

SECRET

UNCLASSIFIED DOCUMENT
REF ID: A67004-2415
DATE 1/1/00

NATIONAL INTELLIGENCE ESTIMATE

Mexico Under Jose Lopez Portillo: Problems and
Prospects For US-Mexican Relations

SECRET

NE 311-76

December 1976

NO 415

~~SECRET~~
NOFORN/NOCONTRACT

NIE 81-1-76

MEXICO UNDER JOSE LOPEZ-PORTILLO:
PROBLEMS AND PROSPECTS FOR
US-MEXICAN RELATIONS

~~SECRET~~

~~SECRET~~



iii

CONTENTS

PRINCIPAL FINDINGS	Page 1
DISCUSSION	4
I. SETTING THE STAGE	4
A. Mexico and the United States	4
B. The Mexican Economy and Society	4
C. Dynamics of Policymaking in Mexico	7
II. THE OUTLOOK FOR MEXICO UNDER LOPEZ-PORTILLO ..	7
A. Profile of the New President	7
B. Priorities of the Administration	8
C. Prospects and Possible Strategies	9
Stabilization, Confidence, and Trade	9
Oil	11
Agriculture	12
Growth and General Economic Outlook	13
Political and Social Prospects	13
III. THE IMPACT ON THE UNITED STATES	14
A. Illegal Immigration	14
B. Narcotics	15
C. Trade Relations	15
D. Oil	17

MEXICO UNDER JOSE LOPEZ-PORTILLO: PROBLEMS AND PROSPECTS FOR US-MEXICAN RELATIONS*

PRINCIPAL FINDINGS

Jose Lopez-Portillo, when he assumed the presidency of Mexico on December 1, 1976, inherited an economy in the grip of a psychological crisis. Successive attempts at a managed float of the peso in the last days of the Echeverria administration, while bringing about an undervaluation of the currency, failed to check capital flight and, in fact, further reduced business confidence, already undermined by the antibusiness acts and attitudes of the outgoing government. The extensive last-minute land redistribution of the outgoing president added to the air of tension and uncertainty.

Fortunately for Lopez-Portillo, the Mexican presidency is a powerful decisionmaking center that operates under remarkably few institutional constraints. If he has the will, a new president could move quickly on the troublesome issues that confront him. Lopez-Portillo has given every indication that he has both the will and a program to arrest and reverse the current downward spiral. This is not to say that the road will be easy. He is faced with such basic problems as rapid population growth, high unemployment and underemployment, and low productivity in agriculture. Echeverria's populism has some momentum, and

* This Estimate was written during a period of transition in the Mexican government. A follow-up Estimate is planned for mid-1977, when the policies of the Lopez-Portillo administration will have become more fully known.

various interest groups, particularly organized labor, will at times cause problems. Some compromises are likely. However, the Mexican president has unique tools with which to cope with his problems and insure the success of his programs.

The new president, generally considered to be pro business and economically conservative, is expected to: (a) hold public and private talks to persuade businessmen that his administration understands their problems; (b) affirm the objective of maintaining exchange rate stability; (c) reemphasize that the government has no intention of establishing exchange controls; (d) take special measures to aid individual industries; (e) make use of wage and price controls to reduce the inflationary effects of devaluation; (f) announce specific programs to reduce the public sector deficit; and (g) emphasize agricultural productivity over land distribution. This program should begin to show results in 1977 and achieve substantial success by the end of 1978.

As the emphasis of Lopez-Portillo's economic policy shifts from stabilization to growth, oil will become increasingly important. While there are strong forces within the Mexican government that will resist all-out development of the country's oil reserves—which may be as much as 60 billion barrels and nearly as large as those of Kuwait—the president would clearly like to produce and export oil at something near the maximum prudent rate. We believe that the president will win most but not all of his battles with the bureaucracy and that by 1980 production and export levels will be on the order of 2.3 million barrels per day and 1.2 million barrels per day, respectively. Such rates would allow Mexico to achieve a substantial current account surplus. By the end of Lopez-Portillo's term in 1982 Mexico could be well on the way to becoming one of the world's major oil exporters.

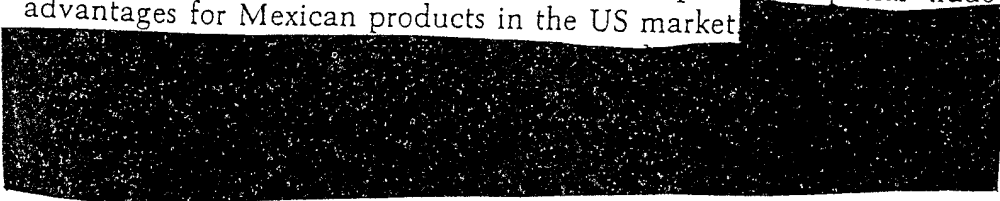
On the political side, we believe that Lopez-Portillo can prevent Mexico's admittedly serious social problems from becoming unmanageable, but land redistribution and labor problems will be particularly difficult. The government should be able to maintain its authority and to stifle and deflect pressures through the traditional methods of cooptation, coercion, and limited reform.

With regard to the United States, Lopez-Portillo promises to be a much more cooperative neighbor than was Echeverria. It is clear, however, that the new president sees improved relations with the United States as a two-way street and hopes to maximize the economic, financial, and commercial benefits of the new relationship.

~~SECRET~~
~~NOFORN/NOCONTRACT~~

Thus, while the president's cooperative stance will extend to those areas of most concern to the United States—such as illegal immigration, narcotics, trade relations, and oil—both institutional and political factors will prevent rapid breakthroughs in most of these areas.

Illegal immigration to the United States will continue to be a problem until Mexico can offer potential emigrants a viable alternative. In narcotics matters we can expect the Lopez-Portillo government to continue cooperative enforcement efforts, but, in spite of US assistance, inefficiency, corruption, and the profit potential will continue to limit the effectiveness of enforcement programs. In trade relations Lopez-Portillo can be expected to press for special trade advantages for Mexican products in the US market



3
~~SECRET~~

DISCUSSION

I. SETTING THE STAGE

A. Mexico and the United States

1. On December 1, 1976, the administration of Luis Echeverria was replaced by that of Jose Lopez-Portillo y Pacheco. The Echeverria years had been a time of economic difficulties for Mexico and considerable strain for Mexican-US relations. The new administration inherits a number of old problems as well as some unexpected opportunities; how it faces its problems and makes use of its opportunities will impact directly and indirectly on US interests.

2. Present US interest in Mexico is stronger than at any time in the recent past. The United States desires a Mexico that will be:

- a source of increased oil supplies for the US and world markets;
- a hospitable market for trade and investment;
- a secure southern border;

- a helpful and moderating influence in international forums;
- a cooperative partner in working out such bilateral problems as narcotics smuggling and illegal immigration; and
- a politically and economically stable nation that is well enough on top of its domestic problems to dispense with demagogic diversions.

This Estimate will examine the Mexican situation and prospects under the Lopez-Portillo Administration insofar as they have implications for US interests.

B. The Mexican Economy and Society

3. For most of the period since the late 1930s, Mexico has been among the more successful developing countries in terms of both political stability and economic growth. Despite the country's violent past, Mexico's presidents have been able to rule and transfer rule without threat of coup, revolution, or military pressure. Successive administrations, though far from democratic, have responded to the interests of most groups in Mexican society reasonably well. Moreover, they have maintained public order and their own authority without relying heavily on the more blatant forms of censorship and repression.

4. Effective political authority has allowed Mexico to follow an economic policy that has balanced growth and stability more effectively than has generally been the case in Third World countries. The results have been spectacular. Real growth has averaged 6.2 percent annually since 1950, inflation has generally been low by LDC standards, and diversification has progressed rapidly. During this period the mining and agriculture-based economy evolved into a semi-industrialized one. The share of manufactured goods in total exports rose from 7 percent in 1950 to 54 percent in 1974. with the border



President Jose Lopez-Portillo

MEXICO			
Land: 764,000 sq. mi. 12% cropland 22% forested, 26% other	Literacy: 65% estimated 84% claimed, official		
Population: 63 million, average annual growth rate 3.3%	Labor force: 16 million est. 1975 organized labor 20%		
THE ECONOMY			
	1974	1975	1976 (est.)
Gross Domestic Product (billion 1960 pesos)	375.0	390.9	406.5
Real GDP Growth Rate (%)	5.9	4.2	4.0
Per Capita GDP (1000 1960 pesos)	6.2	6.5	6.5
Inflation Rate (consumer prices) (%)	23.7	15.0	20.0
Budget: Public Sector Deficit (billion pesos)	18.9	31.3	115.0
Current Account Deficit (billion US\$)	2.6	3.8	3.4
Exports (billion US\$)	3.8	3.3	3.9
Manufactures	1.7	1.5	1.7
of which border industries	0.4	0.2	0.6
Petroleum	0.1	0.5	0.6
Other	1.5	1.3	1.6
Imports (billion US\$)	6.1	6.0	6.5
Consumer Goods	0.6	0.6	0.5
Raw Materials and Intermediate Goods	3.0	2.9	2.7
Capital Goods	1.7	2.4	2.3
Foreign Debt (billion US\$)	13.6	17.1	22.0
Direct Foreign Investment (billion US\$)	1.2	.7	N/A
of which			
United States	.3	.3	N/A

industries playing a large part. These achievements were the direct result of an overall strategy that included (a) maintenance of a stable exchange rate, (b) banking and financial policies conducive to the growth of private savings and investment, and (c) public resource allocation policies favoring growth of the private industrial sector.

5. Nevertheless, Mexico faces serious and growing economic problems. Some of these problems have been caused or exacerbated by Echeverria's politically motivated disregard of the three-point strategy that had served the country so well in the past; others are more basic.

6. Mexico's population growth rate of 3.3 percent annually is one of the world's highest and is reflected

in growing urban slums, deterioration in some public services, and—most important from our point of view—shortages of land and jobs that accelerate the illegal flow of immigrants. A few facts should be noted:

- Agriculture, with more than 40 percent of the labor force, accounts for less than 10 percent of GNP.
- Land redistribution—an issue of great ideological as well as practical importance—is nearing its physical limits, while an estimated 4 million peasants remain landless.
- The migration of peasants to such large urban centers as Mexico City, Guadalajara, and Mon-

terrey is a major factor in Mexico's 5.5 percent urban growth rate.

- The rate of unemployment and underemployment, though extremely difficult to estimate, could range as high as 40 percent.
- Income differentials between rich and poor are increasing; in 1950 the lowest decile earned almost 3 percent of total personal income and the highest earned 49 percent, while in 1970 the lowest decile earned only 2 percent compared with 51 percent for the highest.

7. Echeverria came to power in 1970 at a time of considerable political and social unrest. The new president was considered a political hard-liner, the man largely responsible for the Tlatelolco student massacre. Although most opponents of the government, including the students, were middle or upper class, they claimed to speak for the worker, the farmer, and the unemployed. Echeverria, in an effort to shore up his position and perhaps also for basic philosophical reasons, decided to change both his image and traditional economic policy.

8. During the early years of his administration, Echeverria boosted wages and sharply stepped up welfare spending and government investment. The public sector took on a larger role, and social welfare was emphasized with some adverse consequences for economic productivity. When Mexico began to be seriously affected by the world recession, government spending was increased in an effort to sustain economic activity. This expansionary fiscal policy resulted in rising prices and balance-of-payments pressures. Wage increases further eroded Mexico's competitive position. Rising current account deficits in a country already heavily dependent on external borrowing fed rumors of devaluation that encouraged capital flight. The government instituted a managed float of the peso on September 1, 1976—Mexico's first devaluation since 1954.

9. As was true in 1954, the government failed to make clear the rationale of the September devaluation to business, labor, or the general public. It failed to resist union demands for sharp wage increases or to scotch rumors of a coup and fears of a bank account freeze. Business confidence was thus further undermined. In response to resumed capital flight, the government made a second devaluation in October

and on November 22 suspended temporarily the sale and purchase of all foreign currencies and gold by banks.

10. The IMF, responding to Mexican requests for assistance, put together a financial package totaling 837 million in Special Drawing Rights, contingent on Mexico's adopting certain stabilization measures. In order to tide the country over until IMF assistance could be obtained, the United States agreed to a \$600 million special currency swap in addition to the existing \$300 million swap. Thus far Mexico has drawn down \$365 million from the special swap—subsequently repaid—and \$150 million from the US Treasury and \$150 million from the Federal Reserve Bank. Mexico will be eligible to draw down the remaining \$235 million from the special swap when negotiations for IMF extended fund financing are concluded in 1977.

11. The devaluation and subsequent measures taken by the Echeverria administration did not produce the early improvement in the economy that was hoped for; indeed, they may have pushed business confidence to a new low. In addition to having to cope with those basic problems cited in paragraph 6, Lopez-Portillo has inherited an economy afflicted by:

- sharply higher federal spending.
- a record budget deficit,
- a rapid rate of inflation,
- a stagnation of foreign and domestic private investment,
- a slowing of economic growth.
- a large current account deficit, and
- greatly increased foreign indebtedness.

12. Despite Echeverria's attention to social goals, unorganized labor and the unemployed have received few if any lasting benefits. More fundamental problems such as the population growth rate have only begun to be addressed. Nevertheless, surface social tensions are undoubtedly lower in 1976 than they were in the late 1960s. The students are largely cowed, the never-very-important terrorist and bandit movements are well under control, there is little agitation (and even less inclination on the part of

party leaders) for the "democratization" of the government party, and the press remains reasonably happy in its twilight zone between freedom and subservience.

13. In foreign affairs, Echeverria's activist effort to enlarge his—and Mexico's—prestige in the Third World led to increased friction with the United States and other developed countries. Mexican presidents in the past, although sharing their people's distrust of US motives and power, have generally tried to maintain good relations with "the Colossus of the North." Echeverria was a partial exception; while giving private assurances to the US Government, he made common cause with the Third World in his rhetoric against the developed world. Mexico's votes and influence in international forums have reflected Echeverria's orientation.

C. Dynamics of Policymaking in Mexico

14. The Mexican president is the center of decisionmaking in a highly authoritarian system, and, during his single six-year term, he operates under startlingly few institutional limitations. Public opinion and interest groups including the industrial-commercial elite, the government political party, the military, unions, peasant organizations, and the middle class play only a minimal role in influencing policy formulation; they have at best a chance to react to the president's policies. The legislature, the courts, and local governments do not have even this reactive function.

15. There are, of course, external influences operating on the president. At the most basic level, these influences include environmental factors such as available human and material resources, the traditional structure and style of internal politics, the inherited network of foreign relations, the country's geopolitical location, and the existing guiding ideology of the governing elite. This guiding ideology, the so-called "revolutionary consensus," stresses nationalism, social justice, economic development, and constitutionalism (i.e., no reelection). Although a president cannot appear to be acting against any of the elements of the consensus, he has great latitude in defining these elements and setting priorities among them. In any case, all of these influences act primarily as constraints or limits, conditioning what a president feels he can do.

16. Of more direct relevance is the influence of the various state agencies on the president's decisions. The bureaucracies of the national government (e.g., the ministries and the semiautonomous agencies such as PEMEX [the state oil monopoly]) have taken on an increasing number of functions involving the stimulation and guidance of societal development. Particularly in labor and economic matters—wage rates, profit sharing, Mexicanization, type and rate of industrialization—state bureaucracies have taken on increasingly wide responsibilities. Mexican presidents are becoming less able to control these bureaucracies and more dependent on the technical expertise that they can provide, both for understanding the problems on which decisions must be made and for executing the decisions. The technocrats of these agencies—in many cases feeling themselves to be more patriotic and less corrupt than the "politicians"—often have strong opinions on the proper course of government policy within their areas of expertise; their influence could be great on a distracted, uncertain, or weak-willed president. However, it is unlikely that Lopez-Portillo will be this kind of a leader.

II. THE OUTLOOK FOR MEXICO UNDER LOPEZ-PORTILLO

A. Profile of the New President

17. Given the Mexican system, the philosophy, stability, and strength of the president are all important. Unlike all but one of Mexico's post-revolutionary civilian presidents, Lopez-Portillo came to the presidency from an academic and administrative background rather than through the official party organization and the political bureaucracy (Interior Secretariat). While this augurs well for public administration and the economy, the new president's lack of political experience could cause him problems in managing the political process.

18. In assuming the presidency, Lopez-Portillo follows a family tradition of government service. Both his great grandfather and his grandfather served as governors of Jalisco state. His father, Jose Lopez-Portillo y Weber, was a recognized soldier-historian-engineer who played an important role in the historic petroleum nationalization of 1938. He authored a number of scholarly works, including a history of Mexican oil. The new president appears to have

identified strongly with his father's intellectual and literary bent; Lopez-Portillo's novel, *Quetzalcoatl*, is based in part on his father's historical work. On the occasion of his father's death in 1974, he referred to his father as his best friend and distributed copies of his father's book on Mexican oil.

19. Lopez-Portillo joined the official party shortly after he enrolled in the National Autonomous University of Mexico in 1939. After earning his law degree in 1946, he taught law and political science at the University and at the National Polytechnic Institute for the next 21 years. In 1959, he began his concurrent public career with a series of appointive jobs that included membership on commissions on urban development and administrative reform and the position of chief legal consultant to the Secretary of the Presidency. In 1970 he was appointed Undersecretary of National Patrimony by his former schoolmate and long-term friend, President Echeverria. During the Echeverria administration he also served as Chairman of the Federal Power Commission (1972-73) and was Secretary of Finance (1973-75) until resigning to become the official party's candidate for president.

20. Lopez-Portillo appears to be an unusual combination of idealist and pragmatist. He places political events in a broad temporal perspective, which recognizes the evolutionary character of historical development. Although his tendency is to move in a cautious and deliberate fashion, this does not hinder his ability to respond to current problems and urgent needs.

21. A man of precise and meticulous intellect with a strong philosophical inclination—amply evidenced in his treatise *The Genesis and General Theory of the Modern State* and his philosophical satire *Don Q*—he places a high value on language and ideas, emphasizing especially the importance of individual rights. Particularly in times of stress or uncertainty, he can be expected to rely on his intellectual approach to problems developed over many years in the academic world. On the other hand, he is well aware of the dangers of ivory-tower thinking; in his novel *Quetzalcoatl*, the great Toltec culture-hero lets his nation fall into administrative chaos while he studies the stars. Indeed, the elimination of inefficiency in government was one of the strongest themes in his campaign speeches. According to an Embassy assessment,

"Lopez-Portillo's personal style of governing should contrast with Echeverria's. We suspect he will delegate more authority, engage in less frenetic activity, and be less austere in his public and private manner. He has an appealing personality and presidential appearance, which will stand him in good stead with a Mexico that yearns to be proud of its president. He is likely to be Mexico's first genuinely respected and well-liked president since Lopez Mateos (1958-64) and perhaps easier to deal with as a result." A major question that arises with regard to the new president is whether, given his tendency toward broad-scope thinking and delegation of authority, he will maintain adequate control over the bureaucracy and particularly over the state agencies.

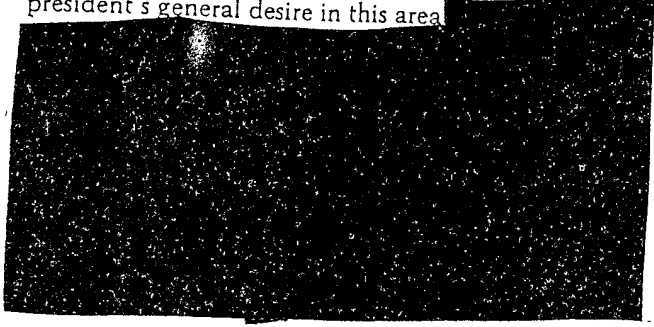
B. Priorities of the Administration

22. The priorities of the Lopez-Portillo administration will be determined by the gravity and immediacy of Mexico's social and economic problems, by the limitations of the Mexican decisionmaking process, and by the character and philosophy of the president. Although, in keeping with the Mexican tradition, the president-elect was unable to publicly define his position to the extent that it conflicted with that of the outgoing president, Lopez-Portillo has revealed much of his political and economic thinking in his writing and in private conversations. We assume that the new president's personal bent will prevail in all cases where it does not conflict directly with Mexican social and economic reality; in other cases a compromise will be reached.

23. The Lopez-Portillo administration will put its economic problems, including those involving US-Mexican relations, first. Mexican relations with the Third World, so strongly emphasized by Echeverria, will not be given the same importance under the new president. The shift in emphasis will, we foresee, create little popular opposition, since neither the general public nor any important subgroup has wholly identified itself with or benefited from the official position on the Third World advanced by Echeverria himself. The United States must, however, be prepared to see Mexico maintain positions in international forums that at times run counter to its own.

24. Lopez-Portillo has indicated through a variety of channels that he wants a closer and more harmonious relationship with the United States than

existed in the time of Echeverria. Here again, we see no important forces that would work against the president's general desire in this area



25. It is in the area of domestic priorities that Lopez-Portillo will face his greatest obstacles. Although concerned with social justice, he will give highest priority to achieving progress through implementation of sound economic policy. The first priority will be to restore financial stability. All interest groups recognize the importance of this task, but they also all hope that it can be done at little or no cost to themselves. Compromises are likely. A closely related priority is that of restoring business confidence—including that of foreign investors—and the president's program may run afoul of reactive groups such as organized labor. Here again, some compromises appear probable. In the longer term, we expect the president to attack the interrelated issues of oil, agriculture, economic growth, and international trade. We believe that Lopez-Portillo will—at least in the first years of his administration—give relatively low priority to political and social problems. Although the president is concerned with the all-important problem of population growth, he is unlikely to find the time or resources to make a vigorous attack on this problem early in his administration

C. Prospects and Possible Strategies

Stabilization, Confidence, and Trade

26. After successive devaluations, the Mexican peso is now undervalued; the problem is no longer one of restoring international competitiveness, but of restoring confidence. The peso's depreciation in international exchange markets after the September decision to float was more than double the estimated erosion of its value through inflation from 1957 through 1976. Despite undervaluation, further depreciation was feared, and massive capital flight was stemmed only

by temporary limitations on foreign exchange transactions.

27. Mexico's last devaluation before the current series (April 1954), which set the stage for two decades of growth with stability, also had severe initial effects. The cause of the 1954 devaluation and the immediate public reaction to it were much the same as in 1976. Although the balance of payments had been under severe pressure for over a year because export prices and volumes had slumped with the end of the Korean War boom, it was substantial capital flight that precipitated the move. Popular reaction to the devaluation was swift and much sharper than expected. Confidence in the government fell, and capital flight increased rather than moderated after the devaluation. Foreign reserves fell by about one half between April and June. Other hoped for benefits of devaluation also failed to appear. Imports, primarily capital goods, continued unchanged, while the dollar value of exports, primarily raw materials, declined. Tourism sagged as domestic prices jumped. The government set about the task of restoring public confidence, attracting investment, and encouraging exports. Some three months after the devaluation the situation began to improve—largely because of a good harvest in Mexico and economic recovery in the United States. Capital flows were reversed before the end of the year. In 1955, inflation receded and the current account went into surplus. The initial undervaluation of the peso—despite its lack of immediate effects—enabled Mexico to live with inflation rates higher than those of its major trading partners for many years.

28. This does not mean that stabilization will come as quickly this time as it did in 1954. Progress will depend on such imponderables as the rate of recovery in the United States and the size of the Mexican harvest. If Lopez-Portillo acts as we believe he will, however, the final results should be similar. The new president reportedly is critical of the handling of the devaluation. His implicit argument appears to be that, given the declining inflation rate and improving trade deficit in the months immediately preceding the devaluation, improved confidence to stem speculative capital flows was an indispensable companion piece to devaluation.

29. If this is indeed the president's understanding of the situation, we believe he will follow the following stabilization strategy:

- Hold a series of public and private talks to persuade businessmen that his administration understands their problems;
- Solidly affirm the objective of reestablishing the strength of the peso;
- Reemphasize that the government has no intention of establishing foreign exchange controls;
- Take special measures to aid individual industries;
- Make use of wage and price controls to reduce the inflationary effects of the devaluation; and
- Announce specific programs to reduce the public sector deficit without greatly increasing the tax burden on business.

30. Lopez-Portillo is known to support the stabilization plan presented to the IMF in the last days of the Echeverria administration. This plan sets out a number of economic measures designed to bring about important structural changes in the Mexican economy. The somewhat optimistic basic objectives of the plan are to:

- Improve the real economic growth rate;
- Increase employment;
- Stimulate domestic savings and reduce foreign borrowing;
- Bring prices in line with those of major trading partners; and
- Achieve a sustainable balance-of-payments equilibrium. The program relies heavily on a fiscal policy of reducing the public sector deficit as a percent of GNP and on an effective incomes policy.

31. The public sector deficit increased rapidly under Echeverria and is currently more than 8 percent of GNP. This should be reduced to no more than 2½ percent of GNP in order to bring external and domestic borrowing down to a manageable level. We doubt that the government can effect such a reduction in less than three years.

32. On the expenditure side, we believe that the government will try to hold its investment expenditures at about 8 percent of GNP—the current level—through better management and strict prioritization. The growth of current expenditures will be cut partly through a reduction of government subsidies but mainly through control of the public sector wage bill. The stabilization program calls for reducing the annual growth rate of federal employment from 10 percent to 2 percent. In pursuit of this goal, the government freeze instituted in the last months of the Echeverria administration may be extended well into 1977. Lopez-Portillo is also known to be considering a major streamlining of the executive branch to cut costs and increase control, and he is expected to hold down the rise in public sector wage rates. On the revenue side, the new government plans to raise its receipts from 26 percent to 30 percent of GNP by hiking taxes and increasing the prices charged by state enterprises.

33. Although cutting the public sector deficit would in itself have a favorable effect on business confidence, the tax hikes involved in this effort—which will fall mainly on business—could undermine this effect. Confidence will be doubly undermined if Lopez-Portillo is unable to limit the growth of real wages. Organized labor traditionally has been a reactor rather than an actor in Mexican decisionmaking; there are signs, however, that this is changing. Independent unions are growing in importance, the aged leadership of the government dominated labor confederation can not last another six years, and the favoritism that Echeverria showed labor may have become institutionalized. Despite these factors, we believe that the new president has the inclination and the political power to hold real wages below pre-devaluation levels during the crucial first years of his stabilization plan.

34. Substantial improvement in the balance of trade is not expected in the short run. Commodity export trends depend heavily on continued recovery of foreign demand, notably in the United States which accounts for 60 percent of Mexico's foreign sales. Capacity limitations caused by several years of lagging capital investment will limit increases in manufactured goods exports. Foreign tourism in Mexico, which usually provides 10-15 percent of foreign exchange earnings, is expected to respond more quickly, and Mexican tourism abroad will be

discouraged Imports, primarily raw materials and capital goods, cannot be cut sharply without curbing economic growth. This year's current-account deficit will total an estimated \$3.4 billion. The government has used most of its foreign exchange reserves and is now relying on large foreign loans to offset recent massive capital flight.

35. In the medium term, currency devaluation should improve the trade account. If Lopez-Portillo is able to induce increased investment in the private sector, a sharp upswing in exports of manufactured goods, especially those of the border industries, should be possible. Exports of raw materials and agricultural products should also increase somewhat as foreign consumers adjust to changes in relative prices and producers take advantage of the more favorable foreign market. Continued import substitution will be encouraged, especially in the manufacture of capital goods.

36. We believe that Lopez-Portillo's stabilization plan will have achieved substantial success by the end of 1978. This will have been as much a result of the president's words as of his actions. As foreign exchange earnings—led by oil, border industries, and tourism—pick up, foreign and domestic businessmen will begin to believe in the presidential commitment to exchange rate stability. Pro business statements, backed by even partially successful efforts to cut budget deficits and hold down wage rates, will create a new atmosphere. Large-scale capital flight should cease in 1977 and new inflows begin well before the end of 1978. The inflation rate, which may exceed 20 percent in 1977, should fall substantially the next year.

Oil

37. As the emphasis of Lopez-Portillo's economic policy shifts from stabilization to growth, oil will become increasingly important. [REDACTED] estimates place oil reserves in the Reforma area of Tabasco and Chiapas states at 20-40 billion barrels, and we believe that additional drilling could yield reserves as large as those of Kuwait—over 60 billion barrels. An all-out development effort would allow Mexico to produce 2.7 million barrels per day and export 1.6 million barrels per day in 1980. At current prices—and we expect Mexico to follow the OPEC-set price though not to join the organization—such a level of exports

would bring in \$7 billion a year. By the end of Lopez-Portillo's term in 1982, Mexico could be well on the way to becoming one of the world's major oil exporters.

38. The new president would clearly like to produce and export oil at something near the maximum rate. He has already indicated that the petroleum sector, along with agriculture, would receive the lion's share of government investment funds. Shortages of equipment and, in some cases, trained personnel could slow development. Although there is a worldwide shortage of rigs capable of drilling to the depths where oil is found in the Reforma area, this shortage has ameliorated greatly in recent months. Lack of equipment should not prove an insurmountable problem, provided PEMEX can obtain sufficient funds or supplier credits. The Mexican policy of demanding a percentage of domestic content in equipment purchased by PEMEX could prove troublesome, if not modified by the government. Although PEMEX workers and engineers are in general quite competent, the pace of development could be increased greatly if foreign contractors were used. Such a step would be contrary to government practice and ideology; Lopez-Portillo has indicated privately, however, that he may make some moves in this area even at the risk of antagonizing PEMEX officialdom.

39. Obstructionism by PEMEX officials and others in the government may prove to be the most serious obstacle to the president's plans for increased production. These officials generally believe that crude output should eventually be limited to amounts that Mexico's refineries can process and that only refined products should be exported. Conservationists within PEMEX also worry that accelerated rates of production could result in the waste of associated gas and limit the long-term productivity of the fields. Lopez-Portillo has some sympathy for these views—wasteful production in the Faja de Oro fields in the 1920s is given great emphasis in his father's book on Mexican oil. The president feels, however, that much higher than current growth rates are well within the bounds of prudent exploitation policy.

40. Much will depend on the ability of the administrators that the new president appoints to the PEMEX hierarchy to make the president's desires felt throughout the organization. Middle-level engineers

and bureaucrats have been notably secretive about the country's increasing oil reserves—in some cases apparently withholding such information from their superiors and from the president himself. On the other hand, the desire of PEMEX technicians to show themselves technically efficient—and how better could they do so than by rapidly increasing production?—and the need of PEMEX to increase exports to pay for equipment imports will strengthen the president's hand. The appointment of Jorge Diaz Serrano as the Director General of PEMEX should greatly assist the president in his efforts to control the PEMEX bureaucracy.

41. In an assumption which we consider most probable, Lopez-Portillo wins most but not all of his battles with the bureaucracy. This would result, by 1980, in a production level of 2.3 million barrels per day and exports at 1.2 million barrels per day (see Table). Such rates would allow Mexico to achieve an estimated current account surplus of \$1.4 billion, despite large and growing imports required for rapid economic growth. Under an alternative, far less likely assumption, Mexico limits its oil output to the level of its domestic needs. With zero oil exports, the current account deficit would be close to \$4 billion in 1980 (see Graph).

PROJECTION OF CRUDE OIL PRODUCTION AND EXPORT LEVELS

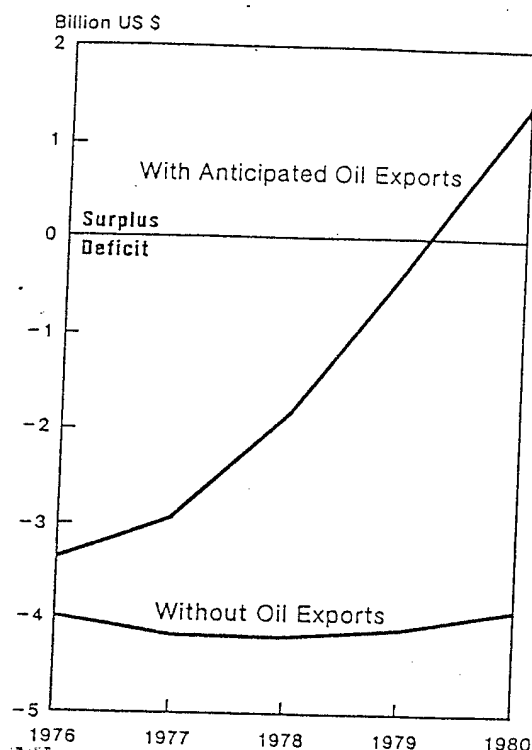
(assuming major but not all-out effort)

Year	Production	Exports
1977.....	1,200,000 b/d	300,000 b/d
1978.....	1,500,000 b/d	550,000 b/d
1979.....	1,850,000 b/d	850,000 b/d
1980.....	2,300,000 b/d	1,200,000 b/d

Agriculture

42. Along with petroleum, Lopez-Portillo has stated that he will give increased attention to agriculture. Mexican agriculture is gripped by two very difficult problems. Increased food production primarily from large commercial farms (i.e., farms having the legal maximum of 100 hectares of irrigated land) is needed to feed the rapidly growing population and to earn foreign exchange. Continued land redistribution to create more rural employment is needed to slow down migration to the cities and to the United States.

Mexico: Outlook for Current Account Balance



~~SECRET~~

Attempted solutions to one problem often exacerbate the other.

43. The factors limiting increases in food output are not easily overcome:

- Mexico has almost run out of new land to bring into cultivation unless expensive long-range development of the tropical southern low land is undertaken;
- The most readily irrigable land is already under cultivation;
- About 80 percent of the crop land is in small plots cultivated by subsistence and semicommercial farmers; and
- Expectations of further land reform keep the large commercial farmers from investing to increase output.

44. The new government must raise productivity in both the modern and traditional farming sectors. The large farmers need security for their holdings or they will continue to restrict needed investments. These farmers also need continued price incentives, a steady flow of new technology, and other economic encouragement to use their land more intensively. The greatest potential for improving agriculture, however, is in those areas of the traditional farming sector with high annual rainfall. Widespread application of presently available technology could in time make Mexico self-sufficient in corn. To do this, the government would have to provide significantly more direct assistance to the small farmers in the form of financial assistance, education, price incentives, and modern infrastructure facilities. Organizing this assistance would be a slow process and would be costly. It would take five to ten years to make a significant improvement in output.

45. Although land reform is an important part of the governing party's ideology, we believe that Lopez-Portillo will stress increased production rather than continued land redistribution. He has stated that "the land doesn't stretch," that he wishes to avoid further division of land holdings into non-economic units, and that many small farms and cooperatives should be combined. We doubt that Lopez-Portillo will reverse the land redistribution executed in the last days of the Echeverria administration. Echeverria's action, however, will pose a serious problem of private sector confidence for the new president. In any event, even radical land redistribution could help only a small part of the 4 million landless peasants in the country. From the point of view of political and social stability, it may be more important to feed the many peasants who go to the city than to accommodate those who stay behind agitating for their own plots of land.

46. Mexico currently has a small favorable balance of agricultural trade, and we expect that it will be able to maintain this favorable balance during most of the next six years. Corn imports, however, will continue to increase sporadically, and, in years of poor rainfall, could cause an overall agricultural trade deficit. The growth of agricultural exports will depend largely on the government's attitude on land reform and the amount of resources that the government is willing to invest in the agricultural sector.

Growth and General Economic Outlook

47. A dramatic improvement in the economic growth rate is highly unlikely during the next two or three years. Only after stabilization is seen to be working and business confidence is fully reestablished will foreign and domestic entrepreneurs make the investments necessary to return Mexico to its traditional growth rate. We doubt that the average annual growth rate will exceed 4½ percent in the period 1976-78. The outlook for the last three or four years of the Lopez-Portillo administration is much brighter. Given the absence of domestic turmoil and foreign recession, we expect Mexican economic growth to average in excess of 7 percent annually in 1979-82. We see such growth being export-led, with oil, tourism, and border industries playing the most important roles

Political and Social Prospects

48. Although Mexico faces serious long-term social problems, we do not see these becoming unmanageable. We do not expect rural and urban unrest, land seizures, strikes, and guerrilla or terrorist operations to cease; indeed, they could increase marginally as the initial social costs of stabilization begin to be felt. We believe, however, that the government will be able to maintain its authority and to stifle and deflect pressures through the traditional methods of cooptation, coercion, and limited reform.

