I enclose herewith a memorandum that explains in detail why we attach great importance to such an investment.

Yours very sincerly.

c.c. -Mr. Hans A. Wuttke

Enclosure.

Lic. Jesús Silva-Herzog F.

SECRETARIO DE HACIENDA Y CREDITO PUBLICO

May 31st, 1984.

MR. A.W. CLAUSEN
President
World Bank/I.F.C.
P r e s e n t

Dear Mr. Clausen,

On occasion of the visit to Washington, D.C. of President Miguel de la Madrid, I mentioned to you the great interest that the Mexican Government has in the financial support that the International Finance Corporation could give to the [illegible] steel [illegible] project to be built by [illegible] on the north of Mexico.

I am taking this opportunity to confirm in writing the relevance that the Mexican Government gives to this strategic project. At the same time, I enclose herewith a memorandum that explains in detail why we attach great importance to such an investment.

Yours very truly,

c.c. Mr. [illegible]

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

193

DATE May 30, 1984

TO Files — please

FROM Pieter Bottelier, Division Chief, LC1A P.B

EXTENSION 72543

SUBJECT Meeting between Mr. Clausen and President de la Madrid of Mexico

The meeting took place on Wednesday, May 16, 1984, at the Vista International Hotel in Washington, D.C. Present also were Mexico's Finance Minister, Lic. Silva Herzog (for part of the time), Mr. Ayala Gonzalez, Executive Director, Mr. Steckhan and myself. The following subjects were discussed.

Mexico's Stabilization Policies

Mr. Clausen congratulated the President on the initial success of his Government's stabilization measures and urged him to persevere in the chosen strategy until the economy had fully recovered. The present economic situation in Mexico, though very difficult in many respects, was better than most had dared to hope in Toronto (September, 1982), he said. The President responded by saying that, though the initial successes were indeed heartening, the battle was not over yet. But, whilst much energy still had to be devoted to crisis management, his Government was anxious to maintain perspective on Mexico's longer-term needs for structural economic adjustments. He mentioned the need for greater efficiency in agriculture and industry, and greater export orientation of production generally. Major price distortions in the economy remain to be corrected, he said. The main problem now is to get inflation under control. The progress in this respect had been slower than expected but still, the current annualized rate (at 60%) was only half the rate of the same period last year. He hoped that the annualized rate would decline to 40% towards the end of 1984. The burden on the people in terms of real income losses had been very great. Real wages had declined by at least 25% since 1982, he said. A serious threat to the success of Mexico's stabilization/recovery policies was the high level of international interest rates which could - if sustained - cancel or even reverse the progress made.

Economic Report

Mr. Clausen mentioned that the Bank had just completed a new report on the Mexican economy which he hoped would be of interest to the Government. The President said that he was reading the "green cover" version of the report, that he found it, like earlier such reports, indeed of great value to Mexico, and that he would soon share with us his comments through official channels. Mr. Clausen indicated that the Bank would welcome the comments, but stressed the need to protect the independence of the Bank in expressing its opinion on the economic conditions and prospects of developing member countries.

Private Sector and Structural Economic Reform

In response to Mr. Clausen's question, the President said the excessive relative growth of the public sector in Mexico in the past was the result of deep and pervasive psychological problems in the country. Large imbalances needed to be corrected, but it would take a long time. The people of Mexico had come to rely on the State for subsidies through public enterprises and, paradoxically, the rapid growth of the public sector had weakened the State. Private sector confidence needed to be fully restored and both foreign and domestic private investment needed to be encouraged. The foreign investment law would be applied flexibly, he said (meaning that the minimum 51% domestic ownership would not always be enforced). At the same time, public enterprises had to become more efficient, or closed down, as public sector savings needed to rise rapidly to keep the economy in balance and finance investment.

An important dimension of the present Government's longer-term development strategy was the emphasis on regional development so as to create "multiple growth poles", the President explained. World Bank support for regional development was most welcome.

U.N. Population Conference in Mexico City

Mr. Clausen mentioned that he expected to be in Mexico for a few days in early August to address the U.N. Population Conference. The President said that his Government was very conscious of the need to reduce fertility and was supporting many public and private family planning programs in Mexico. "Come to Mexico City and see our pressing population problem with your own eyes," he said. (The question of possible Bank support for population/health/nutrition projects in Mexico was not raised.)

World Bank/Mexico Relationship

The relationship was good, the President said, and of great importance to Mexico. He welcomed continuation of the dialogue on many policy issues. Mr. Clausen said that the World Bank was prepared to step up assistance for Mexico and that IFC could also make an important contribution to private sector recovery in Mexico.

The meeting lasted about 45 minutes and took place in a most cordial and relaxed atmosphere.

Cleared with and cc: Mr. Steckhan, LCl

cc: Messrs. Clausen
Ruisanchez
Stern
Lerdau
Knox
van der Meer
Jennings
Glaessner
Wessels
van Gigch
Mexico Division

PBottelier/ww

FORM NO. 75
(9—78)

THE WORLD BANK

ROUTING SLIP	DATE: May 25, 1984

NAME	ROOM NO.
Mr. A.W. Clausen	E-1227
~~(through Mr. E. Stern)~~	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
X	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL	X	SIGNATURE
	NOTE AND FILE		**URGENT**

REMARKS:

Please sign.. It may be helpful to get a decision from the Mexicans. Its agreed at the staff level, but Cuca is hesitating

FROM:	ROOM NO.:	EXTENSION:
Rainer B. Steckhan	B-906	74621

Acting RVP, LAC

FORM NO. 27 - OCR
(3/82)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

RTANT—PLEASE READ INSTRUCTIONS BELOW BEF TYPING FORM

Typewritten Character Must Fall Completely in Box!

PAGE	OF	OFFICIAL DEPT/DIV ABBREVIATION	MESSAGE NUMBER	TEST NUMBER (FOR CASHIER'S USE ONLY)
1	2	LC1DA		

START HERE

LIC. JESUS SILVA HERZOG, SECRETARIO, SECRETARIA DE HACIENDA Y CREDITO PUBLICO, PALACIO NACIONAL, 3ER PISO, MEXICO D.F., MEXICO.

IN LOOKING AT OUR SCHEDULE FOR BOARD PRESENTATIONS OF NEW LOAN PROPOSALS DURING REMAINDER OF OUR CURRENT FINANCIAL YEAR I FIND THAT A $300 MILLION LOAN TO MEXICO FOR AGRICULTURAL CREDIT - FIRA VIII - HAS BEEN TENTATIVELY INCLUDED IN AGENDA FOR LAST MEETING OF THE YEAR ON JUNE 26. I UNDERSTAND THAT NEGOTIATIONS CONCERNING THIS PROPOSED LOAN HAVE YET TO START BUT THAT THESE COULD PROBABLY BE COMPLETED QUICKLY ONCE THE GOVERNMENT HAS CONFIRMED ITS APPROVAL FOR THE DRAFT GENERAL INTEREST RATE AGREEMENT THAT WAS NEGOTIATED BETWEEN OFFICIALS OF THE GOVERNMENT AND THE BANK EARLIER THIS MONTH. I TRUST YOU WILL APPRECIATE THAT WE NEED TO REACH FULL AGREEMENT WITH YOUR GOVERNMENT ON HOW TO RESOLVE THE INTEREST RATE PROBLEMS THAT HAVE ARISEN DURING THE PAST YEAR UNDER BANK LOANS FOR CREDIT IN AGRICULTURE AND OTHER SECTORS BEFORE WE CAN NEGOTIATE A NEW LINE OF CREDIT. IF YOU FEEL COMFORTABLE WITH THE DRAFT GENERAL INTEREST RATE AGREEMENT AS NEGOTIATED, I WOULD BE GRATEFUL FOR YOUR CONFIRMATION BY RETURN TELEX. IF YOU DO NOT FEEL COMFORTABLE OR IF YOU NEED MORE TIME TO REVIEW THE DOCUMENTS, PLEASE LET ME KNOW, IF POSSIBLE, ALSO BY RETURN TELEX SO THAT I

END OF TEXT

PINK AREA TO BE LEFT BLANK AT ALL TIMES

INFORMATION BELOW NOT TO BE TRANSMITTED

CLASS OF SERVICE: TELEX NO.: DATE:

SUBJECT: DRAFTED BY: EXTENSION:

CLEARANCES AND COPY DISTRIBUTION: AUTHORIZED BY (Name and Signature):

DEPARTMENT:

SECTION BELOW FOR USE OF CABLE SECTION

CHECKED FOR DISPATCH

DISTRIBUTION: WHITE—File Copy CANARY—Bill Copy WHITE—Transmittal Copy BLUE—Originator to Keep

FORM NO. 27 - OCR
(3/82)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

RTANT—PLEASE READ INSTRUCTIONS BELOW BEF TYPING FORM

Typewritten Character Must Fall Completely in Box!

PAGE 2 OF 2 | OFFICIAL DEPT/DIV ABBREVIATION: LC1DA | MESSAGE NUMBER | TEST NUMBER (FOR CASHIER'S USE ONLY)

START HERE

CAN REALLOCATE THE BOARD SLOT ON JUNE 26. I UNDERSTAND THAT FORMAL NEGOTIATIONS ON FIRA VIII WOULD HAVE TO BE COMPLETED BY EARLY NEXT WEEK FOR US TO BE ABLE TO PROCESS THE DOCUMENTS IN TIME FOR BOARD PRESENTATION IN FY84. OTHERWISE WE WILL HAVE TO RESCHEDULE THE LOAN FOR FY85. LET ME USE THIS OPPORTUNITY TO ASSURE YOU OF MY FULL APPRECIATION OF THE COMPLEX AND DIFFICULT TASK OF MANAGING INTEREST RATES IN A SITUATION OF HIGH THOUGH DECLINING INFLATION AS IN MEXICO AT THE PRESENT TIME. OUR STAFF HAVE MADE A SINCERE EFFORT TO UNDERSTAND THE DIFFICULTIES AND TO FIND A SOLUTION, JOINTLY WITH YOUR OFFICIALS, THAT WOULD BE ACCEPTABLE FROM AN ECONOMIC AND FINANCIAL POINT OF VIEW WHILE OBSERVING UNDERSTANDABLE POLITICAL SENSITIVITY. I WILL BE GRATEFUL FOR YOUR EARLY REPLY. WARM REGARDS, TOM CLAUSEN.

END OF TEXT

PINK AREA TO BE LEFT BLANK AT ALL TIMES

INFORMATION BELOW NOT TO BE TRANSMITTED

CLASS OF SERVICE: TELEX
TELEX NO.:
DATE: May 25, 1984

SUBJECT: MEXICO

DRAFTED BY: Pieter Bottelier, LC1DA
EXTENSION: 72543

CLEARANCES AND COPY DISTRIBUTION:

AUTHORIZED BY (Name and Signature): A.W. Clausen

DEPARTMENT:

SECTION BELOW FOR USE OF CABLE SECTION

CHECKED FOR DISPATCH

DISTRIBUTION: WHITE—File Copy CANARY—Bill Copy WHITE—Transmittal Copy BLUE—Originator to Keep

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE May 22, 1984

TO Operations Policy Sub-Committee

FROM Basil G. Kavalsky, Acting Director, CPD

EXTENSION 60115

SUBJECT MEXICO CPP: OPSC Review Meeting

Sonia might want to check next week about ~~whether~~ if it will be scheduled for a MC Discussion in June.

