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Mexico: Prospects for Economic Policy Shifts [redacted]

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An Intelligence Assessment

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ALA 85-10091
September 1985

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Mexico: Prospects for Economic Policy Shifts [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] Office of African and Latin American Analysis. Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA, [redacted] 25X1

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Mexico: Prospects for Economic Policy Shifts [redacted] 25X1

Key Judgments

Information available as of 9 August 1985 was used in this report.

Mexico appeared to rebound solidly from the economic crisis of 1982, judging from its announced 3.5-percent growth rate in 1984 and continued success in negotiating international debt rescheduling agreements. This favorable record was underpinned, however, by unsustainable domestic policies and Mexico City now is facing some hard decisions.

Key government officials began priming the pump in mid-1984 with sharply higher public spending, even though it could cause rising prices and overvaluation of the exchange rate. We believe the policy shift reflected the leaders' belief that Mexicans would not accept more austerity as well as their perception that it was necessary to make a strong showing in the July 1985 midterm elections.

Stimulation of the economy continued during the first half of this year, pushing economic activity to expand at an annual rate of 6 percent. The pickup in the economy, the growing overvaluation of the peso, and declining oil prices, however, precipitated a sharp deterioration in the balance of payments. This trend and the runup in the public-sector deficit forced Mexico City to announce a devaluation and spending cuts soon after the July elections.

Although some of the political imperatives for a stronger economy temporarily eased and allowed new austerity measures to be imposed, in our view the lure of more expansive policies will remain strong as President de la Madrid gauges the public's willingness to accept further stringency. Mexico City will still have to face more than a dozen gubernatorial contests in 1986 and the beginning of the yearlong campaign for the presidency in 1987. The greatest pressure for continued expansion is from the 4 million Mexicans who are unemployed and the even greater numbers who are unable to find full-time jobs. Moreover, given Mexico's demographic profile, the problem will only get worse before the end of the de la Madrid term in 1988.

In 1986-88, at least conceptually, Mexico could achieve an annual growth rate in the 4- to 5-percent range if relatively favorable global economic conditions continued, including United States economic growth of about 3 percent annually, oil prices remaining near their present levels of $24 a

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barrel, and international interest rates holding near their current average level of 8 to 9 percent. However, foreign lenders would have to provide some $6 billion annually, far above the amount they are presently willing to lend.

In reality, an expansionary growth path would quickly run into a number of key constraints. The budget deficit would rise to 12 to 15 percent of GDP and by its very nature result in an easy monetary policy and high inflationary pressures throughout the period. Externally, Mexico's trade and current accounts would also deteriorate further. By 1988, we project Mexico's current account surplus would disappear. As expansive policies take their toll, Mexico's ability to grow would become increasingly checked by the severity of the country's foreign exchange situation.

Continued government expansion, even at present rates, is producing unfavorable economic factors that we believe will inevitably force de la Madrid to introduce belt-tightening policies similar to those imposed in 1983. If such policies were introduced in early 1986, we project economic activity would be throttled back to about 1-percent annual growth.

Given Mexico's relatively sizable foreign exchange reserves and the intense political pressure, the government could decide to postpone full imposition of adjustments for a year or more. As delays continue, the inevitable trauma would be even greater when the government tried to slow the pace of the overheated economy.

The longer the delay, the greater the risk that the government will overcompensate when it finally takes action and cuts back spending. Such overreaction would be made even worse if the wrong policy signals sent to the private sector result in spurred capital flight and a drain on investments. The effects of such a policy fiasco could be substantial. Not only would Mexico enter the preelection period in a serious economic tailspin but the new president would come into office facing a virtual replay of de la Madrid's first six months in power.

From a political perspective, economic backsliding will strengthen the hand of those in the government who favor more nationalistic, anti-US, and protectionist policies. In our view, de la Madrid will find it more difficult to continue building a consensus for liberalizing the economy, a policy lenders

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view as constructive. Economic hardship will exacerbate the competition for limited resources among the traditional pillars of the Mexican political system. The eroded confidence already evident in a large portion of the citizenry could result in activities more damaging than mere discontent should de la Madrid overreact by cutting too much. Support for opposition parties would grow, we believe, with little realistic expectation that the ruling party would open up the political system as an escape valve. In fact, if pushed to the wall in a political crisis, de la Madrid would be likely to employ violence—a technique used successfully by previous Mexican administrations—to attempt to stem the tide. Short of a crisis, however, fallout from a deteriorating economic situation could result in bolder, more risky policy moves at home and a greater willingness to sacrifice recent gains in the US-Mexican relationship abroad.

Under the best of circumstances, the de la Madrid government's present policies risk undoing the gains of the last two years. Once the crunch comes, we expect Mexico City to appeal to Washington to put pressure on the IMF and international bankers to be especially lenient with Mexico. Even before such a critical point, however, we believe Mexico City will continue to look to Washington for special deals, perhaps a generous oil sales arrangement. Barring a major change in the international environment, de la Madrid is unlikely to renege on Mexico's debt obligations, however. In our judgment, any drift in this direction should be perceived as a tactical attempt to gain leverage with international lenders. The period of slow growth we foresee will lead to tensions in other areas because of the increase in the number of Mexicans crossing the US border illegally in search of jobs, the restrictions on resources available for fighting drug cultivation, and mounting pressures on foreign investors.

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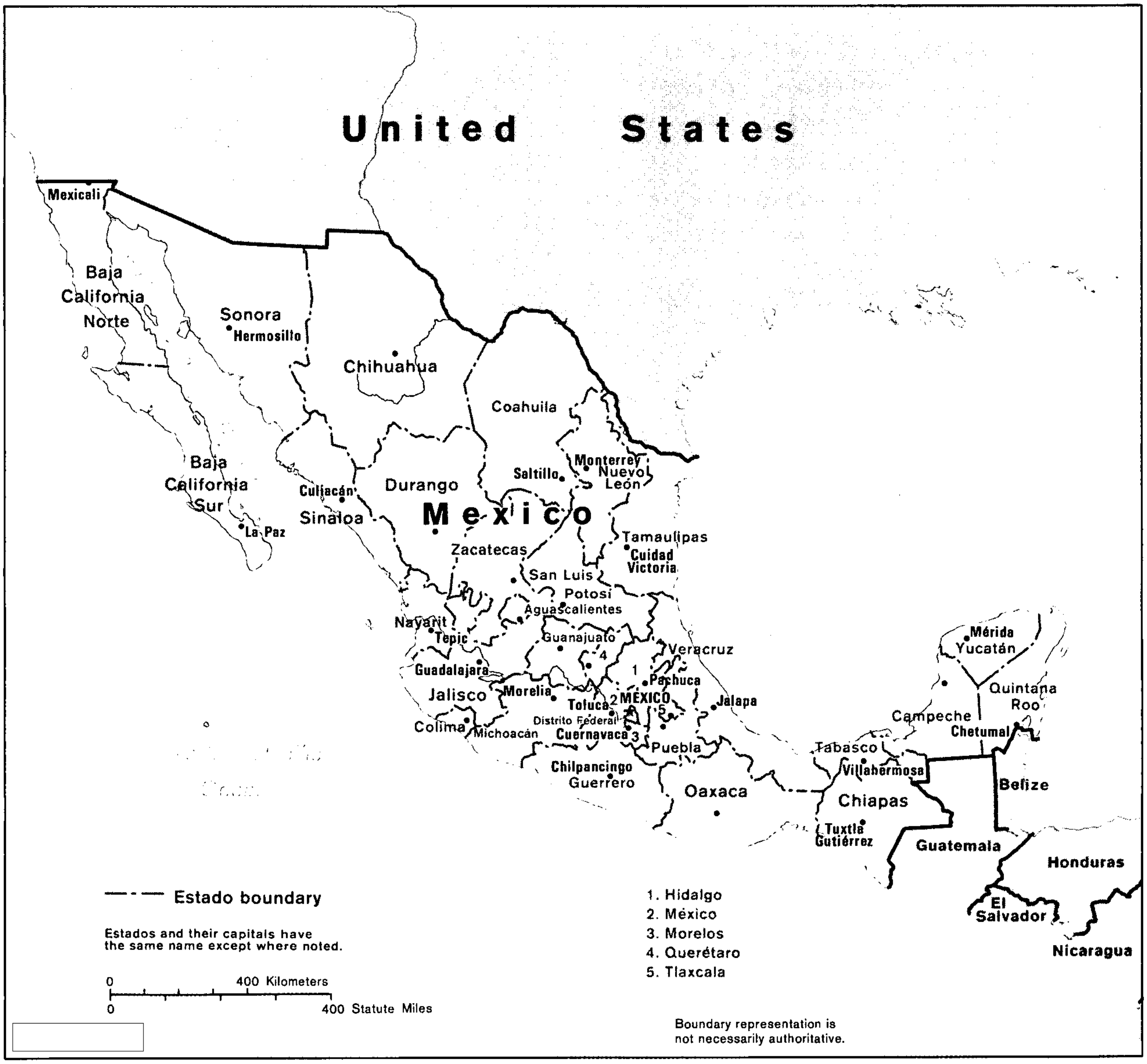
Figure 1. Administrative Units



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Mexico: Prospects for Economic Policy Shifts [redacted]

Introduction

Judging from Mexico's announced 3.5-percent growth rate in 1984 and continued success in negotiating international financial and credit agreements, the country rebounded solidly from its economic crisis of 1982. Even so, this favorable record was underpinned by a domestic policy program that is forcing the de la Madrid administration to reassess its policy stance. Whether fiscal and monetary policies announced subsequent to the July elections become effective in the next few months or are delayed until next year, Mexico City still faces some hard decisions. [redacted]

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Against this backdrop, this report examines the sustainability of Mexico's current policies and the impact of likely alternative policy choices. In doing this, we evaluate Mexico's economic performance during the first 32 months of the de la Madrid administration, focusing on the effects of falling oil prices and other constraints on Mexican economic policies and structures. Using an econometric model, we then analyze alternative policy paths available to the Mexican administration, examining the effects on the growth of consumption and payments tradeoffs that are involved. This study also analyzes how other possible outcomes, which in essence involve government policy miscalculation, could affect Mexican economic performance as the country moves toward the end of President de la Madrid's term in office in 1988. [redacted]

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The Impact of de la Madrid's Policies, 1982-84

When President de la Madrid assumed office in December 1982, he implemented a series of tough austerity measures that considerably eased the financial crisis he had inherited.[1] According to government statistics, the initial policy moves were quite substantial. Mexico City cut public expenditures and domestic credit by one-third during the period 1983-84. Overall, the lower spending and greatly reduced import levels allowed Mexico to end its debt moratorium, work out favorable rescheduling agreements with its international creditors, and rebuild badly depleted foreign exchange reserves. At the same time, these measures cut Mexico's economic growth performance over 13 percentage points between 1981 and 1983. This in turn worsened the country's already growing employment problems, and seriously eroded living standards and real wages. [redacted]

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Priming the Pump

As the immediate effects of the financial crisis eased, the Mexican Government began to reassess its economic situation with an eye toward potential political gain. We believe, on the basis of US Embassy reports [redacted] that key government officials decided in mid-1984 that they had to speed economic recovery even at the cost of rising prices and overvaluation of the exchange rate. The shift in policy direction reflected both Mexico City's belief that Mexicans would not accept continued strict austerity and the view that it was necessary to make a strong showing in the important July 1985 local and gubernatorial elections. All national legislative deputies and seven state governorships were to be elected, and key contests were viewed by party leaders as an important barometer of public confidence in the de la Madrid administration, according to the US Embassy. [redacted]

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From an economic standpoint, the decision to prime the pump was initially reflected in numerous moves to bolster public spending. [redacted]

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[1] For a more comprehensive evaluation of de la Madrid's economic policies during the first half of his administration, see appendix A. [redacted]

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new government investment projects, particularly in areas where the ruling party believed it would face the greatest challenges. For example:

- The government announced in June it would spend the $1.5 billion contingency fund set up under the IMF program for special needs. This "readjustment" of fiscal policy was necessary to spur economic activity.
- The Federal District indicated in August that 200,000 temporary jobs would be created to continue construction of the Mexico City subway and to repair the water system.
- The Bank of Mexico proclaimed a new program that would provide nearly $300 million in credits for housing.

Moreover, throughout the states of northern Mexico, numerous new road projects were begun and other highly visible construction projects—such as sewer systems—were started. 25X1

By the end of 1984, the economic effects of all of these new spending efforts were beginning to be felt. According to Embassy reporting, public expenditures for the year as a whole jumped far in excess of the level agreed to in IMF targets. Indeed, the overall public-sector deficit rose to 7.6 percent of GDP, a far cry from the 3.5-percent target established in the original Fund program for 1984. If anything, this figure understates the full extent of government spending. If, for example, arrears on public-sector interest owed to the Bank of Mexico were known and included, the deficit almost certainly would be increased by a substantial margin. 25X1

Mexico's expansive economic policies were not simply limited to the fiscal side. As the government deficit began to grow, the administration allowed the money supply to increase a hefty 60 percent in 1984, compared with 40 percent the previous year. On the basis of a review of government statistics, this increase in the money supply appears to be basically an accommodation to the expansive fiscal spending that was under way. While credit to the public sector, for example, expanded rapidly, loans to private-sector borrowers remained exceedingly tight, according to press and Embassy reporting. 25X1

Even though official information for early 1985 is still sketchy, the US Embassy indicates stimulation of the economy continued at least through June. Not only did Mexico City fail to meet some 1984 IMF targets, but most observers report that public-sector spending remained well above targeted levels during the first half of the year. These spending trends contributed to keeping inflation above the target level. 25X1

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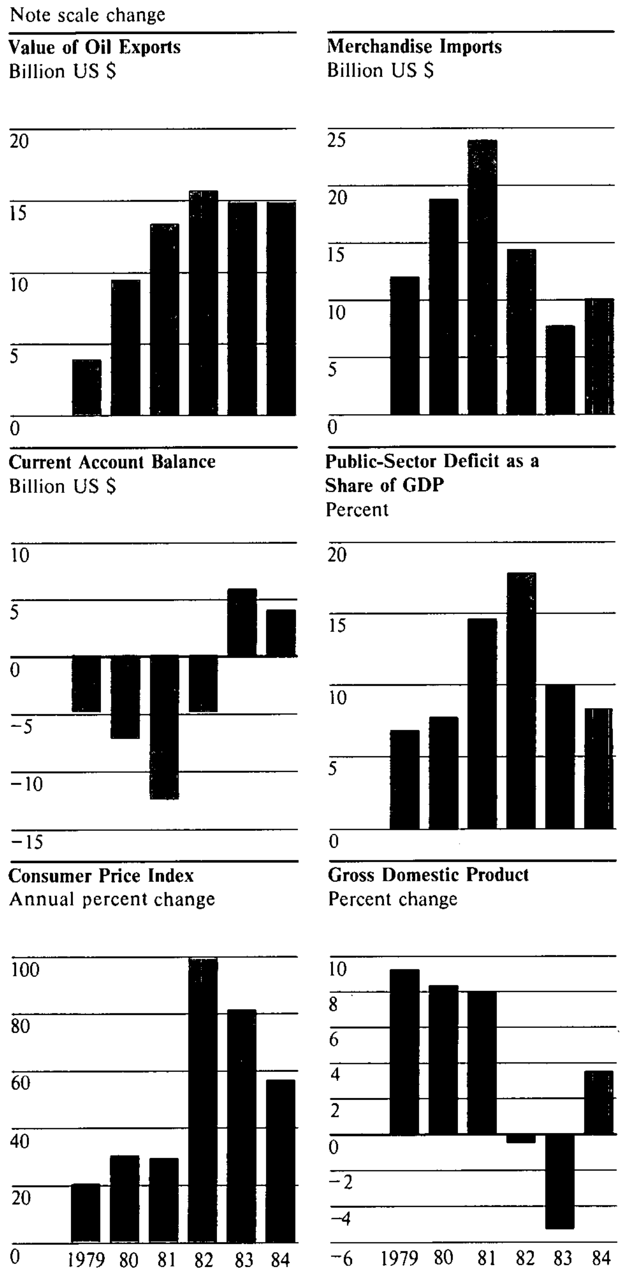
Most Mexicans and foreign observers are waiting to see whether the de la Madrid administration follows through on its latest commitment to return to more austere policies. The government announced once again that it would cut the budget, this time by reducing current outlays 1 percent. It also pledged that it would tighten monetary policy, provide additional incentives for exports, and liberalize imports by eliminating import license requirements for 37 percent of imported goods. Over the next few months, observers will be watching to see if the government's recent decision to regulate the float of the peso keeps exports competitive and whether measures that cushion the negative effect of austerity on the population are introduced. 25X1

Given the size of the budget deficits and the lagged impact of last year's expansion of the money supply, it seems unlikely that Mexico stands much chance in even achieving the 45-percent inflation-rate target agreed to with the Fund. Indeed, on the basis of the

Figure 2
Mexico: Economic Indicators, 1979-84



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performance of the first six months of 1985, we project that prices will end up rising about 60 percent. 25X1

The Short-Term Effects

From an economic standpoint, last year's decision to gear up the economy for the election paid off, at least in the short run. After falling 5.3 percent in 1983, GDP rose 3.5 percent in 1984, according to official Mexican estimates. Government consumption expanded almost 7 percent and the slide in public investment ceased. Moreover, in response to the pickup in aggregate demand, private investment grew by nearly 9 percent, a noticeable turnaround from the large declines of the preceding two years. Even though real wages continued to fall, private consumption showed a slight rebound of 2.8 percent, in contrast to last year's 7.5-percent fall. 25X1