49. We agree with an Embassy assessment that "a split within the ruling coalition, not generalized social unrest, would constitute the most immediate real danger to political stability." The most likely source of such a split would be organized labor.

[REDACTED] This could lead to an internal leadership conflict in which important members of the ruling party, both inside and outside the labor movement, line up against each other. Although rival union leaders would be more likely to look up to the party leadership than down to the workers for their support, there would be an inevitable breakdown of labor discipline. Moreover, a major party split would undermine the president's authority in all areas—and what authority remained would have to be expended

in political fence-mending rather than in solving or containing the nation's social and economic problems. In such a situation, it is not impossible that new leaders—possibly from outside the party and unconnected with the labor movement—could challenge the party's right to rule and the whole Mexican political system. Such leaders might gain considerable middle-class support.

50. We do not believe that the above scenario is likely. The Mexican system has faced a number of similar crises in the past and seems well designed to handle them. Much depends on the strength and will of the president. In the case of a serious union leadership dispute, we would expect the president to come down early and heavily in favor of one of the candidates. The other rivals would be told forcefully that they had everything to lose by crossing the president and a great deal to gain by going along with the presidential decision. The Mexican president has the power to make either the carrot or the stick large enough to do the job.

III. THE IMPACT ON THE UNITED STATES

51. Lopez-Portillo gives every indication that he will take a realistic and constructive approach to relations with the United States and the industrialized world. In private conversations with US officials the president has emphasized his belief that Echeverria's Third World posturing has been counterproductive. It is clear, however, that the president sees "improved relations" as a two-way street and hopes to maximize the economic, financial, and commercial benefits of the new relationship.

52. While we expect Lopez-Portillo to reduce government criticism of the United States and to assume a more cooperative attitude in international forums, he will also try to keep his nationalist credentials in good order. He and his advisers understand US domestic constraints, but if he feels the US response is inadequate to meet what he considers are just demands, Lopez-Portillo may revert to a harder and less cooperative line.

Lopez-Portillo does not seem to have any sense of insecurity vis-a-vis the United States and can be expected to approach issues from a posture of psychological equality and self-confidence. There should be an ample opportunity for businesslike exchanges of ideas.

A. Illegal Immigration

53. The number of Mexicans entering the United States illegally is growing steadily. According to figures compiled by the US Immigration and Naturalization Service, nearly 700,000 illegal Mexican immigrants, or "undocumented migrants," were returned in 1975. There is no reliable data on how many escape apprehension, but the number is probably much greater than those returned each year. Although the problem has not yet been adequately studied, both sides recognize that it originates in Mexico's underdeveloped and overpopulated rural sector and responds primarily to continuing US demand for low-status, low-wage labor.

54. In addition to acting as a safety valve for excess population, illegal migration benefits the Mexican economy in several ways. According to a recent MIT study of selected Mexican communities, most illegal migrants stay in the United States only a limited time—usually from six to eight months. Most migrants, while in the United States, send cash remittances of between \$100 and \$300 a month to their families in Mexico. Such remittances stimulate community economies and slow rural-urban migration within Mexico. Moreover, many returned migrants, having acquired capital and learned new skills in the United States, assume positions of economic or political importance in their communities. The overall effect is to increase the economic and social viability of rural life in Mexico.

55. Since late 1974 the Mexicans have chosen to attack the problem of illegal immigration by establishing labor intensive industries in rural areas. Given the size of the problem, the depressed state of the rural sector, and the shortage of economic resources, this approach will be long and slow.

56. As part of an effort to increase employment in rural areas, Lopez-Portillo will probably ask for special access to US markets for Mexican agricultural products. This would complement plans to create labor-intensive "agricultural production units" to produce agricultural products for export. Lopez-Portillo may also try to get another farm labor agreement with the United States as a part of a

package that would include increased investments in the rural sector and greater access to US markets. The Lopez-Portillo government will try at all costs to avoid any sudden forced return of masses of its nationals from the United States. Such action would greatly increase unemployment, rural unrest, and internal migration to Mexico's large cities.

57. No single approach is likely to reduce the flow of illegal migrants significantly in the near term. Moreover, many approaches encounter conflicting reactions from US labor unions and agricultural interests. Thus, we expect illegal immigration to continue to grow as long as the incentives to migrate—higher wages, better living conditions, and plentiful jobs—are present.

B. Narcotics

58. Most of the heroin and much of the marijuana and dangerous drugs entering the US market are produced in Mexico. Cocaine transits the country en route to the United States. The magnitude of the problem has increased in recent years. There have been indications in recent months that last season's eradication effort has had some impact on the street availability and purity of Mexican heroin in the United States. A sustained Mexican effort will be required, however, if Mexican narcotics are to be reduced over the longer term.

59. Both the United States and Mexico have committed considerable resources to stop illegal traffic, and the Mexicans have made the politically sensitive decision to use herbicides. We believe that the Lopez-Portillo administration, at the policy-making level, will maintain Mexico's commitment to the antinarcotics effort. Lopez-Portillo is concerned over Mexico's own internal drug abuse problem. Because of the centralization of authority in Mexico City, the current poppy eradication program will suffer during the change of administration. Current managers feel that new major program decisions must await the appointment of the new team. More important over the long run will be the degree of dedication of the new leadership, which at this time

remains unknown. Lopez-Portillo asserts that the basis has been set for expanding the drug control program and has indicated that he would welcome more US help.

60

61

Poor management, insufficient manpower, inefficient use of resources, and bureaucratic rivalries remain problems. Natural factors, such as the long growing season and the variety of suitable growing areas, are hard to overcome. Finally, in areas where drug cultivation is the major source of livelihood, any major campaign to eradicate the trade would meet with strong rural resistance which has been increasing steadily over the past eight or nine months. Apparently in recognition of this resistance as well as the severe problems in the rural sector, Lopez-Portillo campaign statements emphasized the need to find alternate sources of income for the campesinos who grow illicit crops.

