Click here for Full Issue of EIR Volume 15, Number 3, January 15, 1988

City of London by Stephen Lewis

Morgan move could trigger new crisis

A seemingly "constructive" proposal for Ibero-American debt could set off new crisis waves in the banking world.

The financial markets have been so preoccupied with the weakness of the United States and the threat which that presents to world economic stability, that they have overlooked the significance of a major development in the Ibero-American debt impasse.

This was Morgan Guaranty's proposal, aided by the United States Treasury and the Mexican government, to retire a substantial portion (up to $20 billion) of Mexico's outstanding external debt.

If this proposal is accepted by the holders of a majority of the Mexican debt (and it is hard to see how these bankers can reject a scheme advanced by one of their own which, on the face of it, represents a constructive approach to the problem), it will risk setting off new crisis waves in the banking system.

Briefly, Morgan Guaranty's plan is that the Mexican government should use $2 billion of its $15 billion foreign exchange reserve to buy zero-coupon bonds from the United States Treasury, which would be redeemed after 20 years at $10 billion.

Mexico would receive no interest on these bonds; the return would come from the capital uplift on maturity.

The Mexican authorities would then use this assurance of a $10 billion receipt in 20 years' time to guarantee securities offered to the banks in exchange for outstanding debt at a discount.

The discount on Mexican sovereign debt in the market has recently been around 50%. A $10 billion capital sum might, therefore, be used to guarantee new securities exchanged for up to $20 billion of existing debt.

Mexico would pay interest on the $10 billion face amount of these securities at $1\frac{5}{8}\%$ over Libor, well above the market rate.

For the banks, the scheme would be voluntary, while the Mexican government would retain the right to reject any bids by banks to exchange existing debt for the new securities.

Why should some banks be unhappy about a scheme which appears to offer them a way out of their problems?

The sticking-point for the banks is likely to be Mexico's insistence on buying in the old debt at a discount.

Such a discount would immediately require participating banks to make loan write-offs in their balance sheets of up to 50% of the value of the exchanged debt and, possibly, for all their holdings of Mexican debt.

These write-offs would differ from the provisions which the banks have already made, in that they would reduce the banks' capital base. If the banks were to write off a substantial portion of their Mexican loans, they would probably have to accept further balance sheet damage from write-downs of other sovereign debt.

It would be difficult for the banks to justify a situation where Mexico's debt stood in their balance sheets at only 50% of face value, while the debt of Brazil and Argentina continued to be carried at full value.

If, however, all Ibero-American debt were subject to write-offs, several of the U.S. money center banks would have more than half, if not all, of their capital wiped out.

Even for those banks in a relatively strong capital position, Ibero-American debt write-offs would seriously dent their capital bases and damage their ability to expand business.

Peripheral activities into which the banks have moved in the past two or three years, such as securities trading, would be liable to be cut back.

This would be a blow to the move to globalize securities markets put under way by Mr. Donald Regan.

The globalization move is now widely seen in senior banking circles to have been a mistake. It caused these senior bankers to lose the control they previously had over the flow of funds between countries.

Morgan Guaranty's proposal is an attempt to use the debt lever to bring about a regrouping of institutions and business in the financial sector.

Donald Regan, the promoter of "globalization," as seen by cartoonist Chris Sloan in 1986.

© 1988 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.