1. Attached is an agenda and comments on major policy issues identified by CPD and PBD for consideration by the Sub-Committee. The suggested agenda items are:

i) the projections and down side risks;

ii) appropriateness of proposed ceiling on IBRD lending;

iii) approach to policy conditionality; and

iv) cost sharing.

2. The Review Meeting will be held on Friday, May 25, 1984 at 3:00 p.m. in Room E-1208.

Attachment

Not for future MC discussion. 5/25

Thanks!!

cc: Messrs. Wuttke
Jansen

Regional Office: Messrs. Lerdau
Steckhan
van der Meer
Bottelier
Pfeffermann
Landau
Haque
Berger

P-1866

Mexico CPP

Topics for Discussion

Mexico's economic prospects have changed dramatically since the last CPP review in early 1981. At that time, some concern was expressed about the country's economic policies, particularly the exchange rate and the large fiscal deficit, but on balance it was considered likely that the country's oil resources and good access to capital markets would permit it to grow rapidly without serious balance of payments strains for the rest of the decade. Given this relatively favorable situation, it was decided to hold Bank lending constant in nominal terms at around $600 million a year through FY86. Today, the outlook is for a gradual and difficult recovery from a balance of payments crisis of unprecedented magnitude precipitated in mid-1981 by massive capital flight and a sharp contraction in Mexico's access to private external capital.

The present Administration has made significant progress in implementing an IMF-supported stabilization program. However, inflation remains high and economic activity remains depressed. As the CPP stresses, a sustained and comprehensive effort will be required to complete the stabilization process, to restore the confidence of the private sector and to provide the basis for dealing with the country's difficult long-term structural and poverty problems. The CPP argues that the Bank's role as a source of long-term finance has again become important, and that the prospects are good for a productive policy dialogue between the Bank and the Government. It proposes a substantial increase in the lending program, conditional on progress in a number of clearly specified policy areas.

The issues suggested for discussion at the OPSC meeting are set out below:

1. <u>How realistic are the projections and what are the down side risks?</u>

Overall, the base case scenario presented in the CPP is a reasonable one. It assumes a moderately favorable external environment, continued success in stabilization, a recovery of non-oil export growth to 10 percent a year, zero growth in oil export volume, a small annual increase in the real world oil price, and an average real interest rate on new borrowings of about 4 percent. It also assumes a gradual restoration of Mexico's access to private capital markets and a willingness of lenders to refinance Mexico's amortization requirements averaging about $20 billion annually during the rest of this decade. This would permit achievement of a GNP growth rate of over 6 percent in the decade after 1985 and a reduction in the interest burden from 35 percent of exports in 1983 to 17% by 1990. The situation could develop even more favorably if the restoration of confidence implied by this scenario were to lead to a substantial return flow of private capital. However, the downside risks are substantial. Of particular concern are: (i) the current high levels of base rates for international lending (12-3/8% LIBOR and 12-1/2% prime) which are aggravating the country's already onerous debt service burden, and if increased significantly over the medium term are likely to result in an untenable debt position for Mexico;1/ (ii) continuing high domestic inflation which is generating exchange rate uncertainties and pressures for further capital flight; and (iii) the extent to which the rapid expansion in non-oil exports projected for 1985-95 can be sustained, given existing policy constraints to export growth and uncertainties about the durability of economic recovery in industrial countries. While Mexico does have some flexibility in coping with an adverse global environment because of its substantial oil resources, the current uncertainties underscore the importance of continued close monitoring of the Mexican economic situation and of linking the level of Bank lending to progress in policy areas critical to improving Mexico's creditworthiness.

2. Is the proposed ceiling on IBRD lending appropriate?

The Region proposes that an upper limit on lending of $5.5 billion be authorized for FY85-89, but that this not be regarded as a target. That level is 25 percent more in real terms than the presently authorized program for FY84-88. However, it is only seven percent more in real terms than actual lending in FY79-83, and it corresponds approximately to the country norm based on population, per capita income and performance. This level of commitments would imply that Mexico's share in the Bank's portfolio would decline from about 8.1 percent at end 1983 to about 6.5 percent at the end of FY93, compared with less than 6 percent with the current allocation. However, given the constraints on commercial bank lending, the need for expanded resource transfers from the Bank is much greater now than appeared likely a few years ago. Moreover, the Government appears much more open to a productive policy dialogue with the Bank. If the lending program can be used effectively in support of that dialogue as suggested by the CPP, the proposed increase seems warranted. Given the needs of lower income countries, we suggest that such an increase be regarded as temporary, and that the Bank plan on a continued decline in Mexico's share in total lending after FY89.

3. How would the proposed approach to policy conditionality work in practice?

The CPP proposes that the size and composition of the lending program be made conditional on progress toward the implementation of key economic policies. A SAL program does not seem feasible for the time being, and conditionality at the individual project level is not regarded as effective in dealing with the broad issues of primary concern. As an alternative approach, the Region proposes to conduct periodic reviews of performance on specified policy issues, with a view to adjusting the size and/or composition of the program in light of the outcome. The CPP acknowledges that further discussion of the links between policy conditionality and lending is needed before this approach becomes fully operational. However, it does identify several policy areas of immediate concern (para. 67): fiscal and exchange rate policy,

---

1/ The current level of interest rates, if maintained through 1984, would add about $2.0 billion to the 1984 debt service burden shown in the CPP, raising the ratio of interest to exports from 31 percent to 37 percent in that year.

interest rates and financial policy, trade policy, energy pricing, agricultural pricing, disbursement performance. The comprehensive range encompassed by these policy areas raises the question whether, from the standpoint of ensuring the Government's acceptance of the proposed approach and gaining credibility early on, it may not be more effective to concentrate on a more limited number of high priority reforms as the basis for assessing progress during the first year or so. Another question is whether this set of policy conditions could be developed within the broader framework of a multi-year program of policy actions that would be agreed with the Government, and perhaps formalized in a Letter of Development Policy that could eventually form the basis for a possible SAL operation. The adjustments in Bank lending that would have to be made if policy performance is unsatisfactory should be clearly understood by both the Bank and the Government. In this context, while the linkage between performance in some areas (e.g., financial policy) and the proposed lending program is specified in the CPP, it is less clear with regard to the others. Finally, for the proposed approach to conditionality to be credible, the Bank would have to be willing, if agreed policy conditions are not met, to risk the loss of staff resources invested in building up the project pipeline and to reduce lending significantly below the proposed ceiling. The proposed semi-annual reporting on country performance should help to minimize the risk of building up a project pipeline independently of the Government's policy performance.

4. Are the proposed project cost sharing arrangements appropriate?

Before the Special Action Program, the Bank's share of total project cost, in those cases where local cost financing was involved, was limited to 35%. For project expenditures during the SAP period, cost sharing has been increased to 70% in some cases with the overall cost sharing ratio remaining below 50%. The CPP recommends continuation of an average ratio of 50% in FY85. Beyond FY85, the CPP proposes a 50% maximum for agricultural and social sector projects, and, while not explicitly recommended, return to 35% for the others. The recommended policy on cost sharing is the same as that being applied to Brazil.

5. Other Topics

The Region proposes that a review of the strategy be held early in FY86. This should incorporate a report on the first two semi-annual reviews of policy performance, and the implications of these for Bank lending.

Annex 1 compares the IBRD lending program proposed in the CPP with those previously approved.

Annex II provides a comparison of various country performance indicators.

Annex III provides selected indicators of Mexico's debt service burden over time.

MEXICO

Annex 1

	Actual		Current	Programs					Five-Year Totals		
	FY82	FY83	FY84	FY85	FY86	FY87	FY88	FY89	FY82-86	FY84-88	FY85-89
Operations Program (No.)											
Approved, February 1981	8	10	7	4	6	..	..	..	35	..	..
Proposed, April 1984	5	6	3	10	11	9	10	7	35	43	47
Lending Program (No.)											
Approved, February 1981	6	5	7	5	5	..	..	..	28	..	..
Rev. Std. Table IVa, Feb. 1984	5	6	3	5	5	7	6	..	24	26	..
Proposed, April 1984	5	6	3	5	8	8	7	7	27	31	35
Lending Program (Cur. $m)											
Approved, February 1981	641.0	575.0	600.0	600.0	600.0	..	..	..	3016.0	..	..
Rev. Std. Table IVa, Feb. 1984	657.3	887.9	575.0	605.0	800.0	1075.0	1090.0	..	3525.2	4145.0	..
Proposed, April 1984	657.3	887.9	575.0	570.0	1250.0	1175.0	1250.0	1250.0	3940.2	4820.0	5495.0
Lending Program (Const. FY84 $m)											
Approved, February 1981	732.6	618.3	600.0	555.6	515.9	..	..	..	3022.5	..	..
Rev. Std. Table IVa, Feb. 1984	751.2	954.7	575.0	560.2	687.9	862.0	820.8	..	3529.0	3506.7	..
Proposed, April 1984	751.2	954.7	575.0	527.8	1074.8	943.0	941.3	885.9	3883.5	4061.9	4372.8
Commitment Deflator (FY84 = 100)	87.5	93.0	100.0	108.0	116.3	124.6	132.8	141.1			

Note: November 1983 Review Group Decisions - FY84-85: IBRD $1145 million
FY86-88: IBRD $3000 million.

PBD/CP
5/15/84

COMPARATIVE COUNTRY ANALYSIS

The current account deficit is now relatively small. Primary school enrollment is high, as is adult literacy, although secondary school enrollment is below the upper middle-income average.

	MEXICO		BRAZIL		MALAYSIA		KOREA	
Economic Structure								
Population 1982 (millions)	73.1		122.7		14.5		39.8	
GNP Per Capita 1982 $US	2250.0		2310.0		1840.0		1760.0	
% Agriculture in GDP 1982	7.4		n.a.		23.0		16.3	
% Industry in GDP 1982	38.3		n.a.		30.0		39.0	
% Services in GDP 1982	54.4		n.a.		47.0		44.6	
Debt Service Ratio 1982 g/	29.2		33.4		3.6		13.1	
Economic Performance								
Real GDP Growth Rate, 1970-82	6.1		7.6 b/		7.7		8.5	
Real Merchandise Exports Growth Rate, 1970-82	13.3		8.8		3.8		18.9 d/	
Exports GNFS/GDP, 1982	17.9		9.0 c/		51.0		38.8	
Current Account Balance/GDP, 1982	-1.6		-6.6		-13.3		-3.9	
Gross Domestic Savings/GDP, 1982	21.9 a/		19.0 c/		26.0		21.2	
Recent Social Indicators								
Population Growth Rate	2.6		2.1		2.4		1.7	
% Change in Crude Birth Rate (1960-82)	-24.5		-26.7		-33.7		-25.3	
% Change in Crude Death Rate (1960-82)	-41.5		-36.8		-56.7		-41.3	
Infant Mortality Rate (per 1,000)	54.4		73.0		29.0		32.0	
Life Expectancy (years)	65.6		64.0		67.0		64.0	
Adjusted Education Enrollment								
- Primary	120.0		93.0		92.0		116.0	
- Secondary	37.0		32.0		53.0		n.a.	
Adult Literacy Rate	82.7		76.0		60.0		93.0	
Lending Program	FY79-83	FY84-88 e/	FY79-83	FY84-88 f/	FY79-83	FY84-88 f/	FY79-83	FY84-88 f/
Nominal IBRD $US	3478.2	4820.0	4392.6	6324.0	659.4	1383.0	2473.0	3825.0
p.c.p.a. Lending $US	9.5	11.3	7.2	10.3	9.1	19.0	12.5	19.3
p.c.p.a. in Constant 1983 $US	10.5	8.8	7.9	8.5	10.1	15.8	13.9	16.0

a/ Gross National Savings.
b/ 1970-81.
c/ 1981.
d/ Exports GNFS.
e/ Proposed.
f/ November 1983 Review Group Decisions.
g/ Excludes service on non-guaranteed debt.

