Part I:

# The real story of Mexico's inflation

by Tim Rush

A zooming inflation rate in Mexico has City of London banking circles demanding a new peso devaluation, the first since the 80 percent devaluation of late 1976. Friedmanite circles both inside and outside the country are invoking the standard shibboleth as the culprit: "government overspending."

But an *EIR* economic survey shows a different picture.

Mexico's problems are in fact the kind most other Third World countries would willingly trade places to face. In November 1978, this publication outlined the nature of the "coming industrial boom" in Mexico. Now it's here. The economy as a whole grew 7 percent in 1978 and 8 percent in 1979.

This year's growth will be similar. Permit requests for new factories in the first six months of this year surpassed the entire number of permits requested in 1979. New investments from abroad are paced by upward of half a billion dollars pouring into new investment in auto and tractors; Chrysler may be on its last legs in Detroit but it recently announced $250 million for building a giant new engine plant in Saltillo for its Mexican operations.

## Time lag in expansion

What Mexico now faces is a serious accumulation of "growing pains." The recovery in the first years after the 1976 dropoff was by and large based on putting idle capacity to work.

By 1979 the productive plant was straining its previous limits. But there was an inevitable time gap before the results of the feverish pace of new investment could come on stream, compounded by delays in key core projects such as steel, ports and nuclear.

In 1979 imports shot up a whopping 48 percent, 30 percent in real terms. During the first six months of this year, according to the Mexican Foreign Trade Institute, imports of machinery and equipment had outstripped last year's levels by another 35 percent.

The supply shortfalls have translated into a sharp inflationary push in the short to medium term. Demand is outstripping supply not only in goods but in labor and management skills and transportation.

Reports from the capital city and regional centers indicate salaries for trained managers and executives are being bid up at unprecedented rates. In many cases the shortfall of skilled labor means investments are stretched out or simply deferred.

And the surge of imports, now compounded by increased foreign grain purchases, has made already congested ports and railroads a nightmare of inefficiency. Transport bottlenecks have led many manufacturers to anticipate raw material and equipment needs, and place import orders "with a delay factor built in." Of course that has only had the effect of further swelling the import flow.

Translated into statistics: the inflation rate, after dipping to about 16 percent in 1978, rose to 18.2 percent in 1979 (the official figure—unofficially, 20 percent is the generally accepted rate). In the first six months of 1980, the consumer index rose 15 percent—for a 30 percent annual rate. And in the first two weeks of July, preliminary reports indicate yet a further sharp boost, as a 100 percent increase in sugar prices decreed in June, price jumps in basic metals such as steel, and the effects of rotating power cuts all took effect.

## Operation 1976

But not just the inflation rate has taken off. So has a furious campaign for a devaluation, led within Mexico by a crowd of Mont Pelerin Society spokesmen housed in *Impacto* magazine, the daily *El Heraldo*, and private sector thinktanks such as IPADE. Their foreign co-



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factioneers include the City of London bulletin, *International Currency Review.*

In the pages of these press outlets, the most extreme Friedmanites hint of "a new 1976" if the government does not adopt policies aimed at restricting growth. In 1976 the finances of Mexico were left in shambles, after a successful campaign for devaluation spiced with a currency flight estimated at $4 billion.

A devaluation in today's situation, as the franker private sector leaders will admit, will have only one effect on inflation, to increase it. Skyrocketing exports of oil are keeping pace with the increases in imports, so the trade deficit is not expanding.

True, Mexico's industrial exports are stagnating. But this has little to do with an "overvalued peso." The extraordinary surge in domestic demand has gobbled up some inventories otherwise destined for export; and the U.S. market, Mexico's largest, is softening rapidly as U.S. growth rates crumble.

Finally, the government is building into both its "oil for technology" trade policies and foreign investment policies special export incentive arrangements. In the case of the multis, investing companies in many areas are being told they're welcome to a cut of the burgeoning domestic market—if they export a prescribed percentage back into their home operations elsewhere.

Thus the real effect of a drive for devaluation is political. The financial uncertainty leading into a devaluation, plus the dislocations in pricing and wage policy that would result, would undermine the credibility of the government as the major protagonist of Mexico's economic takeoff.

This is heady stuff for Friedmanite and other monetarist opponents of Mexico's dirigist development strategy. And needless to say, many in Mexico's private sector leadership are already planning to translate economic chaos into political leverage in the selection of the 1982 presidential choice to succeed López Portillo.

## Drain out of pesos

"Dollarization" has been one of the primary weapons of those seeking to play a devaluation card. The outflow of capital from pesos to dollars resumed in early 1979, after tailing off the previous two years. In the first nine months of 1979, peso deposits increased 18 percent, while dollar accounts zoomed 29 percent. In the first four months of 1980, dramatic growth in dollar accounts continued, causing serious alarm in government circles.

