July 17, 1986

WHAT THE U.S. SHOULD DO AS MEXICO HEADS FOR CRISIS

INTRODUCTION

United States policy toward Mexico is at a crossroads. As Mexico struggles through its worst political and economic crisis since the violence of the 1910 Mexican revolution, Washington agonizes over how to support the stability of its neighbor to the south without appearing to interfere in its internal affairs and thus undermine U.S. influence and interests.

Mexico's importance to the U.S. is almost impossible to overstate. It is the third largest trading partner of the U.S. after Canada and Japan. Mexico supplies the U.S. with 16 percent of its imported petroleum and 5 percent of its petroleum consumption. U.S. banks hold one-third of Mexico's outstanding $75 billion commercial debt, and U.S. business has invested about $15 billion directly in Mexico. A Mexican economic collapse would send disruptive waves across the U.S. economy.

A Mexican political crisis also threatens U.S. interests. A destabilized Mexico no doubt would invite Soviet-sponsored adventurism as well as a possible Soviet surrogate bid for power if a political vacuum were to develop. At the very least, this would accomplish a long-sought Kremlin aim: to force the U.S. to direct increasing amounts of its defense resources, including perhaps redeployment of U.S. troops from Europe, to control its 1,947-mile border with Mexico and prevent violent disruptions in U.S. and Mexican border states.

Four years of steady Mexican economic decline have begun taking their toll on a system of government once considered the model of stability among developing countries. Mexicans increasingly are becoming disillusioned with a government they consider inept and morally bankrupt. Discontent with the "system," as Mexico's one-party rule is called, is manifest openly by people and in sectors once loyal to the government. The legitimacy of the ruling Institutional Revolutionary Party (PRI) is also being tested at the polls. For the first time in its 58-year-old reign, the PRI is losing elections to its major rival, the National Action Party (PAN). Most recently, the PRI's political legitimacy was tested last week in Mexico's northern state Chihuahua. It seems to have won the gubernatorial and municipal elections, but in a manner triggering widespread charges of illegalities.

Indeed, to hold on to its power where elections have been held, the PRI has resorted to fraud and manipulation and sometimes repression. By this, the PRI confirms its growing weakness and unpopularity at the very time when the country most needs a confident and strong government. Moreover, with its interference in the Chihuahua and other elections, the PRI is making clear its intention to stop a growing democratic movement in Mexico that would irrevocably change the one-party "system." This sorely tries the Reagan Administration's policy of fostering democracy throughout the region.

Since 1982, Washington primarily has concentrated on restoring Mexico's financial reserves in the hope of shoring up the PRI's political capital as well. But the political crisis may be eroding the Mexican government's ability to pursue such economically necessary but painful measures as reducing the budget, ending subsidies, and holding down wages.

The U.S. wields considerable leverage over Mexico. The Mexican economy depends on U.S. markets; U.S. backing and positive votes at the World Bank and IMF and its pressure on U.S. commercial banks are indispensable to the Mexican government's efforts to restore economic stability; and Mexico needs U.S. investments and technology to make its stagnant industrial sector competitive in the world market.

The U.S. should use this leverage more effectively to promote those policies leading to Mexican economic growth. Among them are: privatize inefficient state-run enterprises, reduce trade and foreign investment barriers, and reduce inflationary public spending.

U.S. leverage also should be used, cautiously, to encourage the Mexican government to respect its people's wishes at the polls, for only this will ensure long-term stability. The U.S. should not, however, involve itself directly in Mexico's internal politics.

On other fronts, U.S. leverage should encourage Mexico to play a more constructive role in Central America. So far, Mexico has been the most active opponent of U.S. efforts to build democracy in Nicaragua. U.S. diplomacy should be conducted quietly, for public pressure may force the Mexican government to adopt a populist anti-U.S. position.

Finally, the U.S. should encourage U.S. banks to make concessions to Mexico. Example: interest rates for existing debt could be reduced to admittedly below market levels. This could be done by allowing the banks to write down their loans over a long period. This kind of write-down was allowed by bank regulators recently to save the farm credit system. The U.S. at the same time should offer Mexico such trade concessions as lowering barriers, lifting embargoes, and raising quotas.

Given some breathing room, the Mexican government would be in a better political position to restructure its economic policies to promote long-term economic growth. U.S. policy should encourage Mexico to make these changes.

WHAT IS BEHIND THE POLITICAL CRISIS

Mexico's political and economic crises are closely entwined and have their source in the populist-socialist policies adopted by Mexican presidents since the early 1970s. Expropriations of private farms and businesses and increasing state interference in Mexico's social and economic life have alienated much of the middle class and major business groups and, as a result, weakened Mexico's economy. The oil boom of the late 1970s was a bonanza for oil-rich Mexico that was squandered. It allowed the government to expand and, in effect, buy political support by making increasing numbers of Mexicans become dependent on the state for their economic welfare. Buoyed by its oil wealth, the PRI borrowed heavily, assuming world oil demand and prices could go only up. When demand collapsed in 1981, the country found itself saddled with debts it could not pay.