C. Trade Relations

62. The new president will undoubtedly uphold Mexico's traditional policy of using trade to support industrialization. This means protection of Mexican industry by tariffs and import licensing requirements as well as strong opposition to restrictive measures—such as import quotas, seasonal tariffs, and orderly marketing agreements—applied by developed countries against Mexican exports. The differential export taxes imposed after the first devaluation have

been reduced in some cases and eliminated in others, but they remain potentially troublesome.

63. Mexico is the fourth ranking customer for US exports, and the United States is by far Mexico's leading export market. Nevertheless, US-Mexican trade is hampered by restrictions imposed by both sides. Several of Mexico's important agricultural exports to the United States are subject to marketing orders (although these have not seriously hampered exports in recent years), and its industrial exports are subject to a certain degree of tariff escalation. On the other hand, Mexico is a major beneficiary of the US duty-free system of preferences as well as of US legislation governing border industries. Many products of Mexican protected industries can enter the US market at sufficiently low tariffs to compete successfully. Nevertheless, Mexico feels wronged by the restrictions that do exist and by the threat of new or tougher ones (e.g., marketing orders, countervailing duties, and quotas) and believes that its massive trade deficit with the United States justifies its own protectionism.

64. Lopez-Portillo can be expected to ask for increased Mexican access to American markets. In various statements, he has stressed that high unemployment and the resulting flow of illegal aliens into the United States should be attacked by creating jobs in the export sector. We therefore expect him to push for abolition of seasonal duties and US marketing orders (e.g., on tomatoes, onions, and strawberries) and for "special" application of GSP provisions for Mexico. We believe he would react strongly to any attempt by the United States to create new barriers by changing US Tariff Codes 806.30 and 807.00, which are essential to Mexico's border industries program.

65. Mexico has granted its domestic industry almost total protection from competing imports. Its policy is to deny the entry of goods similar to those made in Mexico as well as to restrict most other imports not considered essential to economic growth. The recent devaluation, however, has allowed Mexico to drop import licensing restrictions on some items and to lower import tariffs. Nevertheless, tariffs on consumer goods, especially luxury goods, are still very high and probably will remain so while the government implements its stabilization program.

66. Mexico is not now a GATT member and thus not bound by its trading rules, reducing US leverage on Mexican trade policy. The United States is reluctant to resort to bilateral negotiations at a time when it is attempting to move most trade negotiations into the multilateral arena. The United States has urged Mexico to join GATT, but thus far the Mexican government has stated that its decision will depend on completion of the GATT reform with regard to special treatment of LDCs. The prospects of Mexico joining should improve under the new administration. Lopez-Portillo has privately said he looks forward to working together with the United States in the Multinational Trade Negotiations and that he hopes to bring Mexico into GATT during his administration.

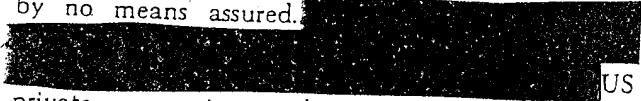
67. Mexicanization, although administered in a nondiscriminatory manner, will continue to affect US private investment. We do not expect Lopez-Portillo to make major changes in Mexico's foreign investment law; we believe, however, that the president recognizes the need for foreign investment and will be willing to adjust procedures and expedite decisions. In his meetings with foreign businessmen Lopez-Portillo has stressed that, while Mexico welcomes foreign investment, such investment must be selective and contribute directly to Mexico's development by creating jobs and earning foreign exchange. Lopez-Portillo has indicated that he will review the controversial Patents and Trademark Law for possible conflicts with Mexico's international treaty obligations. This law includes requirements for the use of a Mexican trademark and shortens the life of exclusive trademark and patent rights. Its modification would be a highly visible welcome sign to foreign investors.

68. Lopez-Portillo's hopes for foreign investment may run afoul of some ideologically opposed Mexican bureaucrats. The National Commission of Foreign Investment recently drew up proposals that would substantially tighten controls on such investment, especially in the food and beverage industries. The proposals reportedly were drawn up without being coordinated at the secretarial level, and their adoption is not likely. We believe that this bureaucratic maneuver was implicitly encouraged by the antibusiness and antiforeign attitudes of the Echeverria administration. To the extent that Lopez-Portillo makes known his own attitudes, we expect lower-level

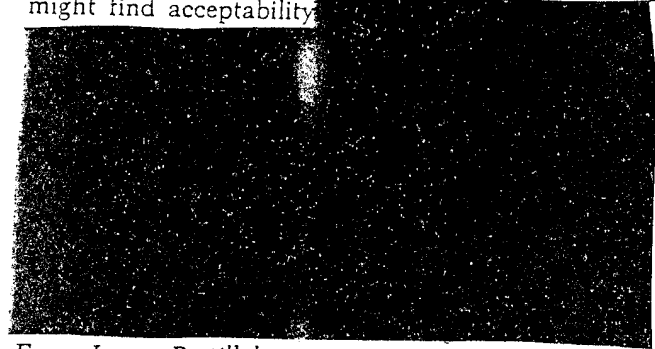
bureaucrats to be much more cautious in their actions and proposals.

D. Oil

69. Although, as we have stated earlier, Lopez-Portillo appears to desire a rapid and orderly expansion of Mexican oil production, such a result is by no means assured.

 US private companies, working closely with PEMEX, could speed up the process, but they are not the critical factor. Lopez-Portillo has indicated that he might be receptive to some form of US private sector involvement; there is a strong under-current of respect for the US oil industry's technical capabilities running through his father's otherwise highly nationalistic book on Mexican oil. Since his new government is short on investment capital, imaginative proposals by

US companies involving financing of equipment, technical assistance, particularly for offshore development, and possibly construction of such infrastructure facilities as coastal storage and loading installations might find acceptability.



From Lopez-Portillo's vantage point it is politically essential that a Mexican oil production campaign be clearly identified as a Mexican initiative serving Mexican, not foreign, interests.