The dollarization trend has for now been reversed, according to a July 14 Bank of Mexico release. Part of this is due to the lowering of international interest rates.

But part of it is due to the late spring decision to take the ceiling off two-year peso deposit rates, which

## The voices against growth

*The following are excerpts from the May issue of the London-based* International Currency Review *(ICR).*

**On GATT:** After having sat on the fence ever since assuming office in 1976, President López Portillo has finally come down on the side of short-term political expediency—sacrificing Mexico's long-term economic welfare. . . . By voting the way he did [against GATT—ed.], he showed himself to be in the mould of the short-sighted protectionist and self-glorifying politicians who have contributed so much to bringing the Mexican economy to its present precarious state.

**On devaluation:** It is now abundantly clear that the López Portillo administration made a most serious blunder in returning to a fixed rate of exchange following the financial crisis in 1976. . . . Having missed the boat in December 1976, Sr. Portillo is drifting toward a repetition of his predecessor's nightmare. The main difference between the present rumbling crisis and President Echeverria's last year in office, of course, is the presence of exploited oil. Far from easing the situation, however, the oil boom has directed the economy into a box, from which a forced devaluation may turn out to be the only viable exit. . . . It is only a matter of time before the country slips into a chaotic revolutionary environment reminiscent of Iran. . . .

*The following are excerpts from a column appearing in the Mexico City weekly* Impacto*'s July 16 edition:*

Evidently, the regime *does not want* to combat inflation [emphasis in the original]. . . .

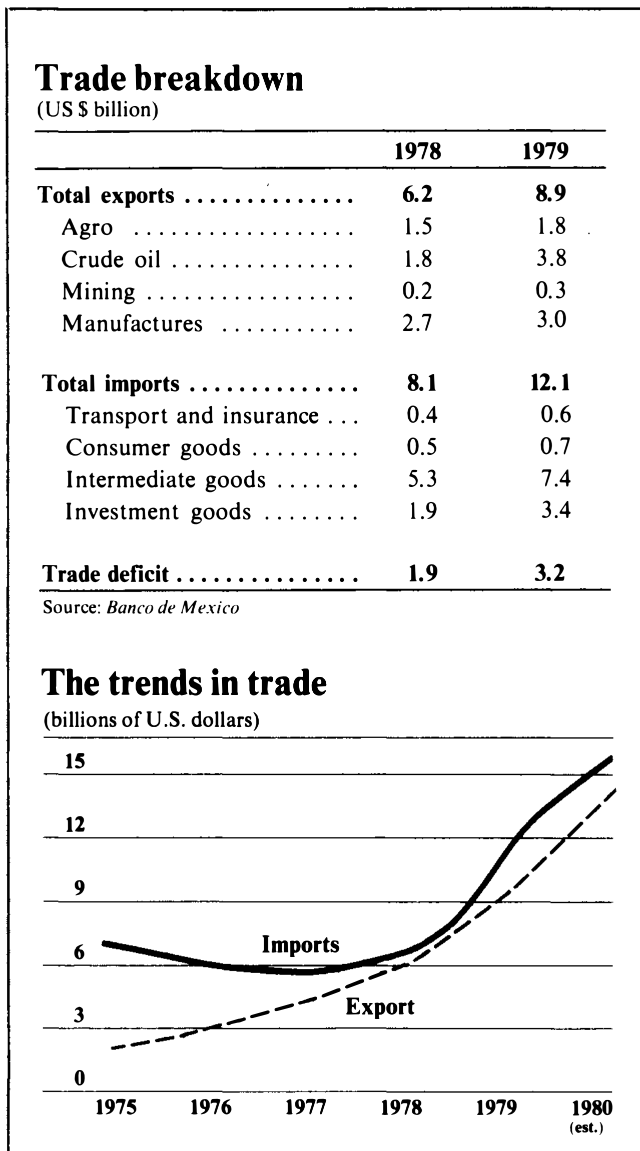
We must not delude ourselves or think that through "dialoguing" we can convince the State Interventionists of their error. . . .

We are at the brink of a huge earthquake, and it is dangerously close to the decision-making moments concerning the not-too-distant presidential succession. We who oppose all this; who constitute an amorphous and dispersed party of authentic opposition, we no longer believe, writing as we have, and as *Impacto* and *El Heraldo* have, that we are going to change things. . . . Many people are breathing a prerevolutionary climate. . . .

promptly shot up 4-5 percent over the then existing 17 percent rate. Higher interest means higher costs for borrowers: the cost of containing dollarization has been high.

The great cry of the devaluation crowd is for a crawling peg, a constantly devaluing peso in "minidevaluation" steps. Recent behavior of the peso has led some financial analysts to assert that that is now de facto the government policy. From approximately 22.85 pesos to the dollar at the beginning of the second quarter, the July 14 quotation had sunk to 23.05 pesos to the dollar.

But there have been similar small downward adjustments since stