Page Denied

Next 1 Page(s) In Document Denied

Directorate of Intelligence

~~Secret~~

25X1

Mexico: Budget Politics— Courting a Crisis

25X1

A Research Paper

~~Secret~~

ALA 86-10031
July 1986

Copy 254

Page Denied

Directorate of Intelligence

Secret [redacted] 25X1

Mexico: Budget Politics— Courting a Crisis [redacted]

25X1

A Research Paper

This paper was prepared by [redacted] Office of African and Latin American Analysis, with a contribution by [redacted] Office of Leadership Analysis. It was coordinated with the Directorate of Operations. [redacted]

25X1 25X1 25X1

Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA [redacted]

25X1

Reverse Blank

Secret
ALA 86-10031
July 1986

25X1

Mexico: Budget Politics— Courting a Crisis

25X1

Key Judgments

Information available as of 30 May 1986 was used in this report.

A review of Mexican President de la Madrid's budget policies over the last three years demonstrates one basic fact—that short-term needs gutted his original program. Looking ahead, we believe that a likely continuation of the President's demonstrated persistence in politically biased fiscal policy will greatly increase the likelihood of an escalating financial crisis. As Mexico finds itself increasingly unable to finance its rapidly growing budget deficit, it almost certainly will continue to turn to the United States to provide financial transfusions and put pressure on international bankers to keep credit lines open and reschedule Mexico's debt payments. Mexico's need for continued US assistance in these areas in the future will place an enduring strain on bilateral relations.

During the early years of his administration, President de la Madrid appeared to be committed to slashing government spending. His widely touted annual budget proposals promised to curb operating expenses—particularly for subsidies and employment—while not excessively cutting spending on public investment. Pressures to increase spending, however, soon mounted on two fronts. Organized labor by late 1983 began clamoring for an increase in living standards, which had fallen dramatically. At the same time, the government, wanting to make a strong showing in the July 1985 midterm elections, began priming the pump as early as mid-1984.

Domestic pressures not only resulted in a higher level of spending than originally planned, but also caused the President to alter his pattern of budget allocations dramatically:

- Government operating expenses as a share of total public-sector spending rose between 1982 and 1985 instead of dropping steadily as de la Madrid had intended.
- To compensate for the inability to trim operating costs, public investment fell dramatically—by more than 50 percent in real terms—from 1982 to 1985.
- Taken together, these two spending trends meant that the government was able to cut the budget by only about one-half the amount that public officials had projected during the first half of the President's term.

In our judgment, de la Madrid's revised overall spending strategy achieved short-term political objectives, but only by sacrificing the country's longer term economic health. Public-sector investment cutbacks have adversely

ALA 86-10031
July 1986

Sanitized Copy Approved for Release 2011/04/04 : CIA-RDP88T00768R000300300001-0

25X1

affected the functioning of key sectors such as the petroleum, steel, electricity, railway, and fertilizer industries. These cuts will only further reduce Mexico's productive potential in the years ahead.

In our judgment, President de la Madrid is unlikely to change his fiscal policy approach even if oil prices remain low over the remainder of his term in office, preferring instead to increase the deficit despite the economic risks. Indeed, the politically expedient moment for de la Madrid to make dramatic changes in spending patterns probably has already largely passed. With most politically aware Mexicans already looking toward the 1988 presidential election, and members of the economic cabinet jockeying for favor, we believe that serious cuts in areas other than investment would be even more difficult now than in the early years of the de la Madrid administration. The President's decision to opt for politically easier investment cuts during the early years of his term in office, however, has reduced his flexibility to deal with Mexico's current financial problems. With investment already cut, any new austerity program would have to focus on politically more sensitive areas of spending.

From an economic perspective, Mexico's current fiscal policy approach is fraught with risks. Domestically, economic growth will probably be inhibited by government efforts to finance ever-increasing budget deficits. At the same time, the role of the private sector could be noticeably reduced as the government continues to absorb almost all domestic credit. As it is, internal Mexican projections call for negative growth, rising inflation, and a deterioration in the balance of payments this year. The Mexicans predict that achieving the 3- to 4-percent annual growth tentatively planned for 1987 and 1988 would require at least $15 billion in foreign loans. Internationally, the failure to check government spending enhances the chances that de la Madrid will declare a moratorium on foreign debt payments. We believe that he probably will continue to approach the United States first for some sort of bailout program, stressing that the fate of Mexico—and the US banking system—is in US policymakers hands. Should no workable solution be achieved, we believe that de la Madrid may decide to default on the debt as a bold gesture, much as Lopez Portillo did when he nationalized Mexican banks in 1982—a decision that would send political and economic shock waves through not only Mexico but the international financial system.

25X1

Contents

25X1

Figure 1

708133 (A02655) 7-86

25X1

25X1

Mexico: Budget Politics— Courting a Crisis

25X1

Introduction

Government spending accounts for about one-third of Mexico's GDP and directly affects most aspects of Mexican economic life. Budget allocation has acquired great political importance since 1982 as it increasingly has become an important tool in limiting Mexico's financial needs and demonstrating adherence to International Monetary Fund (IMF) programs. At the same time, Mexico's economic hard times have increased the importance of government outlays as a means of political reward and control. Spending decisions thus reflect President de la Madrid's sensitivities to political pressures as well as to economic considerations. In this light, many of President de la Madrid's spending decisions can be viewed as a crude measure of the relative weight given to Mexico's priorities.

Against this background, this paper examines public-sector spending patterns over the past three years and focuses on the various pressures that engulfed de la Madrid as he formulated Mexico's budget policies. To accomplish this, we compare annual budget proposals with actual expenditures to determine where the two diverge, thus highlighting the areas where de la Madrid was unable to follow through on his calls for deep budget cuts. This study also briefly assesses the economic and social impact on Mexico of de la Madrid's policy direction, the prospects for change as the country moves toward the end of the President's term in 1988, and the implications of those developments for the United States.

Legacy of the Oil Boom

When he completed his six-year term in December 1982, President Lopez Portillo left behind a public sector bloated by ambitious economic development and consumption policies. Entering office immediately following Mexico's discovery of large oil deposits in 1976, he had used public-sector spending even more enthusiastically than earlier presidents to boost economic growth and redistribute income. According to IMF statistics, the share of government spending in the economy grew almost 30 percent between 1977 and 1981, reaching about 40 percent of GDP in the latter year. Over the same period, real economic growth averaged 8.5 percent yearly.

25X1

The benefits of this rapid economic growth and massive public spending were substantial. Lopez Portillo's self-professed objectives were to lay the groundwork for a modern economic infrastructure and raise the standard of living for lower income Mexicans. He achieved these objectives primarily through public-sector spending:

25X1

- Public-sector investment more than doubled during Lopez Portillo's administration, with the lion's share going to the petroleum sector. The country's electricity network also was dramatically expanded and spending on public works projects, health facilities, and railroads was doubled.

- Government spending on food subsidies nearly quadrupled during his term in office. Farmers received a higher official price for their products, while the government provided basic goods to poor urban dwellers at lower subsidized prices through large-scale subsidies for basic foodstuffs, housing, transportation, and heating and cooking fuels.

25X1

- The public-sector wage bill rose almost 50 percent, creating large numbers of new jobs while holding wages more or less constant, according to IMF statistics. The government was able to create enough jobs to maintain unemployment at levels relatively low for Mexico, even as new entrants flooded the labor force.

25X1

Mexico's Major Budget Categories

In our analysis of Mexico's budget process, we adhered to IMF statistical breakdowns of Mexican budget figures, which placed spending allocations into operating and investment categories.[a] *Using these categories, we compared President de la Madrid's publicly stated objectives in these two areas to actual spending patterns during the first three years of his administration. Within these two categories we focused on the spending components that the government placed the most emphasis on in planning its budget. These components are listed below as a percentage of Mexico's 1982 budget allocations:*

I. Operating expenditures (60 percent of total allocations):

- *Interest payment obligations on domestic and foreign debt (25 percent of operating outlays).*
- *Personnel costs, such as salaries for government employees (20 percent).*
- *Central government transfer payments to help cover the operating deficits—caused largely by price subsidies and operating inefficiencies by Mexico's national electric company (CFE) and by its food distribution enterprise (CONASUPO)—of its 26 largest public enterprises (15 percent).*
- *Central government transfer payments to states, municipalities, and other entities, goods and services purchases, overdue debts, and financial operations make up the bulk of the remaining 40 percent of operating expenditures—which we do not examine directly in this study.*

II. Investment expenditures (20 percent of total allocations):

- *Investment by Pemex, including outlays for exploration and development of new oilfields (30 percent).*
- *Public works projects such as roadbuilding and maintenance of the country's overall transportation network; construction of schools, health, and other public facilities, rural development projects, irrigation and other water projects (15 percent of investment outlays).*
- *Investment in the national electricity network (15 percent).*
- *Investment in Mexico's other 24 major public enterprises, including the government steel industry, railway network, fertilizer plants, and others (10 percent of investment allocations).*
- *Property acquisitions, financial investment, overdue debts, and a large "other" category make up the remaining 30 percent of investment spending—which we do not examine directly in this study.*

[a] *These data—accounting for 80 percent of the budget allocations—are not meant to be all inclusive, but are presented primarily to highlight the character and scale of Mexico's budget allocations. The remaining 20 percent of Mexico's total budget allocations, including items such as unclassified expenditures and foreign exchange losses, do not fall in either of the two categories and were judged to be either too difficult to determine or as not having an impact on budgetary policy.*

25X1

The former President's impressive achievements came at the price of tremendous hikes in government budget deficits that were underwritten by heavy foreign borrowing. By the end of 1981, however, international lending conditions began to sour. Indeed, by the end of Lopez Portillo's term, Mexico faced a current account deficit of almost $3 billion, massive capital flight, and a sharply devalued peso. Mexico was forced to plead for assistance from the United States and other foreign creditors because the country no longer could meet its import bill or service its international debt. [redacted]

Grappling With the Need To Cut Spending

Pressure from the IMF and international creditors caused newly inaugurated President de la Madrid to commit himself publicly to slash spending almost in half during the three-year IMF program (1983-85) instituted at the beginning of his term in office. To accomplish this, he announced that the government would refocus its role in the economy away from income redistribution and industrial development toward a less ambitious, laissez faire approach reminiscent of the pre-1970s. From a budgetary planning standpoint, de la Madrid and his economic cabinet did not develop a specific three-year program of spending cuts over the period, but instead outlined budget targets only on a year-by-year basis, responding in many instances in an ad hoc manner to balance IMF requirements against domestic priorities. A review of the general budgetary guidelines [redacted] suggests that, overall, the government wanted:

- Heavy reliance on the private sector to take the lead in economic recovery. This was underscored in his budget speeches, where de la Madrid emphasized that he expected new export and investment tax incentives to stimulate greater private business activity leading to new investment, increased exports, added employment, and reduced domestic prices.

- Budget cuts occurring primarily in operating expenditures, which make up the bulk of Mexico City's budget outlays. Key areas included interest payments, government subsidies to public enterprises, and personnel costs (see inset).

- General protection for expenditures in public investments, except for the petroleum industry, which had benefited greatly from public investment during the previous administration and certain other industrial projects. Mexico's large public works budget would be maintained to help minimize unemployment. [redacted] 25X1

25X1

De la Madrid's line of march was challenged almost immediately by economic and political considerations, and pressures to boost spending began to mount. According to US Embassy and press reporting, organized labor quickly began clamoring for an increase in living standards, which had begun to fall during the last year of the Lopez Portillo administration and seemed almost certain to plummet under de la Madrid's austerity program. At the same time, de la Madrid's widely heralded plan to induce an economic recovery led by private-sector investment failed to produce results, aggravating the government's economic difficulties. In addition to these problems, the President almost 18 months into his term increasingly became diverted by party considerations. In general terms, as the Mexican economy went into recession, the importance of government spending as a tool of political reward and control increased. At a very specific level, de la Madrid faced important local and gubernatorial elections in 1985, which caused him to place added emphasis on political considerations from mid-1984 on when making spending decisions. These factors forced de la Madrid, in our view, to diverge substantially from his intended fiscal-policy path, causing government operating expenses to remain substantially over budget throughout the three-year period, 1983-85. [redacted]

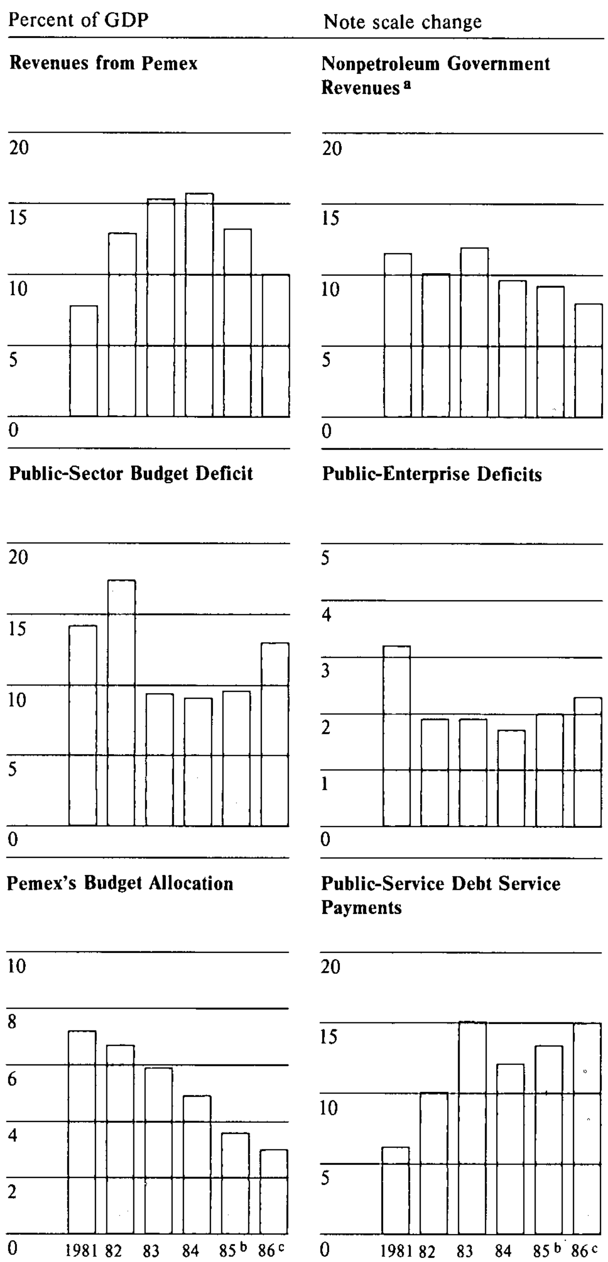
25X1

25X1

Swollen Operating Costs

During 1983, the first full year of his administration, de la Madrid intended to slash total outlays about 20 percent, according to IMF statistics, by cutting back on operating expenditures. This approach failed, however, as the government proved unable to do more than trim operating costs. [redacted] 25X1

Figure 2
Selected Budget Indicators, 1981-86



[a] Not including Pemex, Telmex, or Metro subway system.
[b] Estimated.
[c] Projected.

309838 7-86

According to a review of government announcements and official statistics, the principal reason for the failure was an unexpected rise in interest payments on government debt. In formulating the budget, the government underestimated by 50 percent the level of inflation, and the consequent devaluation of the peso in 1983 caused Mexico's peso-denominated interest-payment obligations to run substantially higher than originally projected. In fact, interest payments, which were projected to rise by only about 10 percent in the original budget plan, actually rose by more than 50 percent. As a result, interest payments soared from 25 to 40 percent of government operating expenses. 25X1

Difficulties in reining in operating expenditures were not limited to one area. Government data show that central government transfers to public enterprises, projected to drop by 35 percent in 1983, ended up rising by about 10 percent as officials moved to cover rising deficits of the two public enterprises charged with providing Mexicans with electricity (CFE) and basic food products (CONASUPO) at low prices. CFE's deficit, programed to decline by almost 40 percent, increased by almost 15 percent. According to US Embassy reporting, the main reason for the shortfall was the fact that increases in electricity rates did not keep pace with the 60-percent rise in inflation that boosted the utility's operating costs. The plan to slice CONASUPO's operating deficit almost in half also was jettisoned. The government continued to subsidize food prices, which rose as the drop in the peso and drought caused increases in the cost of imported and domestically produced food products, pushing CONASUPO's deficit up by 40 percent. 25X1

The government had more success with personnel costs. The scheduled drop of 35 percent in 1983 was nearly met—costs were cut by about 25 percent. Still, the US Embassy reported that even though real wages, factoring in inflation, fell by about 20 percent, the government's reluctance to add to the unemployment problem caused by large layoffs in the private sector significantly curbed its original intent to eliminate many public-sector jobs. De la Madrid's decision to boost military salaries and benefits also limited the drop in overall personnel costs. 25X1
25X1

Comparison of Proposed and Actual Budgets [a]

Billion 1978 Pesos

	1982	1983		1984		1985
	Actual	Proposed	Actual	Proposed	Actual	Proposed
Overall public-sector outlays	**1,501**	**1,117**	**1,198**	**1,037**	**1,109**	**971**
Operating expenditures	906	741	878	742	820	722
Of which:						
Interest payment obligations	230	252	351	270	320	253
Transfers to public enterprises	110	74	120	86	101	86
Personnel costs	199	127	152	118	143	124
Investment expenditures	302	205	178	193	149	169
Of which:						
Public works	44	42	21	45	22	34
Pemex	94	52	57	54	46	45
CFE	39	27	26	22	26	26
Other public enterprises	36	23	30	25	18	17

[a] These data are derived from statistics presented by the Mexican Government to the IMF. They are not meant to be all inclusive, but are presented primarily to highlight the character and scale of Mexico's budget allocations.

25X1

The track record for 1984 was little better. According to Mexican budget documents, the goal was to reduce overall operating expenditures by 15 percent. IMF statistics show that public-sector operating costs in fact only dropped by about 5 percent when overdue domestic interest payments are included. Looking at individual accounts:

- Personnel costs, projected at the beginning of the year to drop by almost 25 percent, were pared by only 5 percent as the government became increasingly reluctant to add to an already disturbing level of unemployment as the economy continued to decline.

- Central government transfers to public enterprises, slated to drop by 30 percent, were reduced by only half that amount as officials moved again to cover large deficits, garnered principally by CFE and CONASUPO.

- Interest payment obligations, previously scheduled to drop by about 25 percent as Mexico City's overall debt burden eased, dipped by only 10 percent.

A review of US Embassy and press reporting indicates that, as in 1983, mounting labor pressure for wage concessions and job security, the rising cost of financing the budget deficit, and Mexico City's continuing difficulty in reducing public-enterprise deficits caused the government to fall short of its goal. 25X1

Although official IMF statistics outlining Mexico City's actual budget performance in 1985 have not yet been released, US Embassy reports and official Mexican data indicate that government spending allocations once again deviated markedly from budget proposals. According to official Mexican Government data, overall public-sector outlays increased slightly last year—a far cry from the promised 10-percent

25X1

reduction. As in 1984, the principal factors in the rise came from interest, personnel, and public-enterprise costs.

We believe much of last year's excess spending related to the government's efforts to build popular support for the ruling party in the midyear elections. For example, Mexico City not only failed to reduce the number of workers on the government payroll, but it also authorized large wage hikes prior to the elections. Thus, instead of decreasing by the planned 15 percent, personnel expenditures are estimated to have increased by nearly 10 percent. transfers to public enterprises were cut by only about 5 percent—less than one-third the programed 15-percent drop. As in previous years, CFE and CONASUPO produced most of the overrun, according to the US Embassy. Interest-payment obligations incurred to finance the budget deficit, moreover—scheduled to fall slightly in 1985—increased by over 7 percent, according to Mexican Government statistics, as mounting public-sector demand for scarce domestic credit caused interest rates to soar.

25X1

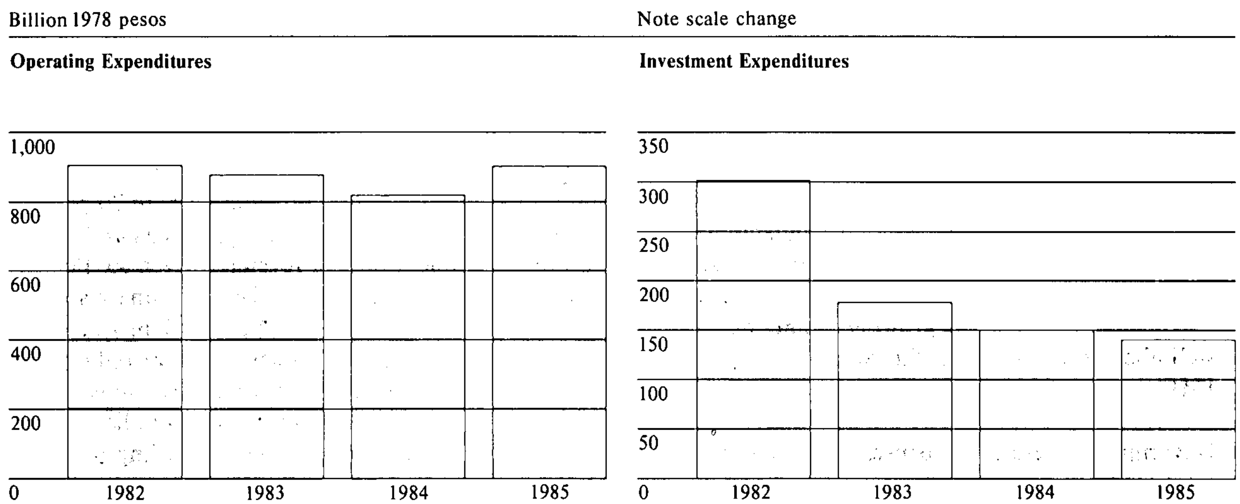
25X1

Compensating for Overruns

To compensate for the increases above planned operating expenditures, and yet hew somewhat to his overall reduction proposals, President de la Madrid

25X1

Figure 3
Mexico: Budget Spending Allocations, 1982-85



[redacted] 25X1

309839 7-86

ended up reallocating funds away from investment. The government also curtailed its highly touted emergency employment programs in public works. [redacted] 25X1

IMF statistics for 1983 show a significant decline in investment outlays that, in percentage terms, far outstripped cuts in operational spending. While the overall level of operating costs fell only 5 percent, investment was slashed over 40 percent. Investment by public enterprises was reduced by one-third, in line with the government's budget proposals. Spending on public works—in contrast to de la Madrid's 1983 fiscal program, which called for almost no cuts—was reduced by more than half. Mexico's national petroleum company, Pemex, was the hardest hit, suffering a 40-percent drop in investment—this on top of a 20-percent drop in 1982. In 1983 alone, Pemex cuts accounted for more than 10 percent of all Mexican budget reductions. [redacted]

Government investment outlays in 1984, according to IMF reports, fell by another 15 percent and accounted for one-third of all budget cuts in that year. Pemex, which had been programed to drop by only 5 percent, once again bore the brunt of the cuts—suffering a 20-percent reduction. Actual cuts in public-enterprise investment ended up being twice originally budgeted levels. At the same time, Mexico's public-employment program disbursed only about half of the amount originally targeted. [redacted] 25X1

Investment spending in 1985, according to IMF figures, once again took a back seat to other priorities, dropping by another 5 percent despite de la Madrid's plan to raise spending by 15 percent. Public-enterprise investment, which had been expected to stagnate, took the heaviest beating, falling by almost 10 percent. 25X1
Although we have no precise reporting on the exact distribution of investment cuts, we believe [redacted] 25X1 25X1
that Pemex and CFE suffered the heaviest of the public-enterprise investment cutbacks. [redacted] 25X1

According to IMF statistics, with this spending approach the government over the past three years neither reached the level nor achieved the pattern of cuts envisioned during the course of Mexico's IMF program:

- Overall public-sector cuts by the end of 1985 in real terms equaled only about one-half the amount that public officials had projected during the course of the three-year Fund program.

- Interest payments on Mexico City's outstanding debt grew to about 40 percent of total public-sector spending because of the need to increase domestic borrowing to finance the growing budget deficit—well above the 25-percent figure targeted by the IMF.

- Government operating expenses as a fraction of total public-sector spending rose instead of dropping steadily as de la Madrid and IMF officials had intended.

- Public investment fell by over 50 percent in real terms from 1982 to 1985—whereas it had been projected to pick up during the past several years of the IMF program. [redacted]

Budget Cuts From a Sectoral Perspective

To understand the impact of the spending cuts on Mexico, it is useful to take a sectoral look at which economic groups or entities have been most affected by the President's budget decisions. In using this approach, it is important to distinguish between three major sectors—public-sector industry, private business, and labor—since the impact on each is different and in turn so are the ramifications. The 26 key public-sector enterprises in Mexico—which the government vows never to sell—together make up the backbone of Mexico's public-enterprise system. Their continued viability, crucial to any turnaround of the present Mexican economic situation, in our judgment, has been threatened by budget cutbacks over the past several years. Private business, considered to have been the catalyst for the country's enviable economic growth record during the 1950s and 1960s, also has been affected negatively by the government's budget policies. Organized labor, which we believe is a key to political stability, also has taken a beating over the three-year period, even though it has been protected more than the other two sectors. [redacted] 25X1

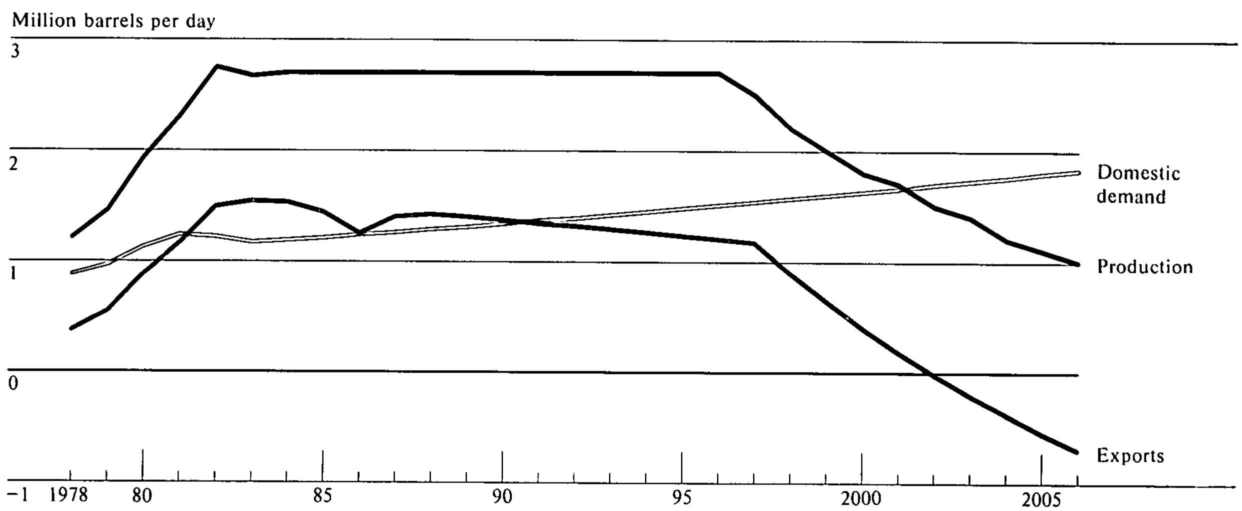
Public-Sector Industry

Of the 26 key public-sector enterprises, Pemex is the most important because it provides close to 70 percent of the country's foreign exchange earnings and about half of government budget revenues. Even so, Pemex has been affected the most by the government's spending cutbacks because of the President's determination, [redacted] that reductions in Pemex allocations were the least sensitive politically. Pemex was forced to slash investment allocations in half over the three-year period, according to IMF statistics. Even these dramatic cuts were not enough, however, and Mexico City also began pushing the company to decrease the costs of production and distribution to boost net oil earnings. As a result, overall Pemex spending allocations fell by more than 50 percent during the period. Because of de la Madrid's unwillingness to confront the powerful oilworker's union, however, the cutbacks were accomplished by dramatically decreasing purchases of equipment and spare parts while holding the line on personnel and wage rates. [redacted]

25X1 25X1 25X1

In the short term, the cutbacks have weakened Pemex's ability to export. Pemex, in coping with budgetary limitations, reduced maintenance expenditures—estimated by the US Embassy to be more than 50 percent below budget—by easing standards, reducing parts inventories, and cannibalizing equipment. Most recently, budget constraints have forced Pemex to delay a badly needed equipment maintenance contract [redacted] As a result, Pemex—which as recently as 1984 had the potential to export up to 1.8 25X1

Figure 4
Petroleum Production and Export Outlook, 1978-2006



25X1

309840 7-86

million b/d—no longer has the capacity to boost production for export much beyond its current target level of 1.5 million b/d

25X1

Over the longer haul, the cuts made by Pemex forced the oil company to curtail its petroleum exploration programs sharply. This in turn could seriously jeopardize Mexico's petroleum export capability further down the road. Because of the reduction of its previously aggressive investment in oil exploration, Mexico's proven oil reserves have been dropping over the past several years, according to official Mexican statistics. Pemex officials claim that Mexico could become a net oil importer by the late 1990s unless more funds are allocated to explore for new oil.

While reporting has not been as detailed regarding the impact of investment cuts in other industries, US Embassy and press accounts suggest similiar problems exist:

- Mexico's publicly owned steel industry is beginning to feel the effects of having operated without an adequate maintenance budget for several years, according to the US Embassy. Spare parts shortages have held steel production in some plants to only 60 percent of capacity.

- Local press reporting indicates that officials have been forced to condemn several fertilizer plants because the government failed to maintain and equip the facilities adequately.

- Both US Embassy and local press reports cite the rapid deterioration of Mexico's public railway system as another visible indicator of government neglect. The press reports that rail stock is so rundown that, at any one time, 25 percent of the company's locomotives are undergoing repairs.

25X1

- Local press reports claim that, as a result of the cancellation of investments, Mexico's public electric company, CFE, lacks the resources to cope with any rise in demand for electric power. [redacted]

The Private Sector

The impact of Mexico's budget cutback program on productive potential has not been limited to public-sector firms. Even though many private businessmen in 1983 profited from the government's effort to stimulate a recovery led by the private sector and from measures such as low-interest financing, generous import licensing privileges for exporters, and bailouts for companies in financial trouble, a review of Embassy reporting shows that gains eroded rapidly as the government began implementing its budget cuts. For example, the sharp cutback in government purchases from private suppliers, caused by the drop in public investment, has hurt many Mexican companies. Meanwhile, heavy government borrowing to cover operating expenses has caused a domestic credit shortage that threatens to bankrupt many businesses. Bank credit to the private sector is virtually nonexistent, according to the US Embassy. Prominent Mexican businessmen have told Embassy officials that a recent suspension by state corporations of payments to suppliers already weakened by tight credit could force many private companies to shut down. [redacted]

The private sector was also adversely affected by a series of government pricing policy decisions. Government price controls on agricultural and manufactured goods cut deeply into private business profits. In addition, to maintain a decent standard of living for Mexico's lower income workers de la Madrid in 1984 imposed a two-tiered pricing strategy for basic goods. Middle-income businessmen personally were hit hard financially by the government's policies of charging higher income earners more than double the prices charged labor workers for food, electricity, and fuel. [redacted]

While the net impact of government policy has weakened private-sector productive potential, Mexico has suffered from other side effects of its policies. The pressure on the private sector has soured relations between business and government. [redacted]

[redacted]

25X1

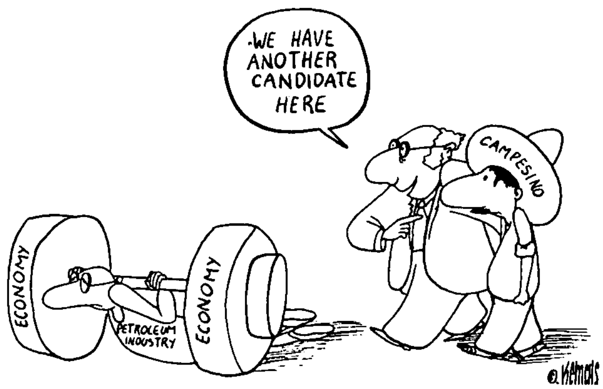
25X1

The Labor Sector

While public and private business has been hurt in recent years, the Mexican Government's efforts to protect the living standards of workers and forestall labor unrest have been relatively successful. Indeed, the contrast between business and labor is one area where the economic-political trade-off is most evident. Even though real wages have fallen by nearly 40 percent since 1982, according to the US Embassy, continued heavy subsidies for lower-income workers on basic food items, housing, electricity, health care, and public transportation facilities have kept price increases on these basic items from rising as fast as the overall rate of inflation. The US Embassy also reports that, even though Mexico City's emergency employment program has failed to materialize, the government so far has kept public-sector layoffs to a minimum. Fidel Velazquez, Mexico's national labor union leader, willingly admits that union members probably have fared better than other groups in Mexico, at least since 1983, according to US Embassy reports. [redacted] 25X1 25X1

Nevertheless, labor leaders, reflecting the dissatisfaction of rank-and-file workers with the state of Mexico's economy, have stepped up demands on the government over the past year. Among the additional concessions labor is pushing for, according to press reports, are greater control over subsidies, possibly through union-issued food coupons, and guarantees of job security within the public sector. Focusing on real wage losses over the past four years, Fidel Velazquez also is pressing the government to increase the number of minimum wage hikes from two to three annually. [redacted] 25X1 25X1

25X1



A Mexican cartoon highlights the fact that the petroleum industry can no longer sustain the economy.

As public-sector resources have continued to dwindle over the past several years, labor leaders also have demanded increased political clout within the government and the ruling party. In return for continued support, organized labor has received a 10-percent rise in its number of congressional seats, as well as dozens of state and local offices. Organized labor also now is prominently represented at all levels of the ruling party and, to a lesser extent, within the executive branch of the government.

Prospects and Implications for the United States

The President's decision to opt for politically easier investment cuts during the early years of his term in office has reduced his flexibility to deal with Mexico's current financial problems. With investment already cut, any austerity program will have to focus on politically more sensitive areas of spending. There is little likelihood, in our view, that de la Madrid will make the difficult cuts needed in operating costs to bring the budget into balance while allocating funds for investment needs. If anything, he will be under more pressure to heed labor demands for such benefits as employment guarantees and subsidies in order to contain social unrest. Even now, according to US Embassy reporting, sales and liquidation of many unprofitable public enterprises are being delayed until the government can ensure that such moves will not result in worker layoffs.[1] Press and Embassy reporting also indicates that labor leaders still may convince the government later this year to increase the number of annual minimum wage hikes to help workers keep up with inflation. Moreover, according to the US Embassy, electricity and gas prices were rolled back in May in Mexico's third-largest urban center, Monterrey, in response to prolonged street demonstrations by workers and housewives, and food coupons are being issued to most workers to soften the impact of rising food costs.

25X1

We believe the politically expedient moment for de la Madrid to make dramatic changes in spending patterns probably has already largely passed. With most Mexicans mentally gearing up for the 1988 presidential election and members of the economic cabinet jockeying for favor, we believe that serious cuts in areas other than investment will be even more difficult than in past years. Moreover, if de la Madrid's past behavior is any indication of his priorities, election-related spending probably will cause outlays to rise considerably. 25X1

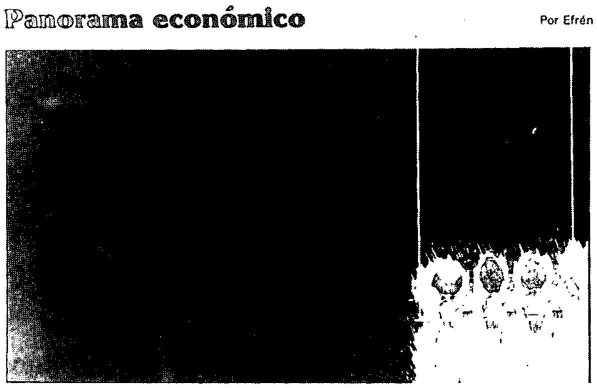
25X1

25X1

Many observers argue that the President's successor will be in a better political position to take dramatic economic policy initiatives. In our view, however, the economic climate de la Madird leaves behind will make it difficult for even the most astute politician to impose tough measures. Even though de la Madrid entered office facing a financial crisis, his problems were softened by a booming petroleum industry and a recent legacy of 8.5-percent GDP growth. His successor will have neither. Already, internal Mexican projections call for negative growth, rising inflation, and a deterioration in the balance of payments this 25X1

[1] We believe that the recent liquidation of the Fundidora Steel Complex was an exception to this trend, aimed at convincing the IMF and international bankers that Mexico is serious about economic reform. We see no signs that this action, which threw 10,000 people out of work and precipitated large antigovernment demonstrations, is likely to be accompanied by the elimination of many of Mexico's other 200 or more money-losing public enterprises. 25X1

25X1



A moderate journal depicts President de la Madrid, Budget Minister Salinas, and former Finance Minister Silva Herzog painting themselves into a corner. [redacted]

year. The Mexicans predict that achieving the 3- to 4-percent annual growth tentatively planned for 1987 and 1988 would require at least $15 billion in foreign loans. Moreover, the country's public-sector, industrial, and transportation infrastructures, in our judgment, have all been weakened over the past three years. [redacted]

At the same time, Mexico's budget performance can only hurt its ability to attract badly needed foreign funding. Given Mexico's poor budgetary track record, foreign creditors are unlikely to help much in bridging the growing gap between revenues and expenditures, [redacted] As a group, they are united in pressing Mexico for serious signs of economic reforms before doling out new loans for 1986. [redacted]

We believe that as Mexico finds itself increasingly unable to finance its rapidly growing budget deficit, it will continue to turn to the United States to provide financial transfusions and put pressure on the IMF and international bankers to be especially lenient with Mexico in keeping open credit lines and encouraging new debt rescheduling exercises. Mexican officials may agree to introduce domestic economic reforms, encourage foreign investment, and liberalize the country's trade regime to qualify for new money, but we do not believe that de la Madrid will go much further than he has in the past to implement such changes. Mexico City also will continue to look to the United States for special deals, perhaps generous oil sales arrangements. [redacted] 25X1

In the event Mexico City cannot negotiate agreements through US good offices to meet the country's budget needs, we believe the Mexican Government would seek to distance itself from Washington and probably would pursue a more nationalistic policy toward foreign creditors. De la Madrid's inability to balance financial constraints with the need to boost spending, in our view, enhances the odds that he will take some dramatic action, such as a declaration of a moratorium on foreign debt payments. We believe that he probably would approach the United States first for some sort of bailout program, stressing that the fate of Mexico—and the US banking system—is in US policymakers hands. Should no workable solution be achieved, de la Madrid may decide that it is politically more popular to make a bold gesture—as Lopez Portillo did when he nationalized the Mexican banking system in 1982—than to make further painful public-spending cuts. [redacted]

25X1

25X1

25X1

25X1

25X1

Appendix A

Methodological Notes on Budget Analysis

Our research has shown that Mexican budget statistics are generally incomplete and unreliable indicators of actual spending allocations. Academic researchers have encountered the same obstacle. For example, one prominent Mexican economist, in the introduction to his own study of Mexico's budget process, began by saying that "the budget for 1986 is still, as in the past, affected by numerous contradictory figures, half-truths in the official publications, and loopholes in the data; preventing either rapid or consistent analysis." In our judgment, this situation exists largely because of the political sensitivity of government spending decisions. By obfuscating budget data, the administration is able to diffuse political pressures. In addition, the categories of data change from year to year, making it difficult to construct a consistent time series.

As a result, this assessment relies heavily on IMF statistics to compare Mexican government spending objectives with actual disbursement patterns during the three-year period, 1983 through 1985, that Mexico participated in an IMF Extended Fund Facility. We realize that the data supplied by Mexico to the Fund are likely to contain some of the same discrepancies as other Mexican official budget information. We believe, however, after extensive review of alternate sources, that IMF data have the advantage of being the most accurate and only consistent series of proposed and actual budget figures currently available.

To the extent possible, we have attempted to overcome many of the limitations inherent in using the IMF time series. To offset the impact of inflation on Mexican budget allocations and ensure accurate comparability from year to year, all references to budget allocations are made in 1978 Mexican pesos, unless otherwise specified. Where IMF data are lacking, particularly regarding Mexico's 1985 performance record, we have relied on analyses of official Mexican data presented by private Mexican economic institutions. Although the actual data are not entirely consistent with the IMF series, we have been able to piece together enough information to complete the trend line. The lack of detailed categories presented in the IMF series, prevents line-by-line, sector-by-sector analysis. We are confident, however, of major spending trends, the political pressures that caused them to occur, and the impact on key sectors in Mexico.

25X1

25X1

25X1

Sanitized Copy Approved for Release 2011/04/04 : CIA-RDP88T00768R000300300001-0

Appendix B

Mexico's Fiscal Policy Team

De la Madrid's fiscal policy team has a fairly cohesive profile that combines US postgraduate education and a long working association with the President. These technocrats, none of whom has ever been elected to public office, have attempted to guide Mexico through its worst economic crisis since the ruling Institutional Revolutionary Party (PRI) consolidated power in the 1920s. Although highly qualified and experienced, they have been unsuccessful in their attempts to improve Mexico's economy. Because most members of this team would like to succeed de la Madrid as president in 1988, we believe that they will become more cautious and less forceful in their attempts to make sharp budget cuts over the near term for fear of being blamed for the government's failure to lead the country out of the economic doldrums. 25X1

Miguel DE LA MADRID Hurtado
President
(since December 1982)

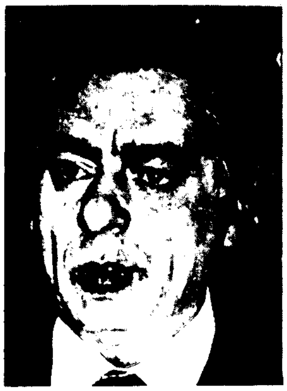
A technocrat with little grassroots political backing, Miguel de la Madrid is the ultimate decisionmaker on all economic policy matters. More of a planner than a politician, de la Madrid makes decisions only after comparing several points of view. [redacted] 25X1 25X1

De la Madrid, 51, holds a law degree from the National Autonomous University of Mexico (UNAM), and an M.A. degree in public administration from Harvard University. He worked for the Bank of Mexico and taught law at UNAM during the early 1960s. In 1965 he joined the Secretariat of Finance, where he served, except for a two-year stint at Pemex, until he became Secretary of Programing and Budget in 1979. He held that post until September 1981, when he became a presidential candidate. [redacted] 25X1

Carlos SALINAS de Gortari
Secretary of Programing and Budget
(since December 1982)

A close friend and protege of President de la Madrid, Carlos Salinas de Gortari controls Mexican Government budget expenditures. He appears to derive much of his political influence from his close relationship with the President. For example, we believe Salinas influenced de la Madrid to increase expenditures in early 1985 to help ensure PRI victories in the July 1985 gubernatorial and legislative elections. Salinas would probably favor a payment moratorium on Mexico's foreign debt rather than a drastic reduction in government spending to stabilize the economy. [redacted] 25X6

Salinas, 38, has strong presidential ambitions [redacted] 25X1 25X1 His chances of being chosen, however, are diminished by his youth and the economy's poor performance. He has, nonetheless, followed the classic pattern of achieving success in the Mexican bureaucracy: he has good family connections; became active in the PRI early on; and has excellent educational credentials including a B.A. in economics and an M.A. degree in public administration from the National Autonomous University of Mexico, and both an M.A. and a Ph.D. in economics and government from Harvard University. He worked in the Secretariat of Finance during the early 1970s. He was subdirector at the Institute of Political, Economic, and Social Studies, a government think tank, and a director general in the Secretariat of Programing and Budget from 1979 to 1981. [redacted] 25X1



Gustavo PETRICIOLI Iturbide
Secretary of Finance and Public Credit
(since 17 June 1986)

A technocrat with extensive banking and fiscal experience, Gustavo Petricioli is financially conservative and a moderate on the debt issue—he is the government's pointman on refinancing negotiations with the IMF and foreign banks. A close friend and adviser to President de la Madrid, he will, in our judgment, closely follow the President's directives. [redacted] 25X6 Economic policy formulation had been hampered by sharp differences between Silva Herzog and Programming and Budget Secretary Salinas. [redacted] 25X1

Petricioli, 57, is somewhat of an unknown because of his previous relative obscurity. While earning an economics degree from the National Polytechnic Institute, he joined the Bank of Mexico in 1948. In the succeeding 20 years he held several positions at the bank and under its sponsorship received a graduate economics degree from Yale. He transferred to the Finance Secretariat in 1967 and there, during the next decade, forged a close relationship with de la Madrid. Petricioli then served as director general of the National Securities Commission and director of Multibanco Comermex before de la Madrid named him to his previous post as director general of the National Financial Bank in 1982. [redacted]

25X1

Mario Ramon BETETA Monsalve
Director General, Petroleos Mexicanos (Pemex)
(since December 1982)

A highly qualified, conservative economist, Mario Ramon Beteta has long been a friend and adviser to President de la Madrid. He was de la Madrid's mentor when both worked at the Bank of Mexico and the Finance Secretariat during the 1960s and 1970s. His position on the fiscal policy team is due largely to Pemex's large contribution to Mexico's revenue base. In our judgment, however, Beteta's influence may be waning because of dramatically low oil prices. [redacted] 25X6 25X6 He favors increased foreign investment in Mexico and the 25X6 reduction of Pemex's domination of the economy. He has stated that he is against a debt payment moratorium or repudiation. [redacted] 25X1

We believe [redacted] that Beteta, 59, 25X1 may have presidential ambitions. His chances may be damaged, however, by decreased oil revenues and poor relations with the powerful petroleum workers union. He holds a law degree from the National Autonomous University of Mexico and an M.A. degree in economics from the University of Wisconsin. He worked at the Bank of Mexico in the 1960s before joining the Secretariat of Finance, where he served successively as director general of credit, Under Secretary, and Secretary. Before assuming his current position, he headed a leading Mexican commercial bank from 1976 to 1981. [redacted] 25X1