Bank Assistance Policy Group
Country Policy Department
May 22, 1984

Mexico: Indicators of External Debt Burden

	1979	1980	1981	1982	1983	Change 79-83
	------------Billion $-------------					--%--
Total DOD	40.2	50.7	74.9	84.9	88.6	120
of which: short-term debt	(6.3)	(11.1)	(22.5)	(25.1)	(25.6)	306
of which: debt with variable interest rates	(15.7)	(37.8)	59.5)	(67.9)	(73.2)	366
Total Debt Service	11.4	9.3	10.6	11.3	16.0	40
of which: interest	(3.4)	(4.5)	(6.0)	(7.5)	(10.3)	203
Exports of Goods and Services	15.3	23.9	29.4	29.5	29.6	93
	-------------Percent--------------					
Total Debt Service Ratio	74.5	38.9	36.1	38.3	54.1*	-28
Interest to Exports Ratio	22.2	18.8	20.4	25.4	34.8**	57

---

* Compared with 42.5% in CPP.
**The same as in the CPP.

Sources and Notes: 1979-1982 data are from the DRS and estimates by EPD for service payments on non-guaranteed debt. Data for 1983 were provided by the Mexican Government after the CPP was prepared. Total DOD at end 1983 is consistent with previous EPD estimates but the share of short-term debt is substantially larger. Amortization payments in 1983 are also larger (by $4.0 billion) than estimated earlier. A mission from the EPD Debt Division is currently in Mexico and is checking on these data.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DECLASSIFIED
CONFIDENTIAL
AUG 27 2013
WBG ARCHIVES

DATE: May 15, 1984

TO: Mr. A. W. Clausen
(through Mr. Warren Baum, Acting SVPOP)

FROM: Rainer B. Steckhan, Director, LC1

EXTENSION: 74621

SUBJECT: Brief for Your Meeting with President de la Madrid of Mexico (Wednesday, May 16th in the Vista International Hotel at 1730 hours)

1. The main purpose of President de la Madrid's visit to the USA this week is to discuss Central America and bilateral Mexico-USA relations. Your meeting will last about 30 minutes and is expected to focus on Mexico-World Bank relations. Central America is not expected to be raised, but should the subject come up, we have included some relevant information in the background notes (attached). Secretary Silva Herzog also may be present. From the Bank, Pieter Bottelier (Division Chief for Mexico) and I will be in your office shortly after 17:00 and accompany you to the hotel.

2. The meeting has been arranged at the initiative of the Mexicans, mainly as a courtesy call. We have not been advised of any specific points that President de la Madrid may wish to raise. From our side we suggest the following three topics for discussion:

i) Mexico's stabilization policy performance. President de la Madrid should be congratulated for the firmness and foresight with which his Government has been implementing its draconian stabilization program following the crisis of 1982. The present economic management team is very able and appears determined in its efforts to restore confidence and conditions for future growth. Although inflation is not coming down as rapidly as had been expected, the Government is on the right track and should be encouraged to continue present policies until financial stability is re-established. They should above all resist growing pressure to re-open the public spending tap prematurely. Mexico should also establish a more open trade regime as a critical part of its long term development strategy. Mexico's economic recovery and subsequent growth will depend on non-oil export development and private investment. The private sector in Mexico is still in a state of shock following the traumatic experiences of 1982 and the large devaluation that followed. Restoration of confidence will, in large measure, depend on continued progress towards financial stability and on consistency of economic policies.

ii) Our lending program and policy conditionality. We believe that a favorable climate for increased World Bank activity in Mexico exists and we are prepared to increase commitment levels if policy performance continues to be good and if we are successful in rebuilding a strong project pipeline. For this we need the Government's active support. We have noticed some ambivalence in this regard. Some senior officials argue that Mexico should not seek major new commitments from the World Bank while there still is a large pipeline of undisbursed funds ($2.2 billion at present) reflecting serious project implementation and disbursement problems. From our side we are prepared to make an extra effort in project identification/preparation. In addition to repeater projects in most sectors, we are considering the possibility of re-entering the power sector and have made tentative project proposals for energy conservation, high technology development, low-cost housing, water pollution control, and solid waste disposal. In support of Mexico's "Plan Chiapas" which is very close to President de la Madrid's heart, we appraised two regional projects (agriculture and rural roads) in this State (bordering on Guatemala); they will be jointly presented to the Board in November 1984. We hope to undertake more regional projects of this kind in future.

Mexico has so far rejected the idea of SALs apparently for fear of adverse domestic reaction to policy conditionality. It should be understood, however, that, with the accelerating shift towards program and sector lending, broad policy conditionality in one form or another cannot be avoided even if there are to be no SALs. General policy performance criteria, which we hope to discuss with Government soon and to which we propose to link increases in the lending program as a whole, include improvements in public sector investment programming, continued satisfactory progress towards a reduction of energy and other major subsidies, rationalization of interest rate policy, effective export promotion, and reduced import restrictions. It would be helpful to have President de la Madrid's understanding for our need to move in this direction, not only to justify a significant increase in the World Bank's lending program for Mexico, but also to facilitate our role as lead bank in co-financing, especially after the EFF agreement with the IMF expires, end 1985.

iii) You will be visiting Mexico in early August for the <u>U.N. Population Conference</u> and have agreed to visit CIMMYT. You may wish to ask President de la Madrid about his plans and expectations concerning this conference and give him some idea of what you plan to say on that occasion. We do not have an active policy dialogue with Mexico on population issues. A project was prepared some years ago but the Government decided to finance the project itself. Population control, mainly through private organizations, is discretely encouraged by the Government. Some progress in fertility decline is reported, but the population growth rate, at 2.5 percent, is still too high.

Attachment: Background notes on the Mexican economy, Bank/Mexico relations and miscellaneous topics.

cc: Messrs. Lerdau
van der Meer, LCP
Pfeffermann, LCNVP
Landau, LC1
Bottelier, LC1A

BACKGROUND NOTES

(attached to Mr.Clausen's brief for a meeting with President de la Madrid of Mexico on Wednesday, May 16th, 1984).

List of topics included:

A. Recent Economic Developments and Short Term Prospects

After two years of severe economic contraction (real wages in the formal sectors declined by more than 25 percent) we are beginning to see some early signs of recovery. Although the first quarter still showed negative GDP growth, we now believe that 1984 as a whole may show positive results. Non-oil exports are rising rapidly (January/February 1984 figures show a 60% increase over same period in 1983), demand for investment credit is reviving after two years of decline, electricity sales are rising, in spite of steep real rate increases in January of this year, domestic currency deposits remain high and capital flight appears to have virtually ceased (although there have been reports of a resumption in recent weeks).

Mainly as a result of a dramatic drop in imports (from $24 billion in 1981 to $8 billion in 1983) the balance of payments showed a large current account surplus last year (about $5 billion) and foreign exchange reserves were quickly rebuilt (to around $6 billion at present). The recent $3.8 billion syndicated commercial bank loan was oversubscribed even though many of the smaller banks did not want to participate. Some of the larger commercial banks expect that a resumption of voluntary lending to Mexico may not be far away. Mexico's state sugar financing agency, FINASA, is expected to test the market soon with a new $100-150 million loan in the form of a revolving 12-months facility. The external debt service burden in the years ahead remains daunting, however. Even if all amortization payments falling due during the next five years are fully refinanced, Mexico would, on current projections, still have to generate a resource surplus of around 3 percent of GDP p.a. to satisfy foreign creditors. We understand that Mexico is discretely preparing debt-restructuring proposals which it hopes to negotiate with creditor commercial banks later this year.

Although the worst of the Mexican crisis seems to be over, the road ahead to full recovery is still long and perilously narrow. There is practically no room for domestic economic policy mistakes and Mexico's growth prospects are very dependent on international economic conditions, particularly with regard to growth of the U.S. economy and protectionism in OECD countries. Domestic U.S. interest rates and the international price of oil stand out as two critical short term variables. For example, an increase in the U.S. prime rate and LIBOR of one percentage point, adds about $600 million (or more than 10% of current non-oil export earnings) to Mexico's annual debt service burden; a $1 per barrel drop in the international price of oil would have a comparable effect on the current account of Mexico's balance of payments.

Two important potential dangers facing Mexico, are:

i) Civil disorder. So far the de la Madrid Government appears to have retained credibility with the majority of the population, but an explosion of public anger over declining incomes and rising unemployment cannot be ruled out. Domestic political tensions are high; much attention is at present focused on wage negotiations with the unions, scheduled for next month.

ii) Insufficient progress on the inflation front. The rate of inflation is coming down, but not as fast as the Government wanted and expected. The current annualized rate is about 65 percent, about half the rate this time last year. The Government had hoped that inflation for 1984 as a whole would not exceed 40 percent but it now looks likely that it will be at least 55 percent. For the past 6 weeks the Government has stopped lowering deposit rates and some senior officials are considering whether a temporary acceleration in the exchange rate slide (13 centavos each day - pre-announced) is called for. Others, however, appear to be in favor of a deceleration in the slide so as to reduce inflationary pressures. On balance, it seems likely that the Government will not change the current rate of the slide for the time being. This also means that nominal lending rates cannot be reduced, which will delay private sector investment recovery. The Government is very worried that inflationary expectations will become stronger again and that it may be forced to adopt some generalized indexing system. But to date it has not wavered in the pursuit of its objective to reduce the fiscal deficit through expenditure cuts, improved tax collection and gradual public sector price adjustments for energy and a wide range of other goods and services.

B. Past and Future Lending to Mexico - Major Issues

Starting with a power project in 1949, the World Bank has committed a total $6.5 billion for 82 loans to Mexico. Fifty-three projects have been completed, 29 are under implementation; the outstanding undisbursed balance is about $2.2 billion. A table showing past and proposed future lending is attached as the last page to these background notes. We committed $888 million in FY83 and on average $696 million during the past five years. This year we expect to commit $576 million, but one large loan - $300 million for agricultural credit - remains to be negotiated. The major issue concerns onlending rates to farmers. While inflation is still high, many lending rates in Mexico are negative in real terms. The Government has decided not to go the Brazilian route of indexing amortization payments for fear that this might make the fight against inflation even more difficult, and create insuperable cash flow problems for small farmers and other priority borrowers.

To overcome the many problems that have arisen over the implementation of interest rate covenants in existing loan agreements, we have proposed, and the Mexicans have accepted, to negotiate a general interest rate agreement that would apply to all ongoing and new credit-type projects supported by the World Bank. A legal document embodying the agreement is being negotiated this week; <u>we have indicated to the Mexicans that we can only proceed with the proposed new agricultural credit project if we reach full agreement on how to deal with the existing interest rate problems.</u> The draft legal document provides for the gradual reduction of interest rate subsidies to the point where all lending rates would be positive in real terms by the end of 1986, except for small farmers and municipalities, who would continue to be eligible for subsidized loans for certain purposes.

As mentioned in the brief in para. 2(ii), a major challenge facing us in the years ahead is to rebuild a strong project pipeline. Until the crisis of 1982, the expectation was that Mexico would graduate in the 1980s. Consequently, project identification and preparation was given relatively low priority both by ourselves and by the Mexicans. More recently, we have been preoccupied with disbursement problems and the restructuring of ongoing projects under the special action program. The Mexicans are also very concerned about slow disbursements and the relatively large pipeline of undisbursed funds. Some senior members of Government openly take the position that Mexico should not seek large amounts of new World Bank commitments until project implementation and disbursement performance have significantly improved. A comprehensive report on these problems and their solution is being prepared for discussion with Government in July. We are anxious to reach firm understandings with the Mexicans on the need for increased project preparation work. We have noted some ambivalence on the part of Government in its support for our current efforts to identify and prepare new projects. It may be useful to explain to President de la Madrid that we understand the Government's dilemma in this regard, but that in our view, there is no conflict in working on solutions for the disbursement problem and on the building of a new project pipeline at the same time. We are aware of Mexico's growing preference for quick disbursing (maximum 3 years) program-type loans and expect that our lending program will reflect this.

C. <u>Co-financing with Commercial Banks - Mexico</u>

The Mexicans have indicated that they would like to try co-financing with the World Bank after they have successfully completed debt restructuring negotiations with commercial bank creditors which, in their expectation, will be sometime in the second half of 1984. They have been reluctant to accept co-financing arrangements so far, because Mexico had little difficulty mobilizing the foreign exchange needed through syndicated commercial bank loans and also because there was concern that co-financing would not be incremental in nature. We expect to be able to make a modest start with co-financing in FY85, using a large proposed railway project as the vehicle. Co-financing could become very important after the EFF agreement with the IMF expires (end 1985) when the commercial bank creditors may look towards the World Bank for lead bank guidance and a measure of security.

D. Export Development Loan - Mexico

The $350 million Export Development Loan made last year as part of our special action program for Mexico is not moving as expected. Very little has been disbursed so far. Parallel lines of dollar credit from official bilateral sources are also reported to move only very slowly. The single most important reason is believed to be that many exporters have access to subsidized peso credit which can be converted into foreign exchange to pay for imports. A major contributing factor is, of course, that import demand remains extremely depressed while the economy is in recession. The World Bank loan is reported to be moving even more slowly than similar bilateral loans, alledgedly because the spread charged to sub-borrowers is relatively high (3 percent over Bankers Acceptance Rate) while procedures are said to be complicated. We are at present considering a reduction in the spread and a simplification of procedures, but it is feared that even with those modifications, disbursements will remain slow. Cancellation of the loan may have to be considered if there is no progress towards the end of this calendar year. The Mexicans have shown no interest in discussing cancellation mainly, we believe, because our loan and similar bilateral loans provide a convenient foreign exchange security cushion at low cost and also because of the political cost of such action vis-a-vis the commercial banks.

E. Bilateral Trade Issues Mexico/USA

Bilateral trade is high on President de la Madrid's agenda for discussions with the U.S.A. Mexico, the third largest US trading partner, is neither a member of GATT nor a signatory to its export subsidies code. In the recent past there have been numerous, sometimes bitter complaints about growing U.S. protectionism affecting Mexican exports. Officials in both countries hope that a bilateral subsidies pact can provide an alternative legal framework for resolving cross border commercial disputes. Having ruled out the pursuit of a comprehensive bilateral trade treaty, the Mexican government is now negotiating for an understanding about export subsidies and countervailing duties. The proposed accord, which would remain in effect for three years, would award Mexico an "injury test" provision requiring US firms to first prove their business is suffering from Mexican competition before filing demand for countervailing duties. Mexico, for its part, would commit itself to stop export subsidies and has already agreed to limit steel exports to the US to 300,000 tons this year (from 575,000 tons in 1983). We understand that good progress has been made in the ongoing bilateral trade accord negotiations, except with regard to the pharmaceutical industry.

F. Miscellaneous Notes - Mexico

An economic report - the first such report by the Bank since the crisis of 1982 - is being distributed this week. A draft was discussed with the Government in April. The report takes a positive view of Mexico's stabilization efforts and sets out the domestic policies and international economic conditions needed for the resumption of steady growth at around 6 percent p.a. in the second half of this decade.

A new Country Programming Paper is to be discussed by the Operations Policy Subcommittee on May 24, 1984. In the paper the LAC Region requests authorization to increase commitments to Mexico to $1.2 billion p.a. from FY86, provided overall policy conditionality is met.

In FY83 gross disbursements fell to $390 million (from $437 million in FY82) and net disbursements to $234 million ($323 million in FY82). As a result of our special action program which includes the establishment of special accounts (revolving funds) with the borrower, and other factors, we expect significant improvement in FY84 ($500 million gross disbursements) and beyond. Net resource transfers are at present only barely positive and are expected to become negative from FY87 even with improved disbursement performance and higher commitment levels.

IBRD's share in Mexico's total public and publicly guaranteed external debt at the end of CY83 was estimated at 3.2 percent. Our share in Mexico's debt service payments in 1983 was 4.5 percent. Mexico's share in IBRD's loan portfolio is at present about 8 percent and is projected to fall to just under 6.5 percent by 1995 if the lending program proposed in the CPP is implemented.

G. Bank Operations in Central America

President de la Madrid may inquire about the status of our operations in support of the Central American countries. He may also make a plea for a stronger Bank effort to help these countries. In addition, he may make a special reference to the case of Nicaragua.

We are prepared to assist the governments of the five Central American countries, whenever possible, through our lending, policy dialogue and technical assistance. However, the unsettled conditions in the region complicate our task.

In Costa Rica and Honduras we have concluded that the most urgent need is for structural adjustment programs. So far, however, we are only supporting such a program with a SAL proposal for Costa Rica. Nevertheless, our staff has been working intensively with both governments for over a year, helping them to put together workable programs. We have made good progress recently in the case of Costa Rica and we may be able to present a SAL to the Board by the end of this calendar year. In the case of Honduras, the economic team has not as yet been able to propose a program that could be considered suitable for support by a possible SAL. Therefore, at present, we cannot predict if and when a SAL can be proposed to Management for approval.

Although Guatemala has a low debt service ratio, its financial management in recent years has weakened and the country may run into severe balance of payments problems if the public sector fiscal imbalance is not corrected soon. At the same time, we feel that successive governments have neglected too long the needs of the majority of the population who live in extreme poverty. Finally, trade policy must be improved to reduce protection and to permit Guatemala to continue to operate within the Central American Common Market (CACM). For these reasons, we have been maintaining an intensive policy dialogue with the government. We are holding in abeyance further lending operations until we can reach an agreement on these critical areas.

As regards El Salvador, the Bank has reluctantly concluded that the country is not creditworthy in the present political circumstances, although we recognize that financial management has been as prudent as could be expected. Therefore, we are not actively preparing any new loans at present. We are, of course, prepared to reconsider this assessment as soon as the situation improves.

Economic management in Nicaragua has not been prudent in recent years and the country is now facing an unsustainable balance of payments situation. For this reason, after having made five loans/credits to the Sandinista government we have not been able to continue lending since February 1982. In recent months we have reinitiated an active dialogue with the authorities with a view to determine whether they are prepared to take the necessary measures to restore the country's creditworthiness. At our initiative an FAO mission visited the country in March and is now preparing an agricultural sector report. Also, at the government's request, a Bank specialist in agricultural marketing visited the country in April to provide technical assistance on food subsidies and the marketing of basic grains. We expect to send his report to the government soon. Finally, a small economic mission visited the country in March and April. Its report is being prepared at present and it is scheduled to be reviewed internally next month. This report should provide a fresh assessment of the creditworthiness question.

As regards our regional approach to Central America, we have been working for years on a possible loan to the Central American Bank for Economic Integration (CABEI). Processing of this operation is delayed, however, because two of the five countries that would have to guarantee the loan are at present classified as not creditworthy for Bank lending. On the other hand, we are prepared to support the efforts of the Central American countries to rationalize their system of protection. Thus, we have provided the five countries with some relevant studies and we shall be sending a mission to Guatemala soon to assess the progress made by the CACM Secretariat.

LAC Region
May 15, 1984

Attachment

MEXICO: Actual and Projected Lending Operations Through FY89
($ million)

Population : 73.1 million (mid-1982)
Population Growth: 2.6% (1983)
GNP per Capita : $2,250
Area : 1.9 million km^2
Literacy Rate : 79% (1980)

NOTE: THIS TABLE IS PART OF DRAFT CPP WHICH IS TO BE REVIEWED BY OPSC ON MAY 24, 1984

		Through	Actual					Current	Program					Total	Total	Total	Total	Reserve
		FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY88	FY89	FY74-78	FY79-83	FY84-88	FY85-89	Projects
Agriculture/Livestock Credit I - VI	IBRD	600.0																
Agriculture/Livestock Credit VII	IBRD				325.0													
Agriculture/Livestock Credit VIII	IBRD																	
Agriculture/Livestock Credit IX	IBRD							300.0										
Papaloapan Integrated Rural Development	IBRD	26.0									250.0							
Integrated Rural Development PIDER I-II	IBRD	230.0																
Integrated Rural Development PIDER III	IBRD																	
Irrigation I - VII	IBRD	243.7				175.0												
Irrigation (Rio Panuco Supplementary)	IBRD		(25.0)															
Irrigation VIII (Rio Sinaloa/Rio Fuerte)	IBRD		92.0															
Apatzingan Irrigation	IBRD																	
Ocoroni Irrigation	IBRD			160.0														
Bajo Rio Bravo Irrigation II	IBRD				23.0													
Irrigation Rehabilitation	IBRD					180.0												
Small Scale Agriculture Infrastructure I	IBRD		60.0						100.0									
Small Scale Agriculture Infrastructure II	IBRD																	
Rainfed Agriculture Development I	IBRD									175.0								
Rainfed Agriculture Development II	IBRD				280.0													
San Fernando Rainfed	IBRD												300.0					
Tropical Agriculture Development I	IBRD	56.0					138.4											
Agricultural Marketing I	IBRD																	
Agricultural Marketing II	IBRD						115.0											
Chiapas Rural Development	IBRD											200.0						
Regional Agricultural Development II*	IBRD								50.0									
Agriculture Extension and Research*	IBRD												200.0*					
Soil & Water Conservation	IBRD										150.0*							
+ 3 Reserve Projects	IBRD										100.0							70.0(86) 90.0(86) 75.0(87)
	IBRD																	
	IBRD																	
Industry	IBRD	0.5																
Export Oriented Industry (FONEI I-III)	IBRD	185.0																
Export Oriented Industry (FONEI IV)	IBRD		175.0															
Export Oriented Industry (FONEI V)	IBRD																	
Small & Medium Industry Development I	IBRD	47.0										150.0						
Small & Medium Industry Development II	IBRD			100.0														
Small & Medium Industry Development III	IBRD																	
Small & Medium Industry Development IV*	IBRD						175.0											
Small & Medium Industry Development V	IBRD									175.0*								
Fertilizer I	IBRD	50.0										150.0						
Fertilizer II	IBRD		80.0															
Capital Goods Credit	IBRD																	
Capital Goods Credit II*	IBRD					152.3												
Mining Development I	IBRD										200.0*							
Mining Development II*	IBRD			40.0														
Industrial Sector I	IBRD										100.0*							
Las Truchas Steel	IBRD	70.0							250.0									
Pollution Control I	IBRD																	
Pollution Control II	IBRD					60.0												
Export Development I	IBRD										100.0							
Export Development II	IBRD						350.0											
Industry Unidentified	IBRD										200.0							
+ 4 Reserve Projects	IBRD											150.0						50.0 (87) 70.0 (87) 100.0 (88) 100.0 (89)
Power I - IV	IBRD	704.8																
Power V	IBRD																	
Power VI	IBRD									300.0								
+ 2 Reserve Projects	IBRD											250.0						300.0 (87) 250.0 (89)
Tourism I-III	IBRD	114.0																
Highways I-VII	IBRD	265.7																
Highways VIII (Sector I)	IBRD		120.0															
Highways (Sector II)	IBRD																	
Highways (Sector III)	IBRD							200.0										
Chiapas Highways (Rural)	IBRD											200.0						
Railways I-III	IBRD	236.0							70.0									
Railways IV	IBRD																	
Railways V*	IBRD				150.0													
Railways VI	IBRD									200.0*								
Ports I	IBRD	19.7											200.0					
Industrial Ports Preparation	IBRD																	
Ports III	IBRD				14.0													
Airports	IBRD	25.0						75.0										
+ 1 Reserve Project	IBRD																	250.0 (87)
Urban Development I	IBRD	16.5																
Urban Development II	IBRD																	
Mexico City Urban Engineering	IBRD				164.0													
Housing Development I	IBRD						9.2											
Housing Development II	IBRD								100.0									
Urban Development V	IBRD											150.0						
Urban Development VI	IBRD									125.0			150.0					
Water Supply - Mexico City I	IBRD	78.2																
Water Supply - Medium Cities I	IBRD	40.0																
Water Supply - Medium Cities II	IBRD																	
Water Supply - Medium Cities III	IBRD				125.0													
Water Supply - Medium Cities IV	IBRD						100.3											
Water Supply - Medium Cities V	IBRD									150.0								
Water Supply - Small Cities and Rural*	IBRD												260.0					
Solid Waste*	IBRD										75.0*							
Water Pollution II	IBRD												75.0*					
+ 2 Reserve Projects	IBRD												65.0					25.0 (85) 15.0 (85)
Vocational Training I	IBRD																	
Technical and Industrial Training*	IBRD					90.0												
Technical and Productivity Sector Loan	IBRD									80.0* 45.0								
Total : Amount		3,008.1	552.0	300.0	1,081.0	657.3	887.9	575.0	570.0	1,250.0	1,175.0	1,250.0	1,250.0	1,494.5	3,478.2	4,820.0	5,495.0	
Number		52	6	3	/	5	6	3	5	8	8	/	7	21	2/	31	35	
Lending Program in constant FY84 Commitment $			683.2	366.3	1,288.4	751.2	954.7	575.0	527.7	1,074.8	943.0	941.3	885.9	2,128.4	4,043.8	4,062.0	4,372.7	
Commitment Deflator (FY84 = 100)			80.8	81.9	83.9	87.5	93.0	100.0	108.0	116.3	124.6	132.8	141.1					
Standby Projects: Value								-	455:0	525.0	-	275.0	-					
Number								-	3	4	-	2	-					

* Standby Projects

LAC Regional Office
April 18, 1984

February 8, 1984

Dear Chucho:

Thank you very much for your telex of January 24,1984 informing us about your Government's decision to contribute 151.93 million pesos to the FY84 account. We are deeply grateful for this action.

May I take this opportunity to express once again my appreciation to you and your Government for your continued support.

Warm regards.

Sincerely,

A. W. Clausen

Su Excelencia
Senor Lic. Jesus Silva-Herzog
Secretario de Hacienda
y Credito Publico
Mexico 1, D.F., Mexico

bcc: Mr. Patricio Ayala-Gonzalez
Executive Director

cc: Messrs. Qureshi
Ikram
Mistry
Van Puymbroeck

PDeSantis:eok:sb

1/25/84

[illegible] IIS1859[illegible] RCA[illegible]
DISP
WHEN REPLYING TO THIS MESSAGE REFER TO [illegible] TCP FCA
[illegible]

RCA[illegible]
248423 WORLDBANK
1777317 SHRCM[illegible]
TLX.NO. 5[illegible]
10:38 A.M.
MEXICO, D.F. [illegible]UARY 21, 1984

INTERNATIONAL DEVELOPMENT ASSOCIATION
WASHINGTON, D.C.
U.S.A.

ATTENTION: MS. RINA DE SANTIS

REFERENCE IS MADE TO RESOLUTION NO. IDA 82-6 OF THE EXECUTIVE DIRECTORS OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION ENTITLED ''ARRANGEMENTS FOR SPECIAL CONTRIBUTIONS'', WHICH WAS ADOPTED ON OCTOBER 26, 1982.

THE GOVERNMENT OF MEXICO HEREBY GIVES NOTIFICATION - - PURSUANT TO SECTION C, PARRAGRAPH 5 (A), OF SAID RESOLUTION THAT IT WILL MAKE A SPECIAL CONTRIBUTION IN THE AMOUNT OF 151.93 MILLION PESOS TO THE FY-84 ACCOUNT IN ACCORDANCE WITH THE TERMS OF THE SAID RESOLUTION.

REGARDS,

LIC. JESUS SILVA-HERZOG F.
GOVERNOR FOR MEXICO

[illegible]

August 15, 1984

Dear Mr. President:

It was extremely gracious of you to take time from your heavy schedule to host a breakfast during my brief visit in Mexico. My colleagues and I appreciated the opportunity to continue the dialogue we started here in Washington.

My visit has reconfirmed for me that your Government and our Bank share the same perceptions of what key economic policies are required for your country to recover stability and growth over the coming years. I find mutual concerns about the need to increase the international competitiveness of the Mexican economy, to rebuild private sector confidence, and to maintain strict control over public sector deficits.

As you know, the Bank is prepared to consider a substantial increase in its lending to Mexico. To implement that commitment, with the degree of flexibility that we want to show in our lending operations in Mexico, will require that we jointly identify areas of policy that the Bank can usefully support. That is why I believe the policy dialogue is so important to our efforts to build up our lending program in Mexico.

Again, my thanks and appreciation for your hospitality.

Sincerely,

TC

A. W. Clausen

His Excellency
Miguel de la Madrid Hurtado
President of Mexico
Palacio Nacional
Mexico, D. F., Mexico

RS:hh

BC: R. Steckhan

December 8, 1982

Dear Mr. President,

Please accept my heartiest congratulations on assuming the Presidency of the great Mexican nation, to which you were elected by the largest voter turnout in the history of the country.

Mr. Devbrat Dutt who represented the Bank in your inauguration has presented to me your bold inaugural address which we have studied with much interest. With a rare political insight and imagination you have presented the ten-point program for reordering the economy, you have called on the people to brave the days of austerity ahead, you have dedicated the Government to work for moral regeneration of the society and lay the foundation for a sustained and equitable growth of the economy. Your many friends in this institution join me in wishing you success in these challenging tasks.

We were informed that on December 2, the very second day of your presidency, you adopted several far reaching reforms affecting the economy and moral fabric of the Mexican society. We are confident that under your leadership, Mexico will get over the present crisis and begin anew and in a sounder fashion its development effort.

I was away in Europe during the time of your inauguration and, on my return to Washington, am taking the opportunity of reiterating our offer of assistance. The staff of the World Bank is ready to work with your staff and arrange such assistance as would be appropriate for meeting the challenges of the coming years. I should also like to wish you a very happy birthday which you--and the Mexican nation--will be celebrating this coming Sunday.

Warm regards,

Sincerely,

A. W. Clausen

His Excellency
Miguel de la Madrid Hurtado
President of the United Mexican States
Palacio Nacional
Mexico, D. F., Mexico

ccb: Messrs. Stern
Ardito Barletta
Lari, LC1

DDutt:crm

Mexico City THE NEWS

De la Madrid's Inaugural Address

Honorable Congress of the Union; Mexicans:

I have sworn before you to observe and protect the Constitution and the laws of the Republic, to carry out loyally and patriotically the duties of the office conferred upon me by the people, and to seek in all things the well-being and prosperity of the Union. That oath is not a mere formality, but the most solemn declaration of the political, legal and moral obligation I hereby assume to the people of Mexico.

In line with those imperatives, I shall make the Presidency of the Republic the instrument of guidance and service that the framers of the Constitution designed for leading the nation towards the goals set by the sole legitimate author of our history — the Mexican people.

I shall govern in accordance with the Constitution and the laws. I shall govern with the purpose of pursuing the high objectives they set forth. I shall govern with the purpose of preserving and strengthening national independence; of protecting and increasing the enjoyment of individual and collective freedoms; of enriching democratic participation in political, economic and cultural affairs, and of fostering the fraternal and harmonious community life of all Mexicans. I shall govern with the purpose of preserving and reinforcing the peace of the Republic.

I shall govern within the framework of a rule of Law. My administration will subject its action to the law. I shall respect and exact respect for the legal system born out of the Mexican Revolution. That is the way to guide free community life and social efforts towards justice. I firmly believe that there are no rights that run counter to the law and that the more we obey the laws, the less we will have to obey men.

Our State of Law, as mandated by the Constitution of 1917, is a strong State. The strength of the State guarantees the unity of the nation, ensures our independence and enables us to carry out the mandate for social change. The Mexican State is strong, not because it arbitrarily imposes its will, but because it rests on the consensus of the majority. We shall preserve its strength, for there can be no justice with a weak State, nor can any State be strong without freedom or with injustice. We shall strengthen ourselves in the laws, freedom and justice that are our justification.