The ensuing financial crisis, aggravated by the earlier and sudden nationalization of the banks in 1982, ruptured the uneasy alliance between the PRI and the business groups and middle class. The near collapse of the economy, meanwhile, coming so soon after a period of unprecedented wealth, exposed the mismanagement and corruption of PRI officials and led to a steady erosion of confidence in the government. This, of course, has prompted many of the urban poor to question the PRI's "revolutionary" legitimacy.[1]

1. PRI legitimacy has derived largely from its successful identification with the aspirations of the 1910 Mexican revolution.

A WEAKENING SYSTEM

Faltering popular support, increasing isolation of the ruling circles in Mexico from local political bases, and severe economic pressures now strain Mexico's political cohesiveness. The government often seems paralyzed. The cabinet has been openly divided on such critical issues as foreign debt payment, International Monetary Fund agreements, and economic and political reform. Dissension forced the sacking of Finance Minister Jesus Silva Herzog in mid-June. Even Miguel de la Madrid, Mexico's President since 1982, seems to lack direction and is widely perceived to be weak. This is unusual and alarming, for Mexican presidents are usually at the peak of power as they enter their fifth year of a six-year term. His perceived weakness underscores the extent to which the system he heads is slipping.

Increasingly defensive, the PRI has begun to overreact to public criticism. In May the government stopped the weekly magazine Impacto from publishing an article criticizing de la Madrid. Since then, in a move that shocked Mexico's otherwise cynical press, the government illegally seized control of the magazine and replaced its staff with government supporters. While such action is not unprecedented in Mexico, the resulting furor among journalists is. Naked government repression, moreover, reveals the extent to which the PRI is losing its ability to coopt its critics and negotiate behind the scenes.

ELECTIONS

• There is mounting evidence that the PRI altered registration lists in its own favor and resorted to ballot-stuffing measures to ensure a victory for its candidates in the July 6 Chihuahua election. Before the balloting, the PRI poured money into the region and promised better economic conditions, more hospitals, and social programs. The party mounted a lavish campaign throughout the state. It forced the press to give PRI candidates and spokesmen considerably more coverage and air time than the opposition.

The Chihuahua election was a crucial political test, which the PRI could not afford to lose. Since the PRI had never lost a governorship, to do so would encourage its rivals in the other state elections this year. What the PRI perhaps most fears is that the idea of honest democratic elections is catching on, as a means to protest and change a corrupt and inefficient system. Electoral fraud, once winked at by Mexicans, is now publicly and widely criticized by the press, the influential Catholic Church, and such other important sectors as middle class and business groups. If this democratic movement is not stopped now, the PRI worries that it could destroy the country's centralized one-party system and splinter the PRI into factions.

Fixing the Chihuahua election to prevent a PAN victory hurt the PRI's image at home and abroad. Party leaders, however, apparently feel that the PRI can absorb the damage, and eventually its opponents, once the latest economic crisis is resolved with U.S. and IMF help. The PRI hopes that, if firmly resisted, the growing opposition will in time fizzle out.

HOW THE U.S. HAS DEALT WITH MEXICO

Although U.S. policy on Mexico is conducted through a variety of official channels that are often at cross purposes, the Mexican debt crisis has meant that U.S. policy making has been dominated by the Treasury and, less conspicuously, Federal Reserve Board Chairman Paul Volcker. The basis for this policy has been the stability of U.S. financial institutions and the provision of new loans to debtors so that they can pay the banks back.

To a large extent, the Treasury inherited its lead role by default. The U.S. focus on Mexico traditionally has been primarily economic with political and security issues in the dim background. Improving economic relations has been the overall rationale for U.S.-Mexican policies. Thus when the debt crisis broke in 1982 and Mexico teetered toward default, it fell to Treasury to formulate a "debt crisis" policy. Since then, debt crisis policy has provided the rationale from which flow the policies of the State Department, the U.S. Trade Representative's Office, the Commerce Department, and the National Security Council.

The result has been U.S. support for increased borrowing by Mexico and other Latin American debtors and insistence by Washington that the debtors comply with onerous austerity programs crafted by the IMF. That such programs impose huge political costs on Mexico and other debtors has been ignored, as has been austerity's poor track record in igniting economic growth.

By and large, Mexico's crisis was viewed by the U.S. Treasury as a temporary liquidity problem rather than the more complex systemic and structural problem that it has become. Although the deeper problem is recognized by Treasury Secretary James Baker's 1985 plan for promoting economic growth through structural reforms, Treasury's policies still hinge mainly on increased borrowing by debtors.

This predictably has caused Mexican debt levels and debt service to increase, led to the imposition of IMF austerity policies that undermine economic growth, and in effect guaranteed the current replay of the 1982 crisis. Treasury's approach in fact rests entirely upon an IMF austerity plan that makes Mexico's ability to get new credit from the industrial nations contingent on Mexico's adopting the IMF's short-term stabilization policy. For the Mexican government, however, yet a new IMF austerity program and yet a further increase in foreign debt is politically infeasible, coming as they would after a four-year recession produced to a great extent by earlier IMF austerity programs.