Results so far this year suggest the growth spurt has continued. The US Embassy estimates that GDP probably was growing at an annual rate of about 6 percent in January-June, while production of automobiles was up 25 percent during January-April, and construction activity rose 25 percent in January-March. Another indicator of the pickup in the economy has been the sharp runup in imports that contributed to the deterioration in the trade balance. Indeed, during the period January-June 1985, Mexico's trade account surplus plummeted 50 percent to $4 billion. This pattern, combined with large interest payments on foreign debt, is likely to cause Mexico this year to experience its first current account deficit since the financial crisis of 1982. 25X1

From a political standpoint, a readout of election results suggests that the de la Madrid administration emerged relatively unscathed. The ruling Institutional Revolutionary Party (PRI) captured all seven gubernatorial seats and the vast majority of local offices. Official results for the 300 congressional seats contested and the 100 seats reserved for opposition parties reflected reduced representation for the conservative National Action Party (PAN). The government's decision to sweep the contests and to use such pump priming and irregularities as necessary to ensure victory provoked little violence from opposition supporters. Voter turnout was lower than in previous elections, however, indicating many Mexicans are cynical about the democratic nature of the political process,

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Longer Run Pressures for Growth

With the July elections now over, some of the political imperatives for a stronger economy will temporarily ease. Even so, the lure of more expansive policies will be strong. From a political standpoint, the de la Madrid administration still has to contest more than a dozen gubernatorial elections in 1986. Among these, the races in the states of Chihuahua, Sinaloa, and Durango will probably be particularly worrisome because of the growing appeal of the PAN to middle-class voters in northern states. Moreover, in 1987 the yearlong campaign for the presidency will begin.

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In addition to the likely focus on difficult races, high levels of concern remain over Mexico's willingness to accept a return to greater austerity and disenchantment with continuing high unemployment and declining real wages. Aside from bolstering party popularity well before the 1988 presidential election, an active government spending program also would help underscore the government's pivotal role in guiding the economy. If the recent past is any guide, Mexico City will continue to see public-sector investment, state-owned enterprises, and tight regulatory control of the private sector as key ingredients in managing the country's economic life.

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Perhaps the greatest pressure for continued expansion is from the labor front. At present, we estimate that a little over 4 million Mexicans—or roughly 17 percent of the labor force—are unemployed and even more are unable to find full-time jobs. Given Mexico's demographic profile, this problem will only get worse as an additional 4 million persons enter the labor force before de la Madrid's term ends in 1988. We see this surge as only the beginning. As things now stand, Mexico is likely to see its labor force nearly double to as many as 40 million by the turn of the century.

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The Labor Force Time Bomb

The de la Madrid administration's concern over job creation reflects the longstanding fear of Mexican governments that growing unemployment and widespread underemployment will eventually lead to social unrest. High birth rates of the past have created the enormous task of providing jobs for a labor force growing at nearly 4 percent a year, according to government statistics. We estimate that just providing jobs for the 1 million people entering the labor force each year in 1985-90 would require economic activity to expand about 10 percent annually, at current capital labor ratios.

In addition to new entrants to the labor force, however, we estimate there are about 4 million unemployed and about 9 million underemployed. Indeed, of the 23 million Mexicans in the labor force, we calculate less than half have full-time jobs earning the minimum wage or better. Under any economic policy mix we envision de la Madrid putting in place, unemployment and underemployment will rapidly worsen; the President has only the choice of slower or faster increases in the numbers of people without full-time jobs at the minimum wages.

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An Expansionary Policy Path . . .

We believe that Mexico theoretically could achieve an average annual growth rate in the 4- to 5-percent range during the period 1986-88.[2] Such a growth path

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would, of course, require the continuation of relatively favorable global economic conditions from a Mexican perspective. Specifically, it would require that:
- GNP gains in the United States average around 3 to 3.5 percent a year over the entire period.
- Oil prices firm near or at the present average level of $24 per barrel.
- International interests rates remain near their present average level of about 8 to 9 percent.

In addition, such a growth path would assume that lenders are willing to provide on an annual basis about double the average of $3 billion we believe they will grudgingly lend Mexico over the next three years, and that their already shaken willingness to provide even limited new funding would not be further eroded by a major payments crisis elsewhere in the Third World during this period. 25X1

Even assuming such favorable conditions, Mexico would only partially move down the road to full recovery by 1988. A 4-percent growth path, for example, would bring per capita income nearly back to its 1982 level by the end of the de la Madrid term. Even so, the number of new entrants to the labor force in 1988 would still exceed the number of jobs created by perhaps as many as 500,000 people. Indeed, at present productivity levels, 10-percent growth for 20 years would be required to fully absorb Mexico's labor force pool. 25X1

. . . and Its Sustainability

In reality a recovery growth path anywhere near the 4- to 5-percent range would require much more than just a favorable international environment. Indeed, any attempt to stick to a growth path underpinned by expansionary government policies would quickly run into a number of key constraints. 25X1

Internally, an attempt to grow at 4 percent a year, while meeting de la Madrid's pledge to protect real wages, would almost certainly require expansionary money supply growth. Even if credit to the private sector remains tight, simply accommodating government budget deficits, which could equal 12 to 15 percent of GDP by 1988, would by its very nature result in an easy money policy. This in turn would mean that inflationary pressures would continue and increases in the cost of living would remain high throughout the period. In such a case, inflation would be at least several times higher than the 20-percent level that the government has targeted. 25X1

Externally, an overly aggressive government-supported growth path would almost certainly lead to a deterioration in Mexico's trade and current accounts. From the export side, assuming that Mexico City opts for a slight but growing overvaluation of the peso between now and 1988, the best that Mexico could expect to see on its nonoil exports accounts is a 12-percent rise in sales.[3] On the oil side, the picture is not much brighter. Indeed, if consumption rises in line with official Mexican estimates and production manages to increase as planned, petroleum available for export will rise only about 40,000 b/d annually during 1985-88. At present prices, this would represent $385 million in additional export earnings, an amount equal to only 12 days' worth of merchandise imports at current levels. Taking into account both the overall export picture and the import needs associated with government-supported recovery, we project that Mexico's current account surplus would disappear by 1988. 25X1

The need to finance existing debt will further strain Mexico's external accounts. Even though recent debt rescheduling operations have provided some financial breathing room, they have not eliminated a heavy loan repayment schedule. At present we see annual public debt servicing exceeding $11 billion by 1988 under almost any plausible scenario, including one where world interest rates remain at their present levels until the end of the de la Madrid administration. Renegotiating Mexico's private debt under terms similar to those being worked out with the public sector would reduce overall debt service obligations by an additional $1 billion each year through the remainder of the decade. Even with these new reschedulings, we calculate that debt payments during the remaining 40 months of the de la Madrid term will reach $60

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Outlook for Nonoil Exports

As long as the Mexican Government remains unwilling or unable to shift its policies toward external-oriented development, its nonoil export prospects will be constrained. Steps taken so far to spur foreign sales, such as devaluation, new trade credit mechanisms, and reduced regulation, have been only partially effective and their impact is diminishing:

- *Complex and unpredictable exchange rate policies make business decisions difficult, while the increasing overvaluation of the peso makes Mexican exports less competitive in world markets.*
- *Mexico's financial crisis has reduced the availability of foreign and domestic credit for exporters.*
- *Orientation toward import substitution and protection for domestic industries boosts costs for exporters.*

Until both local and foreign businessmen become confident that economic policies will be favorable and steady, they will limit their investment in export industries. Even so, we believe a 10-percent annual growth between 1985 and 1988 is possible if—but only if—the government keeps the peso competitive. Growth would be driven largely by sales of automotive parts and engines, electronic and mechanical equipment, steel, processed foods, chemicals, and telecommunication equipment.

On the other hand, appreciation of the peso could reduce the growth of nonoil exports to less than 10 percent annually. Mexican officials are reluctant to devalue the peso fast enough to keep it competitive because they want to break the public's inflationary expectations, to restore imports of capital goods for domestic industries, and to keep the private sector's debt repayment burden manageable.

Besides its own policy constraints, the government's prospects of expanding nonoil exports are limited by external factors:

- *The large, oil-generated trade surpluses Mexico has with many industrial countries limits these countries' willingness to expand purchases of other Mexican products.*
- *Many Mexican exports face stiff competition from industrial country and Third World producers.*
- *Other LDCs are reeling from their own financial difficulties and have had to restrict imports.*

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billion. Assuming the renegotiated payments schedule is adhered to, the interest payments, coupled with the import-boosting trade performance associated with
25X1 high growth, could end up pushing the current account into the red by $2-3 billion in 1988.

As expansive government expenditure policies take their toll on the country's external accounts, Mexico's ability to grow will become increasingly dependent on the country's foreign exchange situation. As things now stand, official statistics show that Mexican factories rely on imports for 20 percent of their raw materials, and the bulk of all machinery and equipment needed for capital formation comes from abroad. Even if Mexico ran down its $7 billion foreign exchange cushion to $1 billion by 1988, this would only buy a few months' worth of foreign exchange relief. 25X1

Beyond these pressures, the key international constraint Mexico will face will be the level of net new foreign lending. Our calculations indicate Mexico could continue to support economic growth in the 4- to 5-percent range through 1988, but only if bankers were willing to provide $6-7 billion annually in new funding. We believe the prospects for such an injection are highly doubtful. Even given Mexico's relatively favorable situation today, we believe that the

Dealing With Foreign Banks

The tough austerity measures that sharply reduced inflation have impressed foreign bankers, and allowed Mexico City to catch up on debt arrears and to work out favorable extended repayments terms with its creditors. Financial authorities are rescheduling public debt in two steps. In September 1983, after more than a year of difficult negotiations, $23 billion in public debt coming due between August 1982 and December 1984 was rescheduled over seven years. In June 1984, Mexico City went back to its more than 500 foreign creditors asking for the refinancing of $48.5 billion of its $65 billion public debt. The proposal included the debt rescheduled in 1983, commercial loans taken in 1983 and 1984, and obligations not earlier rescheduled and coming due before 1990. After months of tough negotiations, Mexico reached agreement in March with creditor representatives to reschedule $23.6 billion in public-sector debt due in 1982-84 on concessionary terms, including lower interest rates and a 14-year payback period with one year's grace. Later this year, Mexico City expects to reschedule on similar terms the remaining $25.1 billion in public-sector debt due after 1984. 25X1

Mexico's $28 billion private-sector debt has proved more difficult. While progress has been made in catching up on some interest arrears, much of this debt is in technical default. Only $12 billion in private debt was registered in October 1983 with the Bank of Mexico when the bank closed access to a trust fund set up to finance rescheduled private debt. Now, nearly two years after the program was set, only a small number of those private debtors have negotiated rescheduling agreements with their creditors. Details on the other $16 billion of private debt are sketchy, although we believe much of it consists of suppliers' credits and other short-term instruments that may not require multiyear rescheduling. In any event, we believe that a sizable portion of this debt has been or will be written off as uncollectible. The peso devaluations have aggravated debt problems, causing unprecedented financial problems for many private-businesses that depended on imports.

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prospects for new loans exceeding $3 billion annually are quite low. Bankers' willingness to go even this high would certainly be tested if Mexico came seeking money at a time when government policy had already run down reserves, fueled inflation, distorted the value of the peso, and further weakened the private sector. 25X1

A Turn to Austerity

The financial ramifications of continued government expansion strongly suggest that sooner or later unfavorable economic factors will inevitably force de la Madrid to introduce belt-tightening policies similar to those imposed in 1983. Such a shift would cause Mexico City's economic policies to aim primarily at fighting inflation and maintaining a sustainable balance-of-payments position. In these circumstances, real wages and the incomes of most Mexicans would be hit again as the government moved to keep spending in line with revenue and other financial resources. 25X1

From a practical standpoint, such a policy shift would likely entail a number of individual moves. For example, Mexico City could opt to:
- Slow the growth in government wages, which presently account for 17 percent of current expenditures.
- Hold down new hiring both in the government itself and in the wide array of state-owned firms.
- Slow outlays on subsidies that account for 15 percent of government spending.
- Pare the growth in investment spending in state-owned industries such as oil, steel, railroads, mining, and utilities.

Even with spending restraints, we project that, for political reasons, the large public-sector deficit could only be reduced gradually and most credit would continue to go to the public sector. Credit to private business would remain tight. To shore up the external accounts, Mexico would have to keep the peso competitive by stepping up depreciation in line with inflation. 25X1

If such belt-tightening policies were introduced sooner rather than later—say early 1986—we project economic activity would be throttled back to about 1-percent annual growth through 1988 to avoid running into major international payments constraints. Growth at this rate would not be enough to make up for the domestic purchasing power losses of the last few years, and at the end of de la Madrid's term per capita income would remain about 12 percent below 1982 levels. Moreover, unemployment and underemployment would grow more rapidly than if Mexico City had been able to sustain high government spending, and as many as 800,000 more Mexicans could find themselves out of work. Weak demand and wage restraint would allow Mexico to slow increases in the cost of living, but we believe inflation would remain at levels considered far too high by most Mexicans.

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On the positive side, these policies would enable Mexico to post a sustainable external account performance. As long as oil prices remain steady, nonoil exports grow at least gradually, and weak demand holds down imports, we believe Mexico could continue to generate the trade surplus it needs to help meet the country's debt service payments. As long as international bankers were accommodating and lending to Mexico totaled at least $3 billion annually, Mexico City would not be forced to draw down its accumulated international reserves and, indeed, could increase them slightly in keeping with current IMF targets.

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Given Mexico's relatively strong foreign reserve position, it is of course possible that the political realities of the situation could force de la Madrid to postpone adjustments for a year or more. If the shift to economic adjustment is indeed delayed, the inevitable trauma would be even greater as the government tried to slow an even more expansive economy later in de la Madrid's term. We calculate, for example, that, if adjustment was held up a year, growth would have to be cut an additional 1 to 2 percentage points in 1987 and 1988 in order to bring the country's financial gap in line with the maximum level of new lending we believe is possible. Aside from the higher economic costs, the delay in action would risk serious political consequences since a more severe downturn would occur even closer to the 1988 elections—a time when pressures for new pump-priming measures will almost certainly be on the rise.

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While delay would be costly, most short-term pressures will argue for holding off on adjustment for as long as possible. Aside from the normal concerns over pork barreling for next year's elections, there will be political debts to be paid for this year's victories. Moreover, even if timely retrenchment is begun, the combination of sharply rising unemployment, continuing inflation, and declining per capita income will bring intense political pressure on the government to ease austerity measures before the 1988 campaign gets into full swing. From a political standpoint, government officials would almost certainly worry that the opposition National Action Party (PAN) would capitalize on adverse economic conditions and shift even more voters away from the fold. Such concerns would only be intensified if the PAN made a good showing in the 1986 gubernatorial contests. On balance, it then seems likely that, given the political realities in Mexico, a general austerity approach marked by fits and starts is the most likely outcome.

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The Risks of Misgauging the Policy Adjustment

Some inevitable variation of a stop-and-go policy approach is not the only possible outcome, however. Indeed, given the need for austerity and the policy pressures to delay it, there is a risk that Mexico City's economic policy community could misjudge the needed degree of correction and accidentally overshoot. If anything, the longer adjustment is delayed, the greater the risk the government will overcompensate by excessively cutting back public spending.

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If the past is any guide, overreaction is a real possibility. The long period of temporizing by the Lopez Portillo government in 1981-82 necessitated the introduction of harsh austerity policies by the de la Madrid administration in 1983. Although the policies were carefully developed, no one envisioned

the severe economic consequences that followed from efforts to cut government spending, reduce inflation, and curb imports. The plan called for reducing growth to just 1 to 2 percent for 1983. Instead, economic activity plummeted 5.3 percent, from nearly 8 percent in 1981, while imports plunged to $7.7 billion, from $24 billion in 1981. Even under these circumstances, the sharp devaluations of the peso contributed to keeping inflation relatively high. The cost-of-living
25X1 index rose 80 percent in 1983, down 20 percentage points from the previous year.

Any overreaction this time around could be made even worse if, in addition to reduced federal outlays, the wrong policy signals were sent to the private sector. As economic constraints became increasingly severe prior to a shift toward austerity, for example, the odds increase that the government could make a number of moves that would be interpreted as a tilt even further away from the private sector. For example, Mexico City could:

- Change the current trend, allowing the peso to become increasingly overvalued to help reduce inflationary pressures domestically. This would not only discourage exports but also encourage imports—both of which hurt domestic business interests.

- Show a greater unwillingness to use dwindling foreign exchange reserves on private-sector import needs.

- Try to project the image of a job creator by reconfirming a commitment to maintain or even strengthen the role of the government in the economy, especially by underwriting inefficient and financially costly state-owned enterprises.

- Revising guidelines on foreign investment to reconfirm the case-by-case review process and further limit areas in which foreign investors could become involved in the Mexican economy.

- Try to protect lower class income levels by publicly pledging not to renege on government support for subsidies and price controls.

If such moves came on the heels of a growing defection of businessmen from the PRI, the perception of anti-private-sector sentiment would only be intensified. Regardless of the actual intent, such policy moves in their totality would only attract additional funds that otherwise could have been used by private businessmen to finance badly needed investments. 25X1

The risks of misperception at a time of policy change are only increased by the recent record of the de la Madrid administration. In numerous speeches de la Madrid and other Mexican officials have pointed out that economic recovery will require substantial private investment as long as public outlays are constrained. Even so, this rhetoric to date has not been matched by clear action even at the margin. Indeed, the US Embassy reports that recent moves to strengthen the private sector by boosting tax credit and cutting red tape have been more than offset by reduced peso credit to the private sector, continued official antibusiness rhetoric, and increased government regulation. 25X1

If private-sector confidence—both domestic and international—were to be dashed, overly aggressive government austerity, along with a push to meet IMF exchange reserve targets, could cause a steeper decline in economic growth. We calculate that the decline could be 2 to 3 percent if, for example, austerity sparked:

- A drop in private investment activity to 1983 levels.
- Capital flight at roughly twice the estimated 1984 level.
- Banker unwillingness to lend net new funds in excess of $1 billion. 25X1

Downside Political Risks

From a political perspective, we believe economic backsliding in the next year or two would aggravate existing policy conflicts within the government, strengthening the hand of those who favor more nationalistic, anti-US, and protectionist policies. In effect, it would make it more difficult for de la Madrid to continue building a political consensus for liberalizing the economy in ways that Washington and the Western financial community view as constructive. [redacted] 25X1

At the same time, economic hardship would make it harder for the government to satisfy the growing demands of organized labor and other influential members of Mexico's so-called revolutionary family, which generally have endorsed de la Madrid's policies. While Mexico's major trade unions almost certainly will remain in the government camp for the foreseeable future, the planned retirement in February 1986 of labor kingpin Fidel Velazquez—who has dominated the unions for close to 50 years—could result in a modest relaxation of labor discipline. More generally, the popularity the ruling party has enjoyed since coming to power in 1929 has derived in large part from its ability to bring greater material benefits to the Mexican people. [redacted] 25X1

The austerity measures imposed since the 1982 economic crisis have already eroded a significant portion of the confidence the average citizen has in the government to rule effectively, according to Embassy reports. While there are no signs of a system breakdown yet, continued worsening economic conditions could result in activities more damaging than mere discontent. We believe these could take the form, for example, of more strikes by workers and land grabs by peasants. [redacted] 25X1

Opposition parties, notably including the relatively conservative PAN, almost certainly would try to exploit the government's economic failings. We know from US Embassy [redacted] reporting that the PAN has the strongest appeal among middle-class, urban professionals in northern Mexico, many of whom have been exposed to US culture and values. While the PAN stands virtually no chance of displacing the PRI on the national scene in the next decade or two, in our judgment, it probably would pick up additional popular support if economic conditions worsened. [redacted] 25X1 25X1

Growing popular sympathy for the PAN and, to a lesser extent, for Mexico's factionalized and largely feckless leftist parties, would, in our view, elicit a strong response from the government and ruling party. Members of the governing elite, [redacted] almost certainly would argue that the ruling party should preserve its political power at all cost, and they probably would favor more repressive policies to accomplish this end. [redacted] 25X1 25X1 25X1 25X1

[redacted] With economic revenues already strained, however, it would be more difficult to satisfy local needs, especially if many demands were made at once. With his back up against the wall, de la Madrid probably would employ force—a policy used successfully by previous Mexican administrations—in an effort to stem the tide. [redacted] 25X1 25X1

Even if the economic situation does not generate a political crisis, there will still be domestic political ramifications. De la Madrid could be tempted to adopt somewhat bolder and riskier policies, much as his immediate predecessors did shortly before leaving office. In the waning days of his administration, Luis Echeverria expropriated a number of large farms in northern Mexico. Jose Lopez Portillo at a similar point in his term nationalized the banks. In an effort to deflect domestic criticism from his administration and to appeal to nationalist sentiment, de la Madrid could conceivably move more aggressively to pursue collectivist solutions to the Latin American debt crisis or more overtly blame external conditions for Mexico's economic woes. [redacted] 25X1

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Implications for the United States

Under the best of circumstances, the de la Madrid administration's present policies of economic stimulation risk undoing the gains of the last two years. The government clearly decided, however, that it was politically necessary to sacrifice the fight against inflation in order to avoid social unrest and to aid the ruling party's chances in the midterm elections in 1985. To some extent, Mexico's policy stance also probably reflects the President's hope that private investors will rescue the economy in time to prevent a renewed clampdown. With the present emphasis on nationalistic economic policies, however, we do not see investors being particularly responsive. Moreover, we expect foreign bankers to be unwilling to lend the amounts necessary to maintain stimulative policies for an extended period. Once the crunch comes, we expect Mexico City to appeal to Washington to put pressure on the IMF and international bankers to be especially lenient with Mexico in keeping open credit
25X1 lines and encouraging new debt rescheduling exercises. [redacted]

25X1 [redacted]

25X1 [redacted]

25X1 [redacted] Mexico City has recently announced it is reconsidering its international trade posture and its position on such areas as GATT membership. Nevertheless, because domestic opposition to such a move is high, for now we see these gestures largely as an attempt to placate the international financial community and gain concessions from
25X1 trading partners. [redacted]

Mounting domestic political pressures, falling oil prices, and rising interest rates conceivably could force Mexico to abandon the rules of the game. Such a response could include a debt moratorium, negotiation through an international debtors cartel, or a scheme to tie debt payments directly to export performance. On the basis of Mexico's need to keep borrowing lines open, reliance on trade with creditor countries, and desire to improve relations with the United States, however, we deem this highly unlikely and see any drift in this direction as a means to gain leverage with international lenders rather than as a serious threat to renege on debt obligations. [redacted] 25X1