I shall govern in accordance with the mandate I received at the polls. I tried to make the elections a true plebiscite on ideology and programs. To that end, I conducted my election compaign as an intensive process of consultation with the people. I probed the nation's sentiments, in order to draft a premise and objectives that would be based on them. The people voted for a detailed and specific platform in the elections marked by the heaviest voter turnout in our history. As a result, I received a clear mandate to which I must adjust the action of my administration. Those are the foundations of the administration I am beginning today at the behest of the nation. We will not have to propose new doctrines, because we already have the doctrine that has been given its legitimacy by our history — the doctrine that has sustained the national consensus under all kinds of circumstances, and the one the people upheld on July 4th. My ideological commitment is to the Mexican Revolution.

Today we begin a new chapter in Mexico's history. We do so within the tradition of the popular movements that spur and guide us: the Independence, the Reform and the Revolution. We shall draw upon the contributions made at each stage of our history, through the efforts of each administration, and, of course, upon the progress achieved under the direction of Jose Lopez Portillo. We owe many accomplishments to his administration: the strengthening of our federalism; a great thrust to economic activity and employment; outstanding advances in energy and food supplies; significant increases in education and social security; support to marginalized groups; the political reform; the administrative reform; the basic stages of the National Planning System; the reaffirmation of the State's guiding role; the nationalization of the banking system; and era of broad freedoms and an active and dignified foreign policy. My recognition and appreciation for the efforts and accomplishments of Jose Lopez Portillo.

In beginning of this new stage, we must recognize and accord the proper value to the national heritage we Mexicans have built.

We have an extensive infrastructure; a major industrial plant; the fourth largest oil reserves in the world and extraction facilities of the first order; abundant agricultural, forest, fishery and mining resources; great tourism potential. Communication media and routes link all parts of the country together. We have educational, health-care and social security systems; administrative and cultural cadres; responsible workers and able, nationalistic entrepreneurs and a system of freedoms firmly grounded in a basic consensus of the people. We have achieved much, thanks to the efforts of all Mexicans.

On the other hand, I am aware that I am assuming responsibility for the Republic's government at a difficult time.

Mexico is undergoing a grave crisis. We are suffering inflation that will reach almost 100 percent this year; an unprecedented public-sector deficit fuels the fire of inflation, while savings to finance public-sector investment are lacking; outdated prices and rates of public goods and services place state enterprises in a deficit position, conceal inefficiencies and subsidize high income groups. Weakness in the dynamics of productive sectors has slowed our growth rate to zero.

The flow of foreign currency into the financial system has been paralyzed, except for that form exports of oil and a few other public-sector products and from loans to that sector. Our public and private foreign debt has reached inordinate proportions, and debt servicing imposes an excessive burden on the budget and our balance of payments, and drains funds needed for productive investments and social expenditures. The tax collection system has been undermined and its inequities consequently accentuated. Foreign credit has been drastically reduced, and domestic savings and investment have been discredited. Under these circumstances, the productive plant and employment are seriously threatened. Thus, we are confronting the highest rate of open unemployment in recent years. Mexicans with low incomes are finding it increasingly difficult to satisfy basic subsistence needs.

The crisis is evident in the expressions of mistrust and pessimism regarding the country's ability to fulfill its immediate requirements. It is evident in the emergence of discord among classes and groups; in the angry search for the guilty; in the mutual and growing recriminations; in the feelings of despair and discouragement and in the exacerbation of individual and sectarian egoism, all of which are tendencies that corrode the solidarity essential to community life and collective effort.

An atmosphere has spread that encourages the enemies of the system, built through the people's extraordinary democratic effort, to rush in to condemn it indiscriminately and to foster doubts about our historical course.

This is the national outlook. We point out assets and advances in contrast to liabilities and difficulties in order to maintain a realistic perspective, taking neither an apocalyptic nor an ingenuous view of the grave circumstances we face. We are confronting difficulties, serious difficulties, but we are not a defeated or bankrupt nation.

The crisis is taking place in an international context of uncertainty and fear; a deep recession is in the making. There are trade wars, even among allies, and protectionism in the guise of free exchange. High interest rates, the drop in raw materials prices and the rise in the prices of industrial products are driving many countries to insolvency. In addition to world economic disorder, there is political instability, the arms race and the struggle between great powers to expand their spheres of influence. Never in recent times has international harmony seemed so distant a prospect.

We are in an emergency. This is not the moment for hesitation or complaining; it is a time for definition and responsibility. We will not simply be carried along with the current. The situation is intolerable. I will not allow our homeland to crumble away through our fingers. We shall act, decisively and firmly.

By integrating our collective efforts in a great movement of national solidarity, Mexico will win out. At this time, more than ever before, we Mexicans have been able to experience and witness the fact that, over and above individual interests, lie the interests of the Republic and the future of our country. That is the national sentiment, which, as of today, we must transform into decisive and vigorous action.

I am launching an *Immediate Program for the Reordering of the Economy*, the main purposes of which are to wage an in-depth struggle against inflation, to protect employment and to reestablish the basic conditions for dynamic, sustained, just and efficient development. Details and procedures will be announced during the first month of this administration. We shall begin work immediately. The severity of the crisis will determine the dimension of our efforts.

These are the ten points of our program:

FIRST: *Reduction of growth in public spending*. I shall propose an austerity budget, strictly adjusted to available financial resources, which will maintain public services at a minimum acceptable level, uphold operational and investment priorities for our most needed programs, provide for payments on the debts we have incurred and limit the growth of current expenses to increase public saving.

SECOND: *Protection of employment*. I shall promote special programs for productive and socially useful work in the most depressed rural zones and in marginalized urban areas. Within our austerity plan, we shall redirect investment resources toward projects that generate a considerable use of manpower and we shall make adjustments in capital-intensive programs. To protect existing jobs, we shall promote a selective program of support to industry that will stress aid to intrinsically sound medium-sized and small enterprises, by such means as timely loans, priority treatment in access to currency, technical assistance and demand that is organized and stimulated by public sector purchases. Responsible and patriotic entrepreneurs — who form a majority — will merit my administration's respect for their legitimate rights and be accorded incentives for the tasks they undertake that further the interests of the majority of the Mexican people.

Employment is the fundamental value to be protected. We shall ask those who are the factors of production for moderation and responsibility in their negotiations, so as to keep wages and profits within reasonable bounds. We shall precisely define the contents of the basic food basket for popular consumption and shall reinforce the strict, effective and honest control of prices of the articles that comprise it, in order to defend the purchasing power of working families in he countryside and the city. Subsidies will be rechanneled and rationalized to this end with a view to a just reconciliation of consumer interests with production incentives.

(Continued on page 23)

(Continued from page 22)

THIRD: *Continuation of works in progress* with a selective criterion. We shall accelerate investment for prioritary and immediate production, decrease investment that is not indispensable and cancel projects when they are found to be unnecessarily expensive or of a low-priority or improperly programmed nature.

FOURTH: *Strengthening of standards ensuring discipline, proper programming, efficiency and scrupulous honesty in implementation of authorized public spending.* Financial responsibility will be the prime criterion in supervising and evaluating the performance of government officials. The exercise of budget outlays will be strictly regulated to eliminate squandering, waste or corruption.

FIFTH: *Protection and encouragement of programs for the production, importation and distribution of basic foods for human consumption.* We shall combat speculation in this field. We shall improve and rationalize State intervention in the production, processing, distribution and consumption of foodstuffs for popular consumption so that the resources employed will really benefit the sectors we are interested in protecting.

SIXTH: *Increase in public income* to curb the unbridled growth of our deficit and the consequent disproportionate rise in the public debt. I shall immediately promote a tax reform to increase the fairness of direct taxes, provide uniformity in indirect taxation and revise fictitious levels of untaxed items. This fiscal reform is also designed to increase tax revenues with a view to providing sounder foundations for financing public expenses. We shall take new steps in tax administration. We shall revise tax incentives so that they will support production and employment and provide sound encouragement for exports.

We will inevitably have to increase prices and rates of goods and services produced by the public sector, charging higher rates for those used by social groups with the highest relative incomes. He who has more must pay more; basic justice demands it. At the same time, we shall demand of administrators and request of workers in public enterprises, explicit efficiency and productivity commitments. This must be their contribution to the essential reordering of the economy to which we Mexicans must all be committed. We must face reality: We cannot tolerate the collapse of our public enterprises, the fundamental heritage of our nation.

SEVENTH: *Channeling credit to national development priorities*, while preventing speculation or the diversion of funds to financing purposes not justified by the production, processing, distribution and consumption of the goods and services required for general consumption or by the best interests of the nation.

We shall take care that the nationalized banking system performs with efficiency and honesty. Domestic credit and savings are based on trust. The Mexican Government will show its capability of fulfilling its responsibility though a trustworthy and efficient management of the national banking system. I will not permit rapacity, nor the use of bank credits for the political advancement of bank officers, nor banking procedures that effect the rights of depositors. I reject financial populism. We will offer attractive returns on savings, security in the management of public resources and productivity and efficiency in banking services, in order to avoid unjustified increases in the cost of credit.

The nationalization of the banking system is irreversible. We shall restructure our lending institutions in such a way as to ensure effective control of the nation through their association with the State. We shall propose new and creative formulas to avoid their bureaucratization, so that savings depositors, loan recipients and society as a whole — workers, *campesinos*, entrepreneurs — will have a proper share in the management and even in the patrimony of these institutions. To nationalize is not to "State-ize." The nationalized bank must belong to the people and not to a new minority group of directors.

EIGHT: *Regularization of the exchange market under the authority and monetary sovereignty of the State.* We shall adjust exchange control mechanisms to achieve a realistic and functional system that corresponds to the actual operation of the Mexican economy. We propose to recover the proper role in the exchange market for our national financial system and to maintain a realistic exchange rate that will encourage exporters and foster the acquisition of the foreign exchange needed to supply goods and services to our productive plant. We shall eliminate irrational exchange subsidies that affect the health of public finances. We shall maintain a strict control over imports and gradually rationalize protection accorded to the various sectors to eliminate unwarranted profits that have a negative effect on the well-being of consumers. These steps will lead to a better integration of industry and will improve the competitive position of our products. We shall strive to reestablish objective conditions that will keep domestic savings in Mexico and prevent the flight of financial resouces.

Mixed-Economy System

NINTH: *Restructuring of the Federal Public Administration* to increase its effectiveness and flexibility. We shall make use of the considerable progress that has already been achieved, rectify what has proved deficient and make the essential innovations. We shall make public administration subject to planning, order and the strictest possible application of rules governing the responsible conduct of government officials.

TENTH: We shall act under the principle of *guidance by the State* and within the *mixed-economy system* established by the General Constitution of the Republic.

For the purpose of affirming these principles and lending clarity and certitude to the path that we shall follow, I shall submit to the consideration of the Congress and the state legislatures, which have permanent constitutional amending authority, a proposal for amendments and additions to the Constitution of the Republic on economic matters.