Ironically, the U.S. Treasury seems to be shelving the sensible Baker Plan at the very time when Mexico most needs it for long-term growth. Treasury's main concern has been to provide Mexico with new money to help it stay current on interest due. As a stopgap measure, Treasury is likely to assemble a rescue package for Mexico that could include commodity credits, strategic oil reserve purchases, special Treasury funds (Exchange Stabilization Funds), and straight transfers from the U.S. Treasury to the Mexican Central Bank. The Treasury is also putting pressure on the IMF to negotiate a more flexible agreement with Mexico. And to encourage continued lending to Mexico by U.S. banks, Washington may guarantee new loans.

Thus Treasury's debt crisis policies have not changed since 1982 when Mexico was first bailed out and given new IMF-tied money. Those measures failed to prevent the current crisis. And they almost certainly will ensure future debt crises and greater instability for the region.

POLICY RECOMMENDATIONS

Change Course of U.S. Mexican Policy

The dominance by U.S. Treasury and Paul Volcker over U.S. foreign policy toward Mexico is leading the U.S. to adopt shortsighted and ineffective policies as Mexico's political and economic crisis worsens. While Volcker and Treasury are not entirely to blame for the current crisis, their policies are doing little to help Mexico and in fact are contributing to its further decline.

To begin applying the brakes to this slide, Washington should work with U.S. banks. One possibility is for the banks to begin writing down their bad loans, in effect recognizing that much of the Mexican debt never will be repaid. Mexico then should be persuaded to give U.S. banks equity in Mexican state-owned enterprises as payment for part of the debt. The banks, of course, would have to be allowed to sell these shares of the enterprises and to do what they want with the cash from the sales. The remainder of the debt--having become a more manageable burden--would be repaid on a new schedule. These measures thus would avert the potentially catastrophic debt moratorium without threatening the U.S. bank's financial stability. Meanwhile, the forced resignation of Mexico's pragmatic Finance Minister Silva

Herzog is a warning that the hard-liners are gaining inside the Mexican government.

By pressuring U.S. banks to absorb their bad loans, Washington will put itself on the right side politically in Mexico and gain badly needed credibility for its sound policies of promoting regional stability through economic growth. This will enlarge Washington's scope of influence at the same time that it furthers U.S. economic and security interests.

U.S. policy toward Mexico should reflect a long-term perspective, guided above all by U.S. security interests. To ensure these security interests, the U.S. should study Mexico's political dynamics closely, not assume that the PRI will rule indefinitely, and put itself on the side of the truly nationalist elements of Mexico. Of course, Mexico's historical and deep-rooted resentment of U.S. interference imposes strict limits on the scope of U.S. actions there. The U.S. thus should not become involved directly in Mexico's political developments. But the U.S. should not look the other way when fraud and corruption subvert the natural course of Mexican political development. Washington should use its considerable economic influence to convince the Mexican government of the need for a stable political process. Just as Washington urges political change in South Africa, Chile, and formerly the Philippines, it should do so also for Mexico.

The U.S. should encourage Japan and its NATO allies, particularly Spain, to emphasize to Mexican leaders that Mexico's political system would be strengthened by honest elections. By ensuring a more stable Mexico in the long run, the U.S. should tell its allies, such policies thus would permit U.S. resources to remain available to defend Western Europe.

The U.S. should conduct its diplomacy silently. Public pressure on Mexico could force Mexican officials to dig in their heels against the U.S. This would play into the hands of the PRI's powerful left wing. Investigations, such as those being carried out by the Senate Foreign Relations Committee, should not be used by U.S. policy makers and diplomats to pressure the Mexican government. This kind of pressure would strain bilateral relations, closing off important channels of communication and forcing moderates into less flexible negotiating positions. The U.S., of course, is entitled to investigate such matters as drug trafficking and the debt crisis that directly affect U.S. interests.

Trade and Investment

The U.S should forge agreements with Mexico that promote free trade. Washington should take the first step by lifting its tuna embargo, which nearly destroyed Mexico's tuna fishing industry. The U.S. also should consider negotiating a free trade agreement with

Mexico that would nullify tariffs and eliminate quotas. Ronald Reagan should discuss these matters with President de la Madrid at their August 13 meeting in Washington.

CONCLUSION

U.S. officials are willing once again to pour money into Mexico to avoid a political upheaval that could destabilize that country and make it vulnerable to externally supported subversion. With the support of the U.S. Treasury, the ruling PRI will be able to buy more time. But as the PRI's internal mechanisms for political survival break down and the country's debt level climbs faster than its economy's capacity to grow, the U.S. may find that its policies merely are propping up a house of cards.

U.S. and Mexican long-term interests would be served by American policies that encourage the Mexican government to adapt its system to the needs of its productive sector and to the democratic aspirations of its people. While this could result in a short period of political disequilibrium, in the long run the U.S. would be ensuring a more prosperous and stable Mexico, which would mean greater security for the U.S.

Esther Wilson Hannon
Policy Analyst