

Page Denied

Next 1 Page(s) In Document Denied



Directorate of Intelligence

Secret

25X1

MASTER FILE COPY
DO NOT GIVE OUT
OR MARK ON

Mexico's Parastatals: The High Price of Politics

25X1

An Intelligence Assessment

PROJECT NUMBER ALA-0621-87
 (L) W M J K (N)
 PAGE NUMBERS 18
 TOTAL NUMBER OF COPIES 470
 DISSEM DATE 87/02/09
 EXTRA COPIES 340-369
 RECORD CENTER 370-444
 JOB NUMBER 425-277

Secret

ALA 87-10002
January 1987

Copy 340

Page Denied



**Directorate of
Intelligence**

Secret



25X1

Mexico's Parastatals: The High Price of Politics



25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office
of African and Latin American Analysis, with a
contribution from [redacted] ALA. 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 87-10002
January 1987*

Secret



25X1

**Mexico's Parastatals:
The High Price of Politics**



25X1

Scope Note

This assessment is part of a continuing effort within the Directorate of Intelligence to analyze the dynamics of Mexico's economic and political systems. It focuses on the country's state-owned enterprises, a sector which causes economic problems for the Mexican leadership but at the same time generates a great deal of political capital for the government and the Institutional Revolutionary Party.



25X1
25X1



Secret



25X1


**Mexico's Parastatals:
The High Price of Politics**




25X1

Key Judgments


*Information available
as of 1 December 1986
was used in this report.*

The Mexican Government uses its system of state-owned enterprises, or parastatals, to great advantage to create jobs, administer subsidies, exert leverage over private business and organized labor, and keep the political system functioning relatively smoothly. These political benefits, however, come only at a substantial economic cost: excessive spending, massive debt, unnecessary inventory accumulation, and higher inflation spurred by the sector's generous labor contracts. 

25X1

Although pressure to divest the largely inefficient parastatals has mounted in the last year with the dramatic decline in oil prices and the burgeoning of the federal deficit, President de la Madrid has for the most part responded with only vague promises to open the sector to private control. His lack of clarity, the onerous conditions attached to many sales, the domestic liquidity crunch, and the poor state of most public-sector firms' ledgers have choked off privatization efforts to date and will probably continue to do so through the end of de la Madrid's administration in 1988. In addition, new lenient foreign financing agreements have dulled much of the fiscal incentive for reform. Any piecemeal progress de la Madrid is able to make could provide limited opportunities for US business in the near term, but at the same time Mexico City is likely to squeeze US banks for further concessions on parastatal debt. 

25X1

De la Madrid is now faced with a dilemma: financially, he finds it nearly impossible to allow the parastatal sector to maintain its size; politically he finds it equally difficult to scale it back. In recent years, the oil revenues and heavy foreign borrowing that masked the losses incurred by most parastatals have been harder to come by, and the subsequent strain on government coffers has been intense. We believe the President recognizes the need for a contraction of the state-run system, but he lacks the political capital required to take decisive steps in that direction. As a result, he has backed off on his promises to divest the sector and is now placing more emphasis on making "priority" state-owned firms more efficient. 

25X1


We conclude that the de la Madrid administration is convinced that the political benefits the parastatals generate make them worth their economic cost. Thus, despite the President's relatively conservative market-oriented economic philosophy and his promises to Mexico's creditors to privatize the sector, his hands are tied by a system that rests on the ruling party's monopolistic control of economic resources. As the economy deteriorates,

Secret


Secret




25X1

de la Madrid now depends more than ever on the state-run sector to buy him time by delaying or softening the impact of austerity-driven economic reforms. 

25X1

Between now and the end of his term in 1988, we believe de la Madrid's administration will enjoy a temporary respite from its immediate financial problems as a result of the lenient IMF agreement signed in September 1986 and the \$12 billion financial bailout from the country's creditors. Rather than use this break to begin economic reform, however, we believe the Mexican leadership will direct most of the money toward foreign interest payments and, with an eye on national elections in 1988, domestic spending that favors the ruling party's major constituencies. In our view, the leverage for change does not exist now: domestic advocates of reform are without strength, and foreign creditors have lost the influence they once held by agreeing to new loans and new terms on old debt without making them conditional on reform. 

25X1

Our longer term outlook is even more troubling because the resources the sector has depended on—mainly oil—have probably permanently shrunk. In our view, the parastatal sector is becoming economically and politically obsolete; as oil prices remain depressed, Mexico's population balloons, and rapid urbanization continues, the ruling party will find it increasingly difficult to continue satisfying its constituencies by means of this mechanism. Over the long term, we believe these pressures will force de la Madrid's successors to search for new means to buffer the pain of austerity policies. A number of alternatives may be pursued, but the easiest and most likely scenario of a muddle-through approach carries risks: given the mounting strains, the eventual trauma associated with economic reform will be more pronounced the longer the adjustment is postponed. 

25X1

Implications of these domestic economic and political strains for the United States over the near term will be limited largely to adverse effects on US firms doing business with Mexico's parastatals and to US commercial creditors that have lent them money. Payment delays and declining markets can be expected for US businessmen, but investors may find new opportunities if Mexico puts some of the smaller, less politically sensitive parastatals on the market. US bankers will increasingly be pushed to offer concessions and creative solutions for their parastatal loan exposures, since

Secret

Secret



25X1

Mexico City will be hard pressed to honor parastatal debt obligations once the current financial rescue package expires. Banks are also concerned about the status of outstanding debt to a parastatal that is sold. In most cases, creditors view foreign governments as better risks than private firms and fear that the new owners may shirk their responsibility to repay old debts. Looking at the long term, the Mexican reluctance to reform, in our view, will accelerate the erosion of the economy and contribute to broader problems that will spill across the US border. For example, we expect illegal migration to increase, since we do not believe that the public sector can absorb the increments in the labor force. In addition, as long as the parastatal sector fails to contract, US banks will face increasing pressure for further loans or face payment suspensions.



25X1

Secret

25X1

Contents

	<i>Page</i>
Scope Note	iii
Key Judgments	v
Introduction	1
Evolution of the Parastatal Sector	2
The Political-Social Benefits of Parastatals . . .	3
Preserving a Patronage System	3
Boon to Labor	4
Controlling the Private Sector	5
. . . And Their Economic Costs	7
Inefficiency and Economic Distortions	7
Drain on Government Coffers	9
Privatization Efforts	12
Outlook	14
Implications for the United States	15
Appendix	
Key Parastatals	17

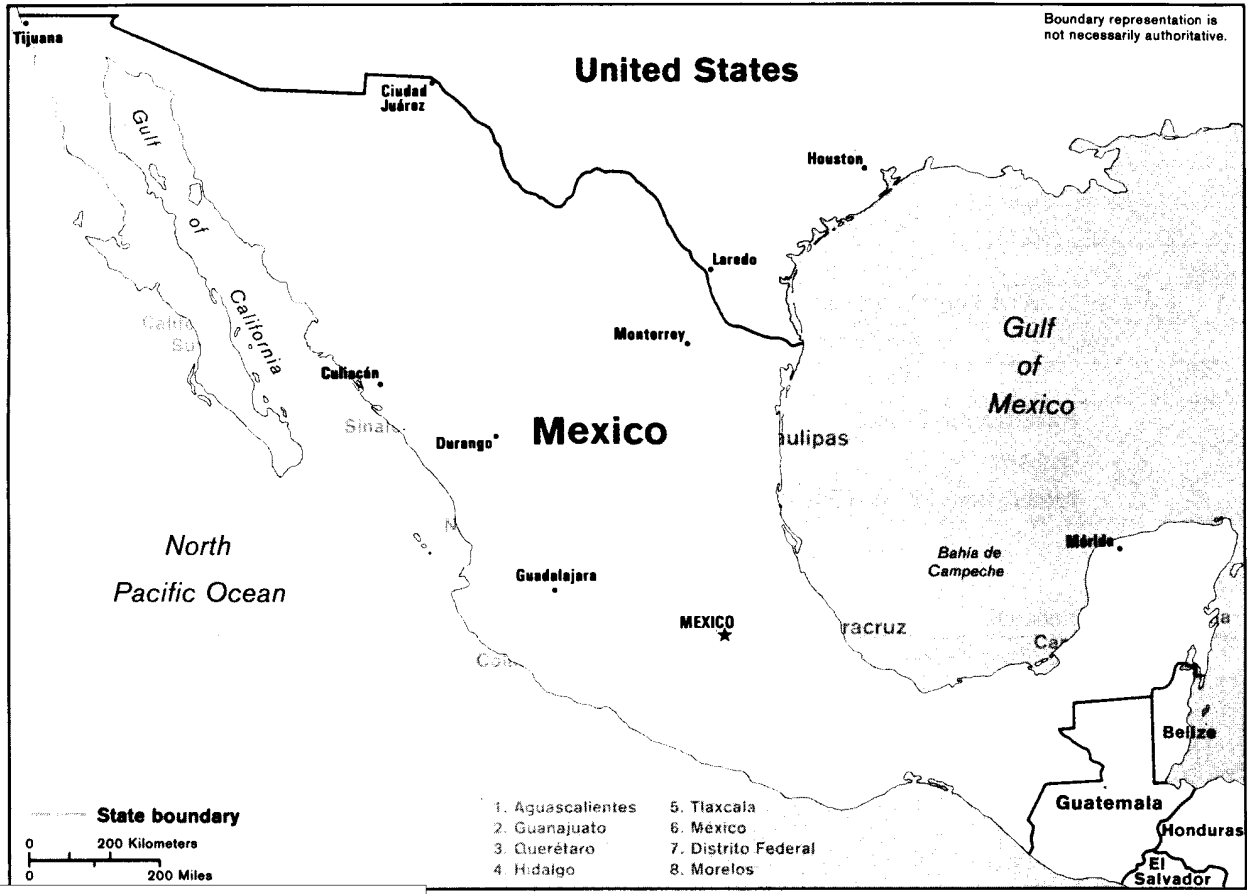
SecretALA 87-10002
January 1987

Secret



25X1

Figure 1



25X1

Secret

X

Secret

25X1

Mexico's Parastatals: The High Price of Politics

25X1

Introduction

The Mexican Government's vast network of state-owned enterprises, or parastatals, is designed to strengthen its control over the economy but also serves other purposes, such as providing political favors and co-opting various interest groups. The parastatal sector has expanded rapidly in recent years; although an exact count is elusive, it appears these firms now number between 750 and 950.¹ Detailed information on the financial operations of the parastatals is largely limited to the operations of the 26 largest so-called controlled enterprises that have budgets subject to congressional approval. Nevertheless, we believe many of the problems that plague these companies characterize all state-owned firms.

filter through to the parastatal sector. Creditors will be reluctant to lend additional money once the current funds are exhausted unless Mexico has demonstrated some progress in reforming the financially burdensome sector. Finally, foreign governments, potential foreign investors, and multilateral lenders continue to urge Mexico toward privatization. Over the next 15 months, the pressure from external actors will be less effective since the rescue package saps their leverage.

25X1

25X1

During more prosperous times, Mexico City was able to build political capital by subsidizing inefficient parastatals with oil dollars and foreign borrowing. Loans and surpluses from PEMEX, the state oil monopoly, masked massive losses generated by the other enterprises, amounting to roughly \$4 billion annually. In the current lean times, however, the de la Madrid administration is hard pressed to continue parastatal funding, especially as oil revenues from PEMEX—which in recent years accounted for 45 percent of government income, 70 percent of export revenues, and was virtually the only parastatal to register a surplus in 1985—no longer can shoulder the burden they once carried. Meanwhile, only a fraction of Mexico's \$12 billion in fresh financing is likely to

These pressures come at a politically difficult time for de la Madrid since the country is in the midst of a relatively deep recession and many Mexicans already are highly critical of his economic policies. Whether the parastatals are sold to the private sector or liquidated, we doubt that many of the displaced laborers would find jobs, since the beleaguered private sector is unable to absorb new workers. Government divestiture also could mean an end to price subsidies on many politically sensitive basic necessities. At the same time, the ruling Institutional Revolutionary Party (PRI) would be forced to find alternative means to gain the political capital it earns by awarding generous contracts, placing influential Mexicans in high-paying upper-management positions, and guaranteeing higher standards of living for parastatal workers.

25X1

¹ Although Mexico City maintains that sales, mergers, and closings have reduced the number of parastatals from their peak level at the beginning of the decade, published data often contradict these claims. The Mexican *Federal Diary* listed 849 parastatals as of November 1982, yet Mexican press reports placed the figure at 1,155 that year, and 971 as recently as last July. The problem is partly one of definitions. According to Mexican law, a parastatal is a company either fully or partially owned by the government. The government probably does not count companies in which its stake has significantly fallen, even though technically they still are parastatals. Similarly, some parastatals recently transferred to various Mexican states are probably not counted, though they still are government owned. For the purposes of this assessment, an exact figure is irrelevant, since the impact of what would be 200 smaller state-owned firms on the Mexican economy probably is insignificant.

This assessment examines the current economic and political role of state-owned enterprises, and the likely evolution of that role given conflicting economic and political demands and constraints. It analyzes the dynamics of state-owned firms in terms of:

- The history and development of the sector.
- The political role of parastatals as they are used to co-opt and coerce, to reward and punish and, more generally, to "grease" the system.
- The economics of state ownership, particularly the impact of these firms on consumers, the federal budget, the private sector, and labor.

Finally, the paper assesses the outlook for privatization in Mexico and the implications of its success or failure for the United States.

25X1

25X1

SecretALA 87-10002
January 1987

Evolution of the Parastatal Sector

Government involvement in the Mexican economy has a long and deep-rooted history. Most Mexicans see the public sector as the engine of economic growth, and state control as a key legacy of the revolution—and hence of the PRI. Lower- and middle-class Mexicans have long relied on the parastatal sector to provide jobs and offer consumer goods at affordable prices. At the same time, some private-sector firms have depended on the parastatals to purchase their goods or to supply them with subsidized inputs. Nonetheless, the state-owned enterprise sector has grown to its present size only in the last 15 years.

[redacted]

25X1

The tremendous surge in the parastatal sector began under the leadership of President Luis Echeverria (1970-76). Our analysis of Mexican budgets shows that Echeverria achieved his goal of economic expansion primarily by enlarging the role of the state. Over the six-year period of his administration, public-sector spending grew much faster than the overall economy. The parastatal sector, in particular, ballooned from 84 firms to at least 850 as the government created new firms and absorbed privately held, debt-ridden companies. Because government revenues failed to compensate for this massive increase in expenditures and domestic sources of credit were insufficient, Mexico City was forced to borrow heavily from abroad. Consequently, public external debt skyrocketed from \$4.2 to \$19.6 billion during the period. This policy of public-sector expansion funded by foreign borrowing has its legacy in Mexico's current external debt problem.

25X1

When he became President in 1976, Jose Lopez Portillo inherited an economic crisis—caused by Echeverria's massive spending and foreign borrowing—that forced him to adopt immediate austerity. Although the number of parastatal firms continued to grow, the expansion was at a much slower pace. By the end of 1977, the unexpected success achieved through economic belt-tightening caused a heated debate within the Lopez Portillo administration between advocates and opponents of public-sector growth. Such divisions are endemic to the Mexican bureaucracy, since the Treasury Ministry is tasked

with generating revenues while the Budget Ministry spends them. Academic observers labeled the two distinct groups that emerged from this debate the "nationalist-populists" and the "liberal-rationalists." The first faction, led by the Budget Minister and strongly supported by labor, favored a dominant public sector, a subordinate private sector, and a closed economy. It advocated large social-spending programs and a rapid growth of subsidies, government spending, and government-owned enterprises. The second group, represented by the Finance Minister and including most of the private sector, called for financial conservatism, an open economy, and restructuring along free market guidelines to achieve sustained growth. In particular, according to scholars, the role of the parastatal sector was openly and bitterly discussed. As the debate raged on and became increasingly strident, Budget Minister Tello and Finance Minister Moctezuma were asked to step down.²

[redacted]

25X1

Major oil discoveries in 1978 in Mexico's southeast and Gulf coasts defused the conflict and, academics argue, allowed Lopez Portillo to finish his term without resolving the debate. As petrodollars began pouring in, Lopez Portillo, in fact, seemed to abandon all fiscal prudence—government expenditures reached nearly 40 percent of GDP in 1981, jumping nearly 200 percent in two years to 2.3 trillion pesos from 816 billion pesos in 1979. Much of this expansion was accounted for by the parastatals, according to our analysis of published Mexican budgets, and real spending in the sector grew 30 percent that year, a large portion directed to the growth of PEMEX. Except for 1979, the parastatal sector registered large deficits in each year of the Lopez Portillo administration. High levels of economic growth were restored, but only at a heavy cost: hefty foreign borrowing and an overdependence on oil earnings caused Lopez Portillo to leave to his successor, Miguel de la Madrid, a much deeper economic crisis in 1982 than he had inherited six years earlier. Although many related economic ills drove the crisis, a public sector that had expanded beyond its means was, in our judgment, central to the problem.

25X1

² This fundamental difference is still evident today, as demonstrated by last summer's dismissal of Finance Minister Silva Herzog following heated debates with Budget Minister Salinas.

25X1

Secret

Today, the parastatal sector is a prominent and firmly entrenched fixture of the Mexican economy. In recent years, these firms have generated over 70 percent of the public sector's massive input to the economy, and we estimate that they now provide close to 1 million jobs.³ Mexican officials have justified the parastatal sector on the grounds that it is necessary to:

- Meet the constitutional requirements for national security and independence.
- Regulate large monopolies and oligopolies.
- Support essential economic activities.
- Preserve general productivity and employment.⁴

[redacted]

25X1

The Political-Social Benefits of Parastatals . . .

We believe most of the Mexican leadership is convinced that, on balance, the political capital parastatals generate makes them worth a high economic cost. These firms play a key role in the Mexican political system, helping provide the PRI with the resources required to maintain its hold on power. As a result, the importance of the public-sector enterprises goes far beyond the economic objectives that successive Mexican governments have used as justification for supporting the parastatals. Mexico City now uses these firms to create jobs, administer subsidies, exercise leverage over the private sector, and grant political and economic favors to key interest groups. In short, through control of all aspects of their operation, the government can effectively manipulate economic activity and thereby reward, co-opt, or punish as it sees fit. These firms also serve political purposes on an even more fundamental level by providing Mexicans with a sense of confidence and, in some cases, pride. The symbolic importance of these firms and the safety net they provide contribute, in our opinion, to keeping the Mexican political fabric intact. [redacted]

25X1

In our view, de la Madrid, contrary to his personal economic philosophy, remains tied to a system sustained to a large degree by the public sector's virtual

³ The labor force in Mexico is about 26 million, with half unemployed or underemployed. In addition to workers directly employed in state-owned enterprises, many more jobs are indirectly created by the sector, including those at firms supplying inputs to parastatals and firms using parastatal output in their production. [redacted]

⁴ For a closer look at four of Mexico's most prominent parastatals, see the appendix. [redacted]

25X1

monopoly on economic resources. As Mexicans' economic well-being deteriorates, de la Madrid must rely on the parastatals to soften the blow. Similarly, he needs them to ward off political challenges. His recent return to traditional statist rhetoric helped quiet his more nationalist critics who charged that the President was too responsive to the demands of foreign creditors and Washington. [redacted]

25X1

Mexican officials and longtime political observers believe that the most notable achievement of the PRI National Council sessions in late May was de la Madrid's success in mending fences with old-guard PRI leaders—party bosses who clearly favor a return to the days of Echeverria and rapid public-sector growth. [redacted]

25X1

Preserving a Patronage System

We believe the parastatals are effective political tools because they provide flexibility to advance or constrain specific interest groups. Even though these firms generate some benefits for the general population—affordable goods and jobs, among others—they channel power to selected constituencies. For example, the President selects the directors of those parastatals that are under congressional budgetary control. Mexicans and many outside observers generally acknowledge that the President uses these appointments to reward members of the political elite who have been useful to him or to pay off those who were adversely affected by the government's policies. In turn, these men can build virtual fiefdoms, since their position affords them considerable influence with local businessmen, labor, and municipal governments. Although the appointees usually have excellent credentials and proven track records, [redacted] we agree with the US Embassy's assessment that parastatal directorships are used primarily to reward political loyalty (see table 1). [redacted]

25X1

25X1

25X1

The parastatal sector also is politically important to the various government ministries and respective Cabinet officials that administer them. Control of the individual firms is exercised through the ministries, and, just as a system of patronage exists for parastatal directors, we believe state-owned firms provide clout

25X1

Secret

Secret

Table 1
Key Parastatals and Their Directors

	Director	Age	Comment
PEMEX (petroleum)	Ramon Beteta	60	Mentor, friend, and close adviser to President de la Madrid. Reputed to be honest, hard working, and discreet. Undersecretary of Finance, 1970-75; Minister of Finance, 1975-76; Director of Banco Somex, 1975-82; rumored to be on his way out of PEMEX.
DINA (truck manufacturing)	Huberto Mosconi	43	Electrical engineer; former Director of Siderurgia National; appointed Director of DINA this year.
SIDERMEX (steel)	Juan Becker	55	Economist. Minister of Economics, 1952-55; Subsecretary of Industry and Commerce; Director General of Industries, 1961-64; member of IEPES (prestigious PRI think tank); Director of DINA, 1982; SIDERMEX Director since January 1986. Considered bright, politically savvy, and confident; has confidence of private sector.
Mexicana (airline)	Manuel Sosa de la Vega	70	Mechanical/electrical engineer. Director of various precursors of Mexicana since 1958.
CFE (electricity)	Fernando Hiriart	71	Civil engineer; former professor and consultant. Secretary to the President, 1971-76; A subsecretary of Mines and Energy, 1978-82; Director of CFE since 1982.
IMSS (social security)	Ricardo Garcia Saniz	56	President of Importers Association, 1957-66; Minister of Programing and Budget, 1977-79; Director of DINA, 1979-82; Director of IMSS since 1982.
CONASUPO (agriculture)	Jose Costemalle	48	Technocrat; former professor and accountant, friend of de la Madrid. Member of IEPES and of the Commission on Public Enterprises. Rose through ranks of CONASUPO's financial management; various positions with CONASUPO since 1971; Director since 1982.
FERTIMEX (fertilizer)	Miguel Davila	52	Subdirector of Ministry of Finance, 1971-74; Director of Expenditures, 1975-76; Subdirector of Budget for Programing and Budget, 1976-82; Director of FERTIMEX since 1982.
Azucar (sugar)	Eduardo Macgregor	NA	NA
PPM (fish products)	Fernando Estrada y Servin	52	Various positions in Ministry of Finance, 1975-82; member of PRI since 1980.
Ferrocarriles (railroads)	Andres Caso Lombardo	62	Economist, worked in PEMEX and CFE. Director General of Productora Mexicana de Tuberia, 1976-80; presidential adviser for administrative reform, 1977-82; Director of Ferrocarriles since May 1986.

[Redacted]

to the various federal offices that preside over them (see table 2). For example, Energy Minister del Mazo's stature is enhanced, in our view, by the control he has over PEMEX and the many other parastatals under his ministry's purview. We also suspect that a great deal of vote buying and co-opting takes place in the murky realm of the "noncontrolled" state enterprises, on which financial information is scarce. Even though they are not under the jurisdiction of the Mexican Congress, parastatals in this group have close ties to individual ministries. For example,

[Redacted] the Ministry of Interior "coordinates" various news agencies as part of the government's overall effort to

control the media, and that the Finance Ministry "administers" numerous funds and trusts designed to provide credit to interest groups favored by the PRI.

[Redacted]

Boon to Labor

Organized labor is another prime benefactor and, as a group, one of the strongest supporters of the parastatal system. This relationship was apparent last June, when the powerful labor arm of the PRI publicly denounced further budget cuts and called for a strengthening of state industries. Mexican policymakers do not take such pronouncements lightly, since the

25X1

25X1

Secret

4

25X1

Secret

Table 2
Ministerial Oversight of Parastatals

Ministry	Number of Parastatals Administered
Energy, Mines, and Parastatal Industry	385
Finance	124
Agriculture and Hydraulic Resources	86
Urban Development and Ecology	62
Communications and Transport	56
Education	52
Interior	43
Tourism	32
Commerce and Industrial Development	31
Fisheries	27
Programing and Budget	22
Health and Public Assistance	19
Federal District	11
Labor and Social Welfare	7
Agrarian Reform	7
National Defense	6
Foreign Relations	1
Total	971

Source: Mexican press, July 1986.

Note: The total number of parastatals shown here is higher than totals cited elsewhere. According to the US Embassy, an authoritative official list is unavailable. The latest official count on 15 November 1982 placed the total at 849. The figure reported above could be higher simply because some parastatals are administered by more than one ministry. [redacted]

estimated 2.3 million unionized public-sector workers formally affiliated with the PRI constitute the core of the government's political base. According to Embassy [redacted] reporting, a significant number of inefficient parastatals remain in operation only because the political cost of eliminating jobs is unacceptable. Even when workers are laid off, they generally are given handsome severance benefits (see inset "The Fundidora Closing"). [redacted]

In general, the parastatals provide the government with the means to keep organized labor as one of the pillars of the PRI. Since de la Madrid took office, we

believe the economic benefits of the parastatals have helped to offset trends that otherwise might have contributed to a deterioration of the crucial PRI-labor relationship. Over this period, real wages have steadily fallen and are now 40 percent less than they were in 1982. In addition, according to press reports, an estimated 1,500 jobs have been lost daily to the economy's contraction since the beginning of 1986. The resiliency of Mexican labor is being put to the test by a series of natural and manmade disasters, high inflation, low and volatile oil prices, and a monstrous debt burden. To some extent, the government has eased these blows by keeping parastatals open and subsidizing the prices of their output. In the past, government negotiators squeezed wage concessions out of organized labor by guaranteeing increases in key subsidies to offset income losses. Similarly, Mexico City nationalized failing firms to save jobs, assume their debts, and thus protect the positions of influential businessmen who support the PRI. [redacted] this ability financially to compensate labor is being eroded by the constraints of falling oil prices and a massive federal deficit. [redacted]

Controlling the Private Sector

While the government has co-opted labor, it generally employs quite different strategies to control the private sector, with which it is often at odds. Private business provides an economic alternative to the state-dominated economy and is the largest constituency of the major opposition party. While we believe there is not a viable alternative to the PRI today, we judge that PRI party leaders still feel a need to limit the business sector's influence. Private-sector linkages to Washington and the international financial community, both real and imagined, also contribute to the government's conviction that it must manipulate that sector. [redacted]

Although the government treats various private-sector groups differently, few observers would dispute that the parastatals have been a key to the PRI's success in politically neutralizing private business. In essence, Mexico's private sector has little political influence, because the Mexican Government has successfully divided it. In some cases, Mexico City has used

Secret

Secret

The Fundidora Closing

The closing in May of the Fundidora Steel Company in Monterrey, the country's third-largest city, located in the northern State of Nuevo Leon, almost certainly strained the relationship between government and labor. The company—one of the three largest state-owned steel complexes that comprise the SIDER-MEX conglomerate—clearly was a financial disaster. In 1985 alone, according to press reports, Fundidora lost \$48 million and increased its total outstanding debt to \$380 million. [redacted]

international markets, while the slowdown in economic activity has reduced domestic demand for steel. Moreover, private business in the area is in no position to absorb any of the newly unemployed, according to US Consular officials in Monterrey. [redacted]

25X1

25X1

The decision to cease operations resulted in significant political and economic costs in addition to immediate financial losses. Workers responded angrily with large-scale demonstrations to the closing, which eliminated some 10,000 jobs directly and will affect another 60,000 eventually. Layoffs are costly to the government: under Mexican law, severance pay covers three months' salary and an additional 20 days' salary for each year of service. [redacted]

For its part, Mexico City points to the decision to close the steel plant as evidence that it is taking the painful steps needed to reform the economy. We believe there is some validity in drawing a parallel between the closing of the plant and the decision in 1985 to allow IBM 100-percent ownership of a Mexican subsidiary. In both cases, Mexico City acted while intense negotiations with creditors were taking place amidst increasing pressure to adopt economic reform. Although financial realities were more pressing in the Fundidora decision than in the IBM case, we believe that the timing of the decision was influenced by the creditor negotiations. More important, rather than signaling similar moves elsewhere, we believe that the negative political fallout from the closing dampened the administration's resolve to eliminate other inefficient state firms. [redacted]

25X1

25X1

Fundidora employees would receive sufficient severance pay to support their families for six to eight months, but beyond that their prospects as steelworkers look bleak. Because of inefficiency and overcapacity, Mexican steel is uncompetitive in

25X1

25X1

private businessmen's dependence on the public sector to hush criticism of government policies. For example, [redacted]

In our view, Mexico City is giving the private sector lower economic and political priorities than other domestic interest groups. For example, following the government announcement last March that parastatals would have to delay payments to domestic suppliers, numerous businessmen have been subjected to lengthy payment delays, even though the country has managed to remain current on its foreign obligations. As a result, many private companies have been forced to lay off workers and suffer deep losses, according to the Embassy. [redacted]

25X1

25X1

[redacted] even though most private-sector leaders do not support the ruling party, few are willing to risk their businesses by openly supporting opposition parties. In other cases, the government lines the pockets of influential businessmen who support the PRI. Whatever the tactic used, the PRI sends a message understood by all: if businessmen support opposition parties, their businesses may be at stake. As a result, most campaign donations to the opposition are handled covertly and few businessmen speak out against government candidates. Those who can afford openly to express their opposition—owners of small companies and those associated with export-oriented firms—have little political influence, according to the US Embassy. [redacted]

Some criticism of government economic policies is voiced by chambers of commerce, but we see no sign that they are effective. On a few occasions, de la Madrid has agreed to discuss his policies with leaders

25X1

Secret

of these groups. However, the PRI leadership has frowned on giving private-sector leaders any input to the policymaking process, so that plans to regularize these meetings have not been realized. Business is shut out at the polls as well. The ruling party is particularly adept at arranging sweeping electoral victories—often resorting to blatant fraud—to legitimize the government’s economic role. This power to reward is complemented effectively by the power to punish, and the PRI is not hesitant to use its influence to quiet vocal private-sector opponents. For example, according to reporting from the US Information Service, earlier this year PIPSA, the monopoly newsprint parastatal, blocked imports of newsprint and associated supplies by a rightwing Mexican newspaper critical of government economic policies. [redacted]

25X1

The annual convention of chambers of commerce provides an insight into how Mexico City handles the private sector. Business leaders long have been demanding the divestiture of CONASUPO (the National Company for Popular Subsistence), the food supply parastatal, and its retail outlets that compete with private stores. As one would expect, Mexican politicians are extremely reluctant to tamper with the company because of its image as the state’s guarantor of affordable food for all classes of Mexicans (see appendix). [redacted]

25X1

[redacted] de la Madrid decided to use the convention—one of the few forums available to forge a private-sector consensus—to reaffirm official policy on state-owned enterprises. With the President in attendance, and apparently at his direction, the Commerce Minister unequivocally reconfirmed “the government’s policy to intervene in the market for the protection of the people.” [redacted] the speech was nearly drowned out by booing and whistling, a spectacle unprecedented in the presence of a Mexican President, according to the US Embassy. Mexico City responded promptly by demanding a public apology from the convention directors. The apology was quickly delivered [redacted] because CONASUPO threatened to stop doing business with chamber members. [redacted]

25X1

25X1

25X1

25X1

25X1

... And Their Economic Costs

From an economic perspective, state-owned enterprises provide Mexicans with goods that, in many cases, might not be available under free market conditions. Perhaps more important, these firms also subsidize basic necessities that otherwise would be unaffordable to some. Finally, although economists argue that direct subsidies are superior to a system of state-owned firms offering subsidized output, the parastatals give many Mexicans a sense of pride and well-being. [redacted]

25X1

Inefficiency and Economic Distortions

Despite these benefits, Mexico, in our judgment, pays a high price to maintain its large parastatal sector. Most state-owned firms are plagued by a host of problems that place a severe drain on the Mexican economy. Many of these difficulties can be traced to the lack of the profit incentives that are found in a free market. In addition, we believe that heavily subsidized state-owned firms often stifle competition by sending the wrong signals and providing misguided incentives to the private sector and, in some cases, knocking relatively more efficient competitors out of the market. Moreover, the monopoly position Mexican parastatals often maintain—especially in natural resources, banking, petrochemicals, electricity, transportation, and communications—in many cases probably causes a misallocation of private-sector investment and stunts entrepreneurial ability and innovation. [redacted]

25X1

US Embassy reporting indicates that, in the absence of key market forces, operational inefficiencies are rampant in many parastatals, quality control often is lacking, and modern management techniques are sometimes ignored by supervisors and midlevel managers who owe their positions to political factors rather than business acumen. [redacted]

25X1

[redacted] unnecessary inventory accumulation as well as cases where rundown equipment—lacking replacement parts and proper maintenance—often

25X1

Secret

25X1

has restricted output and caused unnecessary production delays. Finally, overly generous labor contracts result in high costs and an inability to respond to changing conditions by reducing employment. [redacted]

• Despite heavy subsidization, [redacted] government food stores (CONASUPO) sell their goods at prices only slightly lower than their private-sector competitors. In addition, press reports indicate that CONASUPO store managers employ high degrees of discretionary pricing with little regard to market conditions.

25X1

25X1

[redacted] workers often are overpaid, that unproductive workers usually manage to keep their jobs, and that employment levels are excessively high. Among examples reflected in [redacted] press reporting are the following:

- A source close to DINA, the state-owned truck manufacturer, has reported that the company's director is trying to persuade Mexico City to allow a US firm 100-percent control of a DINA plant as part of his overall effort to restructure the parastatal and bring an end to heavy annual losses. [redacted]

- Generous labor agreements at AeroMexico and Mexicana, Mexico's state-owned airlines, reportedly were scaring off potential private-sector investors, although there are rumors that Mexicana will soon be sold. Meanwhile, Mexican pilots publicly blamed poor maintenance for recent airline disasters. [redacted]

25X1

25X1
25X6
25X6

The distortions caused by Mexican parastatals have varying effects on businesses, labor, consumers, and investors as they permeate the economy. For example, chronic overcapacity ties up resources—in the form of capital and labor—that could be used more productively in other areas. Another problem arises from the well-documented reliance of government-favored private businesses on state-owned firms to supply them inputs at below-market prices. This dependency alters normal business incentives and, we suspect, in turn causes many private firms to become inefficient by placing a lower priority on cost-consciousness. When Mexico City reduces subsidies on products produced by the parastatals, the ability of private companies to compete internationally is often jeopardized, as their costs rise. At the same time, some firms are driven from the international market because they depend on poor-quality inputs from the parastatals. In many of these cases, the private firm cannot turn elsewhere for higher quality goods because the state-owned firm is a monopoly. [redacted]

25X1

- Engineers at the electric power parastatal, CFE, reportedly fear that the country faces brownouts or blackouts unless various spare parts are received soon. For example, many turbines already have been shut down and cannibalized for spare parts to keep other units running. Given the high economic and political costs associated with power outages, we view this as a misallocation of government resources rather than austerity.
- Various press accounts reported that massive overcapacity and excessive wage demands were among the problems that led Mexico City to close the Fundidora steel complex in Monterrey.
- Industry experts estimate that inefficiency and overstaffing in Mexico's steel sector allows the public sector to produce only 70 metric tons per worker as compared to the 170 tons that workers produce in Mexico's private steel firms.
- The state-owned sugar company, Azucar, has announced that it has no plans to scale back its operations or work force even though there is a massive surplus of sugar in the country.

Similarly, many Mexican private businesses depend heavily on the parastatals to purchase their output. Indeed, in some cases the state-owned enterprise is a private firm's only customer, occupying a monopsony position. Because public-sector firms can decide where to purchase their inputs, they are positioned to drive out of business any entrepreneurs who do not

Secret

Secret

25X1 support government policies or the ruling party. Such a relationship also creates an environment conducive to corruption. We are convinced that preferential contracting and kickbacks contribute to the sector's overall inefficiency by inflating the cost of inputs and fostering the production of inferior goods. [redacted]

25X1 Yet another problem arises out of the generous labor contracts characteristic of public enterprises. The high level of wages and benefits contained in these agreements naturally bids up wages throughout the economy and is a major force behind inflation in Mexico. Even though the effect has been dampened in recent years as wages have failed to keep up with price increases, producers' increased labor costs are still pushed onto consumers in the form of higher retail prices. [redacted]

25X1 Finally, we believe that the public sector's dominance over the economy has contributed to the gradual erosion of the private sector, as demonstrated by high levels of capital flight, low private-sector confidence in the economy, and middle-class emigration. [redacted]

25X1 businessmen have moved large amounts of pesos out of Mexico over the last several years. Indeed, a major US investment bank has estimated in a widely quoted study that capital flight from Mexico during the 10-year period preceding 1985 amounted to \$53 billion. We believe the parastatals have stifled the many potential investment opportunities that might have attracted domestic investors, whose funds now have left Mexico for good. [redacted]

25X1 some capital has trickled back in recent months, but our analysis leads us to conclude that the turnaround has largely been in response to the credit squeeze caused by high government domestic borrowing and that it is not an indication of renewed confidence. Moreover, most of these repatriated funds have been used to meet operating costs and have not been directed toward much-needed investment. Over the longer term, continued high levels of capital flight and low levels of investment will threaten any prospect for sustained economic growth. [redacted]

25X1 In a trend with even more ominous implications for Mexico's future, some private businessmen now are "voting with their feet" and leaving Mexico for good.

In our view, Mexico's parastatal sector has contributed to this exodus by closing off entrepreneurial opportunities and, in some cases, limiting middle- and upper-level management jobs to employees supportive of the PRI. Indeed, profiles of immigrants—both legal and illegal—show an increase in the number of educated middle-class Mexicans looking for a better life or an opportunity to capitalize on entrepreneurial talent. In our view, this brain drain and subsequent loss of human capital is potentially more serious than the loss of financial capital. [redacted]

Drain on Government Coffers

The parastatal sector places a direct burden on the economy by draining the Finance Ministry of funds. US Embassy reporting and official government data show that the 10 largest firms—excluding PEMEX—generated only 48 percent of their own revenues last year; the remaining 52 percent was financed by government transfers and borrowing. Among the worst offenders were:

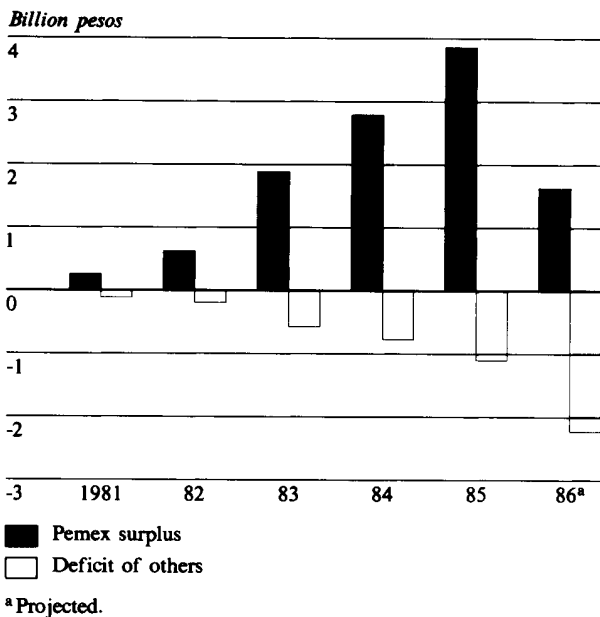
- The public steel conglomerate (SIDERMEX), which earned only 34 percent of its income.
- The state electric company (CFE), which generated less than 35 percent of its income.
- The state fertilizer company (FERTIMEX), whose sales amounted to only 39 percent of total revenues.
- CONASUPO, the food marketing firm, which also generated less than half of its revenues.

On the basis of available information, we conclude that the poor performances we have detailed characterize the entire sector, although the worst offenders appear to be concentrated in the 10 largest firms, excluding PEMEX, which accounted for over half of the massive public-sector deficit in 1985. Indeed, from a financial perspective, the combined fiscal burden of the hundreds of remaining parastatals, reflected in transfers from the federal government, is only slightly lower than that of these larger firms. [redacted]

An assessment of data for the first trimester of 1986 reveals far deeper financial problems for the parastatal sector as a whole. According to press reports, the sector had registered a total deficit of \$2.2 billion by the end of April—more than twice the total authorized overrun. Historically, large surpluses from PEMEX have kept the sector afloat by masking the

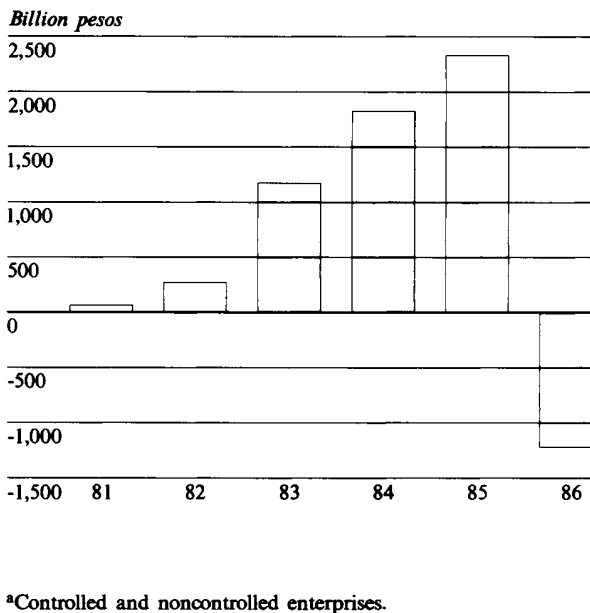
Secret

Figure 2
Controlled Parastatals' Operating
Balances, 1981-86



311046 1-87

Figure 3
Combined Parastatal Sector Operating
Balances, 1981-86^a



311047 1-87

25X1

25X1

other parastatals' deficits (see figure 2). A close look at the other state-owned enterprises revealed waste and inefficiency that was tolerable only as long as oil dollars continued to flow. Thus, we were predicting economic trouble for Mexico even before petroleum prices plummeted because, over the longer term, a system that depends on one firm to support the losses of some 700 others is likely to run into problems, given the limits to expansion of Mexico's oil markets. This year, the oil monopoly's surpluses will be insufficient to compensate for the heavy losses incurred by the other companies because PEMEX's surplus has been far below levels projected before petroleum prices and export volumes tumbled dramatically. As a result, we expect the parastatal sector as a whole to register an operational deficit in 1986 (see figure 3).

information on the financial operations of these firms is scant, [redacted] they have continuously run operating deficits (see figure 4). To offset deep losses, these firms have drawn heavily on government transfers. Last year, for example, transfers to the noncontrolled sector matched those to the controlled sector. [redacted]

25X1

25X1

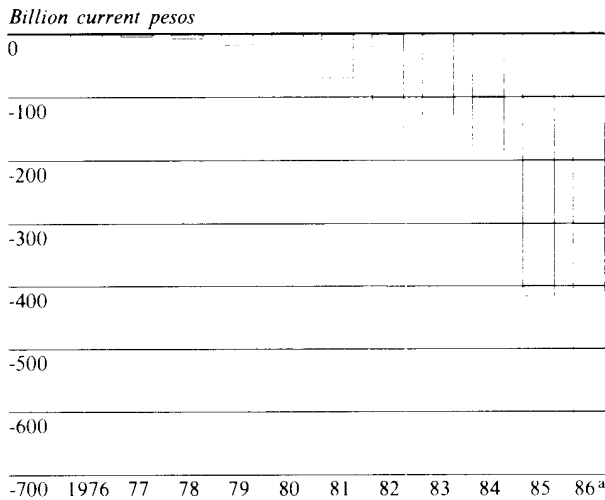
The inability of parastatal firms—except PEMEX—to generate more revenues than they spend will force the Mexican Government to reach even deeper into its pockets to help meet the sector's debt obligations. According to press reports, more than 60 percent of the parastatals' expenditures goes toward external debt payments. We calculate that debt owed by state-owned firms now accounts for more than 40 percent of the public sector's total external debt of some \$74 billion (see figure 5). Prior to the debt rescheduling

25X1

The revenue shortfall problem appears to exist as well where it is least visible—the hundreds of parastatal firms whose budgets are not subjected to congressional control, the "noncontrolled enterprises." Although

Secret

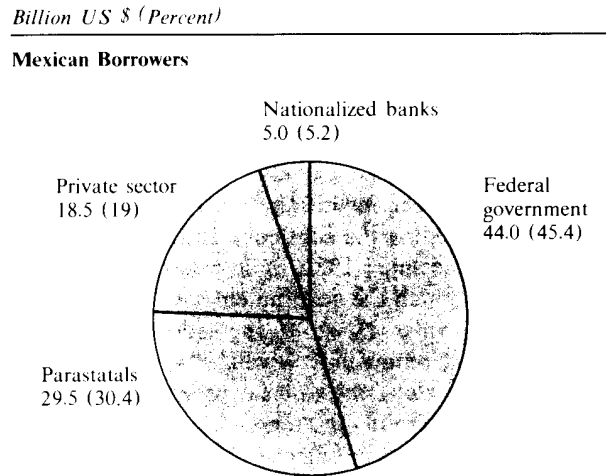
Figure 4
Noncontrolled Parastatals' Operating
Deficits, 1976-86



^aProjected.

311048 1-87

Figure 5
Mexican Debt Profile, 1986



311049 1-87

25X1

agreement with banks, state-owned firms were scheduled to pay foreign lenders about \$5.2 billion in interest and principal, 57 percent of the Mexican Government's total obligation to these sources. Even though principal payments have been postponed, Mexican parastatals seem destined to depend on Mexico City to honor their steadily increasing obligations through the 1990s. In total, the parastatals owed foreign banks \$29.2 billion as of March 1986—a debt larger than that of most countries and 50 percent larger than the debt contracted by Mexico's private sector.

25X1

We expect Mexico City to find it difficult to retire a significant portion of these external loans. Repayment through less conventional means—such as debt-for-equity swaps, zero coupon bonds, or interest capitalization—is complicated by the fact that the foreign creditors generally are less willing to accept creative solutions, partly because of the regulatory environment in which they operate. In addition, while Mexico

25X1

City can take an inflationary course and print pesos to repay its domestic creditors, it must find dollars or other foreign currencies to meet international obligations. This has become increasingly costly as the peso has fallen rapidly relative to the dollar in recent months and currency reserves have been depleted. Further, Mexico's own laws hinder creative solutions by prohibiting majority foreign ownership and dictating that certain industries remain under complete government control. For example, debt-equity swaps resulting in majority foreign ownership would require a constitutional amendment.

25X1

The government, in our view, will also have to help the parastatals repay their domestic debts. Recent reschedulings of the country's external debt will not have bought time on these internal obligations, and this year state-owned firms are scheduled to repay Mexican investors some \$3.2 billion, about one-fifth

Secret

Secret

of the public sector's total obligation to domestic creditors. Moreover, as inflation continues to accelerate and drives domestic interest rates higher, the burden will increase. [redacted]

25X1

Privatization Efforts

In light of their inefficiency and the economic distortions they cause, pressure to divest many of Mexico's parastatals has been mounting for a number of years (see inset "Shedding the Burden"). In his inaugural speech on 1 December 1982, de la Madrid alluded to a program in which the government would sell "non-priority" companies. However, the first move in this direction did not come until April 1984, when the nonfinancial assets of the banks expropriated by Lopez Portillo—mainly brokerage houses and insurance companies—were returned to the private sector. In February 1985, the administration promised to publish a list of 236 parastatals that would be put up for sale. Nearly two years later, such a listing has yet to emerge, although occasionally the government hints that a specific parastatal could be sold, given the proper conditions. [redacted]

25X1

On the basis of US Embassy reporting and our assessments, we believe that de la Madrid originally fully intended to proceed with his privatization plan but that his efforts were halted by political realities sharpened by the July 1985 midterm elections. Mexico's lack of progress in this direction subsequently emerged as a major stumblingblock in negotiations that began in early 1986 with the IMF and other foreign creditors. Typically, the deadlock was overcome by a Mexican promise to privatize, which we believe will not be honored. [redacted]

25X1

In his 1 September 1986 annual address to the nation, de la Madrid finally identified those parastatals that he deemed "strategic and priority enterprises" and, therefore, constitutionally mandated to government control. Rather than naming specific parastatals that could be sold, the President vaguely characterized those that could not (see inset "Divestiture: Commitment or Rhetoric?"). As a result, de la Madrid almost certainly failed to encourage investors and characteristically left himself room to backslide. According to

Shedding the Burden

There are a number of mechanisms governments can employ to divest themselves of state-owned firms:

- *Private-sector sale allows the government to divest itself of control and ownership of parastatal enterprises. To the extent these firms are unattractive investments, the government may be required to create demand by "sweetening the pot" through such means as tax breaks or favorable financing. In addition, either there must be adequate means for the private sector to finance such purchases or the country's foreign investment laws must be conducive to foreign ownership.*
- *Partial divestiture occurs when the government relinquishes only some ownership in the enterprise. By selling less than half of the company, the government maintains formal control over operations.*
- *Leasing transfers the responsibility and cost of operation but does not diminish the value of the government's holdings.*
- *Liquidation is the extreme step, in which the government closes down the firm. This option is feasible only if the product or service provided is deemed nonessential or an alternative supplier can be developed.* [redacted]

25X1

the US Embassy, the President's announcement was overshadowed by Mexican press reports that buyers had been found for only eight of the 53 firms offered for sale since 1983. [redacted]

25X1

Although de la Madrid and members of his administration appear to agree that a key to closing the gap between government expenditures and income lies in the sale of parastatals, Embassy [redacted] reporting reveals that they remain far apart on the pace of adjustment. Some past and present Mexican policy-makers—most notably former Finance Minister Silva Herzog—have risked political backlash by publicly maintaining that the state's economic dominance

25X1

Secret

Secret

Divestiture: Commitment or Rhetoric?

In his 1 September 1986 State of the Nation speech, de la Madrid announced that his government would take steps to save the strategic and priority enterprises by preventing nonstrategic and lower priority enterprises from depleting the Mexican budget. This formulation apparently was intended to indicate that his government would continue to operate some firms but was willing to divest itself of others. The list of sacrosanct firms was divided into the following categories:

- *Exclusive state jurisdiction, per Article 28 of the Constitution:*
 - *Petroleum and hydrocarbons.*
 - *Basic petrochemicals.*
 - *Radioactive minerals and nuclear power generators.*
 - *Electricity.*
 - *Railroads.*
 - *Issuance of currency.*
 - *Coining of money.*
 - *Postal services.*
 - *Telegraph and satellite communications.*
 - *Public banking and credit services.*

- *Other strategic entities, essential for protecting the national interest (mainly social programs):*
 - *Mexican Social Security Institute.*
 - *Social Security and Services Institute for Government Workers.*
 - *National Fund for Workers' Housing.*
 - *CONASUPO.*
- *Enterprises, among others, with priority status:*
 - *Steel.*
 - *Fertilizer.*
 - *Sugar.*
 - *Shipbuilding.*

The President also stated that 205 parastatals have been transferred, liquidated, merged, or sold and that some 261 others are in the process of being divested. According to de la Madrid, there are now about 700 parastatals, compared to 1,155 in 1982. The US Embassy reports that it has been unable to confirm the numbers cited by the President and points out that the inclusion of the caveat "among others" in the last category is a typical Mexican Government loophole.

[Redacted]

25X1

must be scaled back. Others argue, more forcefully and effectively, that wholesale divestiture would be tantamount to dismantling the system that has provided 50 years of political stability. They claim that the widespread plant closings and layoffs that would be associated with these measures simply are politically unacceptable. As a result of this latter group's strength and popularity, no major parastatal so far has been completely sold, although 80 percent of Mexicana Airlines is close to being sold to a group of Mexican businessmen. [Redacted]

Mexico's present severe economic downturn is a major obstacle to privatization. From a political standpoint, de la Madrid lacks the capital required to proceed, even though the need is greater now than before. Moreover, Mexican businessmen have little incentive to purchase parastatals: predominantly unattractive firms are offered for sale, and high inflation and the relatively steep fall in GDP expected this year makes investments risky. In addition, [Redacted] Mexico City has made the conditions for sale too onerous. Some stipulations require purchasers to agree to existing labor contracts, even though these contracts have contributed to the parastatals' inefficiency. In other cases, firms are sold only in packages, grouping one attractive company with several losers.

25X1
25X1
25X1
25X1

Secret

Secret

Even if the private sector wanted to buy state-owned companies, however, the necessary resources currently are hard to come by:

- The Federal government is monopolizing all available domestic capital to finance its burgeoning budget deficit. Indeed, Mexican bank reserve requirements in recent months have exceeded 95 percent.
- Foreign creditors [redacted] are reluctant to lend money to Mexicans to purchase shares of state-owned enterprises.
- Foreign investors who find parastatals appealing are constrained by Mexican laws and discouraged by the country's economic performance and the government's lack of commitment to much-needed reform.

25X1

25X1

In the last two months, de la Madrid has appeared once again to be backing away from his promises to divest the sector and now is placing emphasis on making the "priority" firms more efficient. Given our skepticism that de la Madrid has any intention to engage in large-scale divestiture, a commitment to improve efficiency appears to us a positive move. Nevertheless, in our view, a key to achieving an economic recovery that can produce long-term, sustainable growth lies in the divestiture of some of the larger firms. [redacted]

25X1

little would be gained even if Mexico were to sell most of the so-called nonpriority firms. A look at government balance sheets confirms this: financially, the majority of Mexico City's problems in this area are generated only by the eight or 10 largest parastatals; the hundreds of remaining firms in the aggregate constitute less of a burden. [redacted]

25X1

Outlook

De la Madrid is challenged to deal with the bloated parastatal sector at a time when such moves would be economically and politically most costly. Given present hard times, we doubt he will pursue significant privatization or find other means to divest state-

owned enterprises, especially when the PRI's presidential candidate will be named in a year and elections will be held in less than two years. The President is unlikely to force Mexicans to undergo the additional sacrifices large-scale divestiture would bring as subsidies are cut and unemployment surges. In short, de la Madrid probably believes it would be political suicide to demand immediate pain to realize longer term relief only after he has left office. Likewise, efforts to make the larger firms more efficient require measures that are politically unpopular. Consequently, similar to those before him, this President can be expected to leave the burden of adjustment to the next administration. [redacted]

25X1

Until then, we believe the de la Madrid administration will enjoy a temporary respite from some of its immediate economic problems as a result of the lenient IMF agreement signed in September and the financial bailout from commercial banks. Rather than use this breathing space to begin economic reform, however, we believe the Mexican leadership will direct most of the money to foreign interest payments. The remainder will be used to fund politically sensitive domestic programs and build reserves, while a good portion will be lost to capital flight.⁵ Moreover, even if funds from the multilateral lenders are earmarked for structural adjustment, they are more likely to be used in the politically less sensitive area of trade liberalization than privatization. [redacted]

25X1

To demonstrate some progress on divestiture, however, the government is likely to shed some smaller companies with much fanfare, but in the end the measures are unlikely to go far enough to alleviate much of the problem. The impetus for change is unlikely to come from within, because those business leaders willing to push for privatization are without leverage: they are politically ineffective, lack support, resources, and, most important, a viable alternative to

25X1

[redacted]

Secret

Secret

the current system, given present conditions. Meanwhile, Mexico's foreign creditors will continue to push for divestiture and privatization, but, for the time being, they will be ineffective since they have conceded much of their leverage by agreeing to lend new money and reschedule old debt. [redacted]

25X1

De la Madrid almost certainly will work hard to soften the blows from any moves, however minor, to reform the parastatal sector. The government will lose some economic influence and political good will as it sells even smaller state-owned enterprises and workers are laid off at some of the larger companies. Nevertheless, we expect the Mexican leadership to deal with the resulting problems by promising higher wages, unemployment compensation, or political favors to labor leaders. By selling some firms and making others more efficient, Mexico City is likely to mend some fences with segments of the private sector not directly benefiting from a large parastatal sector. For those whose allegiance to the PRI has been "purchased" by favors channeled through the sector, other mechanisms of co-optation will be found. In the end, some political capital may be sacrificed by the minimal reforms, but certainly not enough to disrupt the political system or substantially handicap the PRI. [redacted]

25X1

Unless circumstances change significantly, Mexico will have to wean itself from dependence on the public sector over the longer term. The level of resources to sustain the parastatals will no longer be available, since oil revenues are unlikely to return to the levels enjoyed before 1986, and foreign lenders cannot be counted on to continue massive lending. Some alternative sources of financing exist—much higher taxes or a deep cut in imports, for example—but, in our view, their costs are economically and politically prohibitive. Therefore, whether the increasing political and demographic pressures push future Mexican policymakers to abandon their traditional reliance on the parastatals or, conversely, corner them into a greater dependence, economic constraints almost certainly will force the sector to shrink. Under any scenario, expanding the state-owned enterprise system to meet the demands of a growing labor force is out of the question, in our judgment. [redacted]

25X1

Given the ballooning growth in population and increasing urbanization, the PRI leadership will probably have to seek alternatives to replace the economic and political capital that parastatals generate for the government. The easiest and most likely course, in our view, would be to adopt a muddle-through approach designed to adapt to the economic realities while minimizing the political fallout. Such an approach would be characterized by a vigorous effort to reduce waste and increase efficiency; the sale, merger, or divestiture of smaller and politically less sensitive parastatals; heavy foreign borrowing facilitated by threats of a debt payment suspension; and an escalation of the federal deficit and inflation. While this approach may be the most palatable from the Mexican policymakers' perspective, it carries great risks. The longer the adjustment is postponed, we believe, the more pronounced the eventual trauma associated with reform will be. [redacted]

25X1

Implications for the United States

The direct implications of the Mexican parastatal conundrum for the United States will be, in the near term, largely limited to adverse effects on US firms supplying the parastatals and to commercial banks that have lent them money. As Mexico City waits for fresh credits, some US suppliers may experience payment delays. Looking farther ahead, until the Mexican economy rebounds, demand for US imports certainly will remain depressed. US firms that have grown dependent on Mexico's parastatal market may be driven to look elsewhere when the Mexican companies are forced to cut back on imports. On the positive side, some of the smaller parastatals that may be put up for sale could offer US investors an opportunity to expand markets. To the extent that US technological and managerial expertise is exported to Mexico, both sides stand to benefit. [redacted]

25X1

US banks face a similarly uncertain future. For example, it is unclear what will happen to the status of a loan to a parastatal if the company is sold. Creditors would almost certainly demand repayment

Secret

Secret

of the loan from the proceeds of such a sale, but Mexico City would probably attempt to reschedule this debt along with the bulk of the country's outstanding obligations. A proliferation of debt-equity swaps involving US banks—which has only limited potential—could give rise to other areas of contention regarding the independence of US management operating in Mexico. In general, foreign banks will continue lending to some parastatals—PEMEX is still considered a good risk, for example—but others will not receive credit. Banks may have to write off the debt of those that fold if Mexico City is unwilling or unable to assume the obligation.

25X1

Over the longer term, the continued reluctance of the Mexican Government to reform the parastatal system will, in our judgment, accelerate the erosion of the Mexican economic system and generate problems that will almost certainly spill across the border. At a minimum, a bloated Mexican public sector threatens to strain the US financial system as banks are forced to either lend additional money or face payment suspensions. Moreover, Mexico's state-owned enterprises, even if they are not pared down, are unlikely to grow sufficiently to create enough jobs to satisfy the country's rapidly growing labor force. Consequently, illegal immigration—already at record levels—is likely to accelerate.

25X1

Secret

Secret

Appendix

Key Parastatals

PEMEX, Managing the National Patrimony

PEMEX (Petroleos Mexicanos) is responsible for all petroleum-related activities in the country including exploration and production of crude oil and gas, refining, transportation, marketing, and the production of petrochemicals. It is by far the dominant company among the state-owned enterprises. [redacted]

25X1

Since the discovery of major oilfields in the mid-1970s, PEMEX has generated large operating surpluses, which have helped to offset growing operating deficits among the other parastatals. Between 1979 and 1983 transfers from the federal government to PEMEX averaged the equivalent of nearly 3.7 percent of GDP. Furthermore, since the late 1970s PEMEX has accounted for about half the investment undertaken by the state enterprises, totaling \$35 billion between 1977 and 1983. [redacted]

25X1

PEMEX revenues are heavily taxed, providing about 39 percent of all tax revenues collected by the federal government. The combination of PEMEX's large investment requirements and the high rate of taxation resulted in a large overall deficit in the early 1980s, much of which was financed by foreign commercial borrowing. In 1981 alone PEMEX borrowed \$10 billion abroad, and by the end of 1984 the company's external debt totaled \$17.5 billion. [redacted]

25X1

PEMEX is also plagued by widespread criticism of management practices. Workers have accused managers of being preoccupied with financial savings at the cost of other programs such as maintenance and replacement. Recently, more accidents have been reported than in previous years, most of which resulted from poor maintenance or improper use of equipment, according to the US Embassy. [redacted]

25X1

CFE, the Troubled Electric Company

Together with the Central Light and Power Company, the Federal Electricity Commission (CFE) dominates the electric power sector. CFE is responsible for producing and selling all commercial electricity, and

sets its prices well below cost. Heavy investments in the sector have been effective but expensive, according to the Embassy. In 1985, the operating deficit for CFE and the Central Light and Power Company was equal to nearly 1.1 percent of GDP, forcing a 59-percent increase in transfers from the federal government. CFE alone relied on these transfers and borrowing for 65 percent of total revenues. [redacted]

25X1

CFE lacks resources to meet the current increase in the demand for electrical power because of the cancellation of investments. The parastatal is stagnant and has had to curtail programs and reschedule projects, all indications that there are no funds. Like CONASUPO, CFE overspent its first-quarter 1986 budget, [redacted] In order to put government spending back within approved targets, CFE, along with PEMEX, SIDERMEX, and other parastatals, was forced to suspend payments in February 1985. Moreover, the 1986 Mexican budget called for 48 percent of direct pricing subsidies to go to CFE alone. [redacted]

25X1

25X1

SIDERMEX, the Beleaguered Steel Complex

SIDERMEX, the government steel complex composed of Altos Hornos de Mexico and Siderurgica Lazaro Cardenas-Las Truchas, produces 60 percent of Mexico's steel. It is faced with high financial costs, stagnant domestic demand, a limited export market, price controls, and management and labor problems, according to the US Embassy. Moreover, it is strapped with a \$3.5 billion debt. [redacted]

25X1

SIDERMEX in 1985 faced a serious setback when the US reduced its imports of Mexican steel by 30 percent. Combined with an acute shortage of capital and a reduction of income, this move caused the parastatal to fail to meet its 1985 production target and to accumulate huge financial losses. The most drastic example was Fundidora Monterrey, which lost \$48 million in 1985, and in May 1986 was the first major parastatal to be closed. [redacted]

25X1

Secret

Secret

In mid-January, SIDERMEX director Miguel Alesio Robles was removed from office for failing to address the problems facing the parastatal and replaced by former DINA director Juan Guillermo Becker. SIDERMEX still faces serious financial problems. Although privatization remains a possible solution, the private sector probably does not have the financial resources to buy SIDERMEX's large firms at the present time, according to the US Embassy. The situation would be considerably improved by a recovery in domestic demand and a reopening of the US market, neither of which appears likely in the near future, however. [redacted]

25X1

CONASUPO, Feeding Mexico

CONASUPO supplies basic agricultural products to Mexican consumers, administers official support prices, imports agricultural products to supplement domestic production, and manages storage facilities. Through transfers from the federal government it also subsidizes the prices of basic food products. In recent years it has branched out into other activities such as the sale of light manufactured products. [redacted]

25X1

CONASUPO has incurred large operating losses in recent years. In 1983 these losses were equivalent to about 1.3 percent of GDP. In 1985, CONASUPO relied on federal transfers and borrowing for 50 percent of total revenues. In 1986, the parastatal overspent its first-quarter budget, and the situation does not show signs of improving. CONASUPO also suffers from widespread corruption and inefficiency, [redacted]

25X1

Although a reform program was established to combat corruption, it was later abolished as part of a cut in government spending. [redacted]

25X1

Secret

Secret

Secret