Based on the operative principles in this field and on the will of the people as expressed in the July 4th elections, this proposal aims to reassert and strengthen the State's responsibility to direct and promote national development; to reaffirm and define harmonious and jointly accountable co-existence of the public, private and social sectors in our economic system; to ratify economic freedoms, subject to the public interest and to establish at the Constitutional level a system of democratic planning for development.

The economic activity of the State and of individuals — whether they be from the social or the private sector — requires a clear legal framework that will strike a proper balance between the authority of the State and individual rights and liberties. This necessary harmony must be governed by nationalism, freedom, democracy and social justice.

With this ten-point program, we shall take our first step in responding to the crisis. All Mexicans must join in this great national task, mindful that no foreign aid or magic solution can do the job for us. Recovery will take time — the next two years. The first few months of our administration will be arduous and difficult. The present situation makes this so. Austerity is imperative; we shall see that it is enforced, and that the burden it implies is shared equitably.

I shall govern with a view to surmounting the crisis, but at the same time I shall also implement the six-year platform that the people voted for when they approved the seven general theses that emerged from the consultation of public opinion. From each of them we shall formulate a set of effective policies in order to start now to build the society defined by the majority of the nation's people. These campaign commitments will orient our government's activities and the work of the National System of Democratic Planning.

Revolutionary Nationalism

My conduct will be guided by revolutionary nationalism. It is the ideology that synthesizes our historic will to form a vigorous political, economic and social community; it is the consciousness of our identity and collective image. Revolutionary nationalism evinces loyalty to our traditions and customs, devotion to the land where we were born and to the meaning of our history; it is rooted in a democratic conviction; it undergirds the transforming power of the nation through the State, and it imposes upon us the obligation to overcome everything that jeopardizes our political or economic independence.

Revolutionary nationalism is the vital unifying force that can enable Mexicans to achieve the goals of the people. I shall strive to strengthen it; I shall maintain its transforming nature and I shall affirm its impact on social justice.

Revolutionary nationalism, as a national purpose, lives on and gains strength in the consciousness of the younger generations. Education is the nation's instrument for affirming its identity. The Constitution calls for public education to disseminate and instill democratic attitudes, egalitarian ideals and pride in and defense of national independence. We shall most emphatically address the quality of education; we shall facilitate access of the people at large to higher education and organize a vigorous ongoing literacy campaign. More and better education for all is an imperative of Mexico's cultucal, technological and economic independence.

Revolutionary nationalism is based on culture, and we shall promote the national and regional aspects of culture in order to preserve and enrich it. We shall make our culture an instrument of individual and collective liberation. We shall defend it against colonializing encroachment. We shall promote creative freedom and the enjoyment of culture by everyone. We shall improve knowledge of our history and devotion to the symbols of our native land. With strict adherence to our laws, we shall orient the use of government-owned communications media toward these high purposes.

Mexico's foreign policy is the synthesis and instrument of our revolutionary nationalism. The affirmation of our identity allows us to meet others on an equal footing; our values of independence, freedom, democracy and justice are projected beyond our borders in our respect for ideological pluralism and in the demand for a new international order.

Without pretensions to leading others, without dogmatism alien to historic conditions or false pragmatism lacking direction and purpose, we shall maintain a policy of principles — our principles. We are aware of the limitations imposed on them in a world of frustrated selfish interests and paralyzing economic insecurity, but we are also aware that repeating them regularly, with firm diplomacy open to negotiation, will serve to defend our own values and objectives and those of other nations seeking their development in independence and freedom.

With unshakable conviction, we shall continue to uphold the principles of self-determination of peoples, non-intervention, peaceful settlement of disputes, sovereign equality of States, disarmament for the preservation of peace, and equitable and efficient international cooperation.

Isolationism is not only anachronistic but impossible. Cooperation among free peoples is the only path to peace in an interdependent world. By improving the coordination of our action and strategies at home, we shall be more effective in upholding our objectives and principles in our participation in international forums and in bilateral action.

We shall work to rebuild world economic and political security, and to strengthen seriously weakened international agencies; we shall work for peace and disarmament, for solidarity with the best causes of the developing world, to promote respectful and equitable relations with our neighbors, to strengthen Latin American brotherhood, for a just and peaceful solution to tensions in Central America, with respect for those nations' sovereignty and support for their development. We shall consolidate the links between our domestic and foreign policies, because we have set ourselves to improve our access to the benefits of international cooperation and to serve the highest national interest efficiently.

In order to strengthen ouc commitment to federalism, I respectfully urge the Senate of the Republic to exert its authority more dynamically in matters of foreign policy.

(Continued on next page)

Social Inequality Continues To Be One of Mexico's Most Serious Problems

(Continued from page 23)

It is with genuine pride that I assume supreme command of the armed forces, fundamental institutions of proven loyalty and patriotism, efficiency and indisputable professionalism. Deeply identified with the people and demonstrating strict adherence to the law and unwavering nationalistic and revolutionary convictions, the armed forces are the country's greatest guarantee of national sovereignty and defense. To every possible extent, I shall strive to provide them with the means for fulfilling the noble mission assigned to them by the Constitution and for ensuring that members of the armed forces and their families will enjoy the same standard of living demanded by the rest of the population. I shall issue orders for the participation of the armed forces within their respective spheres of competence and in accordance with their internal discipline, in drafting the National Development Plan.

Integral Democratization

We are committed to working toward the complete democratization outlined in our Constitution. We shall strengthen the separation of powers, federalism and the free municipality. We shall respect pluralism and all forms of political association and heed public opinion and the media with responsibility and freedom.

We shall not limit ourselves to perfecting the electoral process, but will also strengthen democracy in every sphere of society's life — in communities, neighborhoods, labor unions and political associations and leagues. We shall foster organizations of producers and consumers and dialogue between labor and management, so as to promote productivity and lay better groundwork for the redistribution of income.

We shall maintain constant contact with the people. I will call for public debate to study the progress made in the political reform process, the function and make-up of the Senate of the Republic, citizen participation in the government of the Federal District and the judicial reform. We shall strengthen the systems for keeping the nation informed on government activities. I shall keep democracy alive and well in Mexico.

Egalitarian Society

An egalitarian society is a demand stemming from the Mexican Revolution. Social inequality continues to be one of Mexico's most serious problems.

The struggle for equality involves dynamic action to achieve equity in the production and distribution processes and to expand stock capacity and opportunities. I reject populism which yields to mere expediency and causes society to regress. We shall combat inequality on a realistic, permanent and lasting basis.

We shall strive, with renewed determination, to achieve equity for all; every group and individual must help to the best of their ability to see to it that everyone receives the fair treatment he deserves. We shall strengthen the weakest sectors by providing training, without false paternalism or demagoguery. We shall review all instruments of economic and social policy in light of their impact on distribution. We shall seek to ensure the effectiveness of social spending, avoiding special treatment that leads to injustice. We shall combat the most serious inequality in the country — that which exists between the rural and urban sectors — by every means available to us.

Our fundamental concern will be to satisfy the people's basic needs: food, housing, education, culture, recreation and sports. We shall raise the right to health care to constitutional status so as to lay the foundation for a solid, integrated national health-care system; we shall give priority to preventive medicine, especially in the marginalized rural and urban areas. We shall attack the housing problem on all fronts: by setting aside land reserves, by administrative reorganization, new technologies, financing and support to owner-built housing. In the area of food we shall give the highest priority to production and supply policies, with emphasis on proper planning, effective implementation and equitable treatment for producers, distributors and consumers.

Beginning today we shall fight all inequality, but in this area, as in all others, I must be sincere with Mexicans. As long as the crisis persists, we cannot make quantitative progress in the process of social justice; the immediate danger lies in the deterioration that day by day makes inequality more acute. The first step is to check that deterioration; we shall do so by an equitable balancing of the burden of costs and by fostering the qualitative changes that will give us solid support for progressing more rapidly toward an egalitarian society as soon as possible.

Moral Regeneration

The moral regeneration of society will be a commitment and a permanent standard of conduct for my administration. Through the example given by my government, beginning with my own example, I hope to encourage the commitment of all Mexicans, of each and every one of the sectors and of groups in all fields to strengthen our values.

Law, which is the synthesis of social morality and of the republican, democratic and revolutionary ethics created by Mexicans over the years, will be the fundamental guide for this regeneration. We shall update the constitutional provisions governing the accountability of civil servants and promote a new law on this matter as well as amendments and addenda to existing penal legislation. We shall introduce new techniques of government administration designed to prevent, detect, correct and, if necessary, to penalize unethical conduct on the part of government officials and employees.

I shall promote systems to put an end to illegal compensation and to render a clear accounting of the income of government officials. I shall regulate fringe benefits to which officials are entitled and prohibit the use of government goods and services for purposes other than those for which they are intended. We shall prevent illicit business practices in government construction or service contracts and in purchases by the government and its enterprises. I shall not allow government funds to be used to further the personal political careers of officials.

We shall put a stop to the unlawful misuse of government payrolls; we shall root out illegal conduct in the granting of authorizations, permits, licenses and concessions, and in the inspection and supervision called for by laws and regulations.

I insist: Service in public office is not compatible with operating businesses whose activities are based on economic relations with the government. To do both is unethical. Either one governs or one makes business deals. Government office should not be used for anyone's personal gain.

We shall perfect the systems used for the management of State resources and strengthen the systems for the control and supervision of public administration.

To fulfill the objective of making the government of the Republic a model of conduct, I shall promote the establishment of a Federal Comptroller's Office, with the rank of Ministry of State, to systematize and strengthen the various activities involved in the supervision, control and evaluation of public administration. We shall make vigorous and decisive use of this new instrument.

I expect a dynamic and vigilant attitude on the part of the Chamber of Deputies and the Accounting Office of the Ministry of Finance toward the programs and budgets of the Federal Executive Branch.

The moral regeneration of society is a challenge to be faced by all Mexicans alike. We cannot allow the nation to weaken and decline. Our problems are so serious that it is only through moral regeneration that we will be able to overcome them. Mexicans are a deeply moral people and they demand that I pursue all forms of corruption. I shall do so. I will govern by example.

The people must be given the means of asserting their legitimate interests in dealing with the government. I am hereby instructing the Attorney General's Office to hold public hearings so as to sound out public opinion to be used in drafting bills and promoting actions to provide society with a better system for the administration of justice and of public safety.

We shall clean up and modernize the police departments of the federal government and the Federal District. People throughout the country are demanding this. We must act quickly. The police should be a guarantee of public safety and order, not a cause of their breakdown. We shall work out agreements with the state governments to support them in similar undertakings. The people are entitled to security for themselves and their families, and we shall make sure that they have it.

Decentralization of National Life

We shall promote decentralization of national life. There can be no thought of the Republic's vitality without the full participation of the states in defining and implementing the tasks required by national development. We shall combat the centralization that saps our energy and inhibits far-reaching action.

Adopting one of the nation's demands as my own, I have decided to promote the transfer of pre-school, primary, secondary and normal school education — now administered by the federal government throughout the country — to local governments, together with the corresponding financial resources.