The period of slow economic growth that we project for Mexico will lead to greater tension in other areas. We expect continued growth in the numbers of Mexicans crossing the US border illegally in search of work. Indeed, we estimate that in 1983, following de la Madrid's initial austerity program, an unprecedented 1.5 million undocumented Mexicans entered the United States, up from the annual average of 800,000 to 1.1 million in the years of the economic boom. The flow will be increasingly representative of the Mexican population, including more urban dwellers, women, and families. Continued budget stringency will restrict the resources available for fighting drug cultivation, while the economic incentives for increasing production will be higher. These factors will reduce the effectiveness of any Mexican eradication program. Moreover, as economic difficulties mount, we expect greater pressure on foreign investors to export a greater share of their products or to make special concessions to be allowed to invest in Mexico. In the near term, we do not see Mexico becoming the dynamic market for US exports or investment that it was before 1982. [redacted] 25X1

Appendix A

Recent Financial and Economic Performance

Legacy of Neglect

For several years before de la Madrid came to power, foreign and many Mexican economists had argued that policies of expanding public investments, increasing producer and consumer subsidies, and propping up the peso to take the heat off domestic prices could not last much longer. Dedication to these policies, together with the optimism generated by new oil wealth, had led the previous President, Lopez Portillo, to defer adjustments until it was too late.

According to the US Embassy and our analysis, to keep this bundle of policies intact in 1981 when the world oil market was weakening, Mexico borrowed $30 billion abroad, the major portion in short-term money. When Mexico City ran out of foreign exchange in August 1982 and suspended payment on $2 billion per month in debt service, the whole world became aware that Mexico had squandered much of its oil wealth through premature consumerism, stifling state controls over economic activity, and the exactions of a corrupt bureaucracy.

Thus, when de la Madrid came to power in December 1982, most analysts believed the Mexican miracle of four decades of rapid economic growth, rising living standards, low inflation, and a strong peso was over.

Controlling the Financial Crisis

To avoid debt default and regain foreign exchange liquidity, de la Madrid embarked on a tough, IMF-sponsored stabilization program. We believe his quick devaluation of the peso was designed to slash imports and rein in foreign payments deficits. According to our analysis, maintaining IMF financial support and working out new debt repayments schedules required tough steps to slash public spending, wages, and domestic credit.

During 1983, and to a lesser extent during 1984, the austerity results were remarkable, according to official statistics, Embassy reports, [redacted] 25X1

- State-negotiated work contracts cut real wages 20 percent during 1983 and another 10 percent during 1984. While this disillusioned organized labor, workers generally accepted de la Madrid's explanations for the need for austerity because they were more concerned over protecting jobs.

- Government spending was reduced 25 percent in 1983 and held steady at the reduced level in 1984. Public works and investment were cut one-third, the impact falling heavily on oil development.

- Outlays for both consumer and producer subsidies were lowered 24 percent in 1983 and another 10 percent in 1984. Producer subsidies were marked down 40 percent. Consumer subsidies fell much less, as political pressures kept price hikes for public transportation and most government-supplied staples well below the inflation rate.

- Peso credits, in real terms, plunged one-fourth in 1983 before growing only 4 percent in 1984.

The most visible aspect of Mexico's austerity has been the turnaround in its foreign payments situation. By halving its import bill in 1983, while exports remained steady, Mexico City engineered a $10 billion swing in the current account balance, according to government statistics. The $5.5 billion surplus on current account was the first surplus of any size since 1955.

Depressed imports during 1984 kept the balance of payments strongly in surplus, according to Mexican Government reports. While imports increased a bit,

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they still amounted to only about 80 percent of the corresponding 1982 level and less than half the 1981 level. Stimulated by the dynamic US economy, exports of goods and services during 1984 also rose. In particular, sales of petroleum products and manufactures were higher and income from tourism and cross-border assembly industries increased. This enabled Mexico to have a current account surplus of $3.9 billion, [redacted]

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The strong trade position and new bank loans associated with debt rescheduling allowed Mexico City to substantially rebuild foreign exchange reserves. During 1984, we estimate that bank loans more than offset rescheduled debt principal payments, allowing foreign exchange reserves to increase nearly apace with the current account surpluses. While capital flight persisted, it was substantially below earlier levels. By yearend, net foreign reserves had risen from a negative $1 billion when de la Madrid assumed office in December 1982 to a comfortable $8.5 billion, according to published statistics.

The Whipsawed Domestic Economy

Despite the progress on foreign financial accounts, government deflation and the steady decline in private-sector investment hit the domestic economy hard. Jobs and living standards during 1983 and 1984 also suffered severe setbacks, according to our analysis.

The Crunch in Production. During 1983, according to official estimates, government deflation resulted in a 5.3-percent decline in GDP. Economic activity fell as investment plunged one-fourth and utilization of existing plant capacity dropped to 65 percent overall. In some industries it fell to 40 percent. Industrial production slipped 10 percent, as manufactures declined 7 percent and construction 14 percent. Weak demand caused services to decrease markedly, most noticeably in commerce where activity fell 9 percent. Agriculture bucked the trend, growing somewhat in 1983 as favorable weather ended two years of drought conditions.

During 1984, the depressed demand caused by lower consumer purchasing power, a deteriorating investment climate, and government deflation prevented an early economic rebound, according to our analysis. Official statistics, however, show that the economy bottomed out during the first half of 1984, as the government began to boost spending. Overall, the economy grew about 3.5 percent [redacted] Manufacturing during 1984 increased 4.7 percent, led by small gains in metal industries and mineral products. While the plunge in government investment was halted in 1984, private investment jumped nearly 9 percent.

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Sharp Job Losses. During the past two years, job losses—particularly among unskilled labor—have been severe. In our estimation, the rate of unemployment has edged up to near 20 percent, higher in many urban areas. Official statistics indicate that the average number employed in modern manufacturing fell 12 percent between 1982 and 1984. A recent private-sector survey indicates that, during the first half of 1984, 47 percent of large businesses in the Mexico City area reduced their work force, as did 30 percent of medium businesses and 23 percent of small businesses. Government employees did the best; we believe some increases in defense and internal security slots offset losses in other public-sector positions.

[redacted]

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