Well-founded reasons of a pedagogical, academic and administrative nature indicate that we should now return to the original educational system set forth in the Constitution of 1917, in which basic education was the responsibility of local and municipal governments. Through the Ministry of Public Education, the federal goverment will continue to direct and evaluate programs. The labor rights of the teaching profession and the autonomy of its union will be scrupulously respected.

I respectfully invite the governors of the states to participate wholeheartedly and decisively in this new task of strengthening state governments. The validity of federalism is the concern not just of the federal government, but of everyone. I know that we can count on your valuable support.

I invite the teachers of our nation, who have worked tirelessly in efforts for nationalistic change, to collaborate in this movement to achieve real decentralization. The nation will be stronger for it.

Decentralization of national life will draw support from the vigor snd enterprise of the states. We shall decentralize public health services to bring them closer to beneficiaries. We shall inmediately propose to local governments that agreements be drafted to enable them to take charge of programs in other areas. We shall revise the distribution of functions in order to bring about a new division of responsibilities among the three branches of government.

We shall continue the consolidation of free municipalities; political autonomy depends on economic self-sufficiency. We shall initiate amendments to Article 115 of the Constitution by proposing that the Congress and state legislatures, which have permanent authority to amend the Constitution, assign to the municipalities their own inviolable sources of income with which to provide the public services in their charge. We shall thus comply with widespread demand voiced in our consultation with the people.

The time has come to create the conditions that will enable the municipalities to rely less on federal contributions and more on their own tax programs. We shall soon invite tax authorities throughout Mexico to join in designing a new scheme for the division of authority on these matters.

One of the major challenges where decentralization is concerned is the intolerable growth of Mexico City

(Continued on next page)

(Continued from page 24)
and its metropolitan area. We must take energetic steps to curb the accelerated growth of the area by offering other settlement possibilities. We shall protect the quality of life in our capital, which, because of its macrocephalic growth, is suffering serious deterioration that we must combat. Special attention must be given to the urgent problem of transportation.

Development, employment and the fight against inflation

The people have declared themselves in favor of a strategy designed to promote development and employment and to fight inflation. The measures enumerated in the ten points are based on these objectives. In addition to implementing these immediate policies, we shall also adopt other parallel policies for addressing and promoting the structural changes required by our economy. We shall tackle the problems of inadequate domestic savings, low productivity, the poor competitive position of our products abroad, and social inequality. We shall do so by means of far-reaching and unremitting action.

We shall give high priority to the needs of the Mexican *campesino*. We shall diversify his job opportunities by giving added impulse to agroindustry. We shall make rational use of agricultural, forest, livestock and fishery products. We shall make land tenure secure. We shall improve conditions in rainfall-dependent areas and introduce planning techniques in rural areas. We intend to broaden the social development of Mexico's agricultural sector.

We shall democratize, modernize and streamline the government entities in charge of agriculture. We shall give no quarter in our fight against all the corrupt practices that fleece the Mexican *campesino*. We will promote production and justice in our countryside.

Energy sources are an inalienable part of the nation's heritage. We shall continue to rely on petroleum to support our development, seeing to its rational utilization for the benefit of present and future generations, and without thinking of it as a panacea that saves us from the need to work on other aspects of our development. I will pay special attention to the appropriate planning and efficient and honest operation of our petroleum industry, the mainstay of our economic nationalism. We shall apply this same criterion to our electric industry.

We shall modernize the state-affiliated, private and public industrial plant, employing firm high-productivity criteria that prevent waste, incorporate technological change and maintain national priorities. In view of the prevailing world economic instability, we must do this if we want to keep Mexico a sovereign and viable country, expand our domestic market and also participate effectively in the flow of international trade. We need to carry out a real revolution in technology and productivity. We shall spare no effort in bringing about this transformation, which can no longer be delayed.

We shall address the ecological problem and the preservation of the environment in such a way as to improve the quality of life and protect man and our natural resources. We shall reinforce the national awareness of the importance of ecology, an essential factor in the protection of our environment.

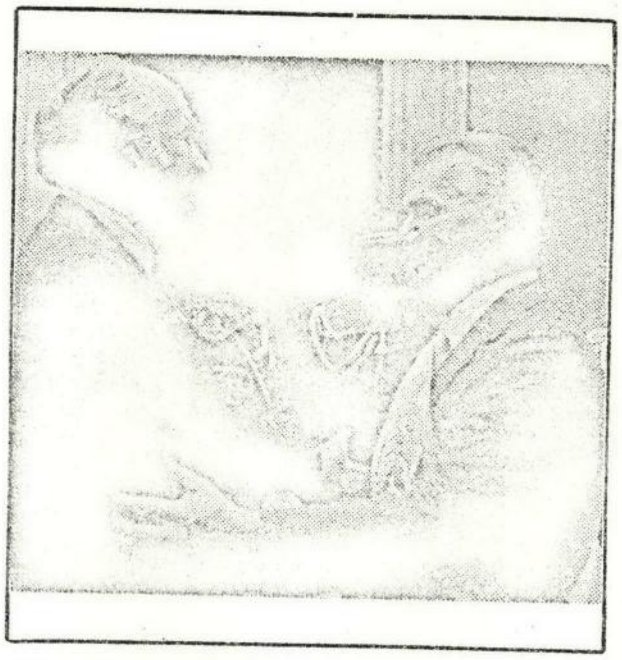
I shall not govern solely to overcome present adversity. I know the immediate and medium-term needs of my compatriots; I shall govern decisively, so as to bring about a future of well-being for all Mexicans. We shall work for our children and for our children's children. We must take care of the country that we want for them, and make it greater still. We can and must do it.

Democratic Planning

A political system that is incapable of regularly voicing popular demand is condemned to failure. State action must be planned as the coherent product of the aims, desires and expectations of the majority of its citizens. Planning, to be democratic, should incorporate the vitality and creative participation of society as a whole and arouse the enthusiastic and fruitful participation of all Mexicans in the great national tasks that cannot be undertaken by the government alone.

In coming days I shall send to this Honorable Congress a bill outlining the National Planning System. With this system, we shall integrate the states and municipalities into our mixed economy system, with all due respect for their sovereignty and regional interests, in order to strengthen our joint national action. We shall institutionalize an ongoing process for consulting public opinion that will enable us to adopt plans to changing conditions and will provide the means for keeping public officials in constant contact with the opinions of those to whom they are responsible.

This bill is based on the constitutional principle of guidance by the State. Governments cannot abdicate



either the responsibilities or the specific mandate given them by the people. For this reason, we are proposing mechanisms for consulting the opinions of the different sectors and organizations and of the general public, and for their efficient participation in the decisions programmed. Within this framework, in May of next year I shall present to the country the 1983-1988 National Development Plan.

Honorable Congress of the Union; Mexicans:

I demand hard work and solidary responsibility on the part of all Mexicans. The country's economic conditions will impose great sacrifices upon us in the short run. But we shall address ourselves to the basic needs of the population, we shall put the economy on a sound footing, we shall fulfill our commitments abroad and we shall steadfastly maintain the free and democratic functioning of society and of the State.

I cannot offer major quantitative changes in the near future, nor any sudden improvement in our situation. To surmount the crisis we must work, produce and save with greater intensity and quality than ever before. Within this framework of severe limitations, however, we propose to carry out the changes that will profoundly transform the nation.

This is the challenge and that will be our victory.

We shall not overcome the crisis by aspiring to return to the conditions that preceded it. It would not be worth the effort or the sacrifice, nor would the people accept it. We are going to create a different and better chapter in our history.

We shall not overcome the crisis merely by paying the consequences; that would only make it recurrent. We will overcome the crisis by doing away with the causes that produced it, by making the qualitative changes that will lead us to a new society. We have the necessary tools: the principles, the institutions, the political will, in a great country endowed with abundant natural resources and an unshakable attachment to the native land we love so well.

We shall make qualitative changes in our democratic life. We shall move decisively and fearlessly toward higher levels of civic participation. The State is society organized into a structure, not a structure empty of content. We shall not "State-ize" society; that would be totalitarianism. We shall seek changes that imbue State structures with all the vitality and creativity of civil society, to and from the State, respecting freedom and with an unwavering commitment to justice, we shall give new impetus to the integral development of society and individuals. We have made progress in political democracy; let us now set about making even more progress in social democracy so as to break down the barriers raised by limited participation and by structures that disregard society. Let us seek not just a larger State, but a greater integration of society into the State. People are the priority.

We shall promote changes in conduct. We shall renew social morality. I shall make use of all my authority. I shall require each and every one of my associates to conform to the highest standards of public honesty. In this there shall be neither compromise nor toleration. New laws and undeniable political determination will be the goverment's contibution to this process. A new civic conscience — which we shall foster by using all the communication and social education media — will be the primary guardian of public morality in both governors and the governed.

We shall promote the meaningful nature and value of work, as well as discipline, perseverance, thrift and civic responsibility, the awareness of a solidary present and a common future, and foster appreciation of what is our own, pride in being Mexican and the love of our native land. These are not mere concepts or phrases; they are the qualities that have enabled us to become what we are and those we must cultivate if we are to eventually become a prosperous nation in every sense of the word, capable of ensuring independence, liberty and justice for all.

We shall reestablish confidence in the country and in ourselves. Confronting the difficult circumstances that afflict us, we shall restore confidence based on the certainty of every individual and group in their inalienable rights and on their awareness of their grave reponsibilities. Respecting both those values, each of us can do his work, and will do his work, because that is the conviction of all.

With history as our witness, we strongly assert our confidence in our national greatness and our indestructible future. We need only recall that we have forged a nation of free men from a structure of colonial domination and oppressed castes; that we have forged a developing society in the face of all types of obstacles, in the midst of an adverse geography and a poor society. We need only realize that we are respected the world over as an original and independent people. We shall move forward, reaffirming our confidence in Mexico.

As president of Mexico, I will do my part to the limit of my abilities and with full awareness of my supreme duty to serve the nation. I will speak truthfully. I will tell the people what can be done and what cannot be done. I will say what has been accomplished, where we have failed and the reason for each failure, demanding accountability and recognizing the limitations the circumstances impose on us.

I will govern with realism, adhering to principles — with realism in the analysis and design of practical policies to broaden our scope of action. I will govern with imagination but avoid fantasy.

I will govern for all Mexicans. The interest of each one shall be my guide, and his right the limit of my authority. I shall do this without forgetting my irreversible commitment to our nation's majority groups — the *campesinos*, the workers and the middle classes who supported me with their votes. I will do so thanks to the collective strength of a revolutionary movement that established, along with social rights, individual liberties and social and political pluralism, for which, with that same collective strength — both democratic and emancipatory — we shall demand respect. I will govern with the strength of the men and women of Mexico and with the vitality and idealism of the country's youth.

Today, fellow countrymen, let us set to the task of national recovery, with everyone on his feet, enthusiastically and vigorously prepared to make the sacrifices the moment requires, prepared to show generosity and patriotism: with all of us prepared to carry on the achievements of Mexico, those of the Mexico of yesterday, rich in heroism; those of the Mexico of tomorrow, rich in possibilities; those of our México, the eternal Mexico.

Long live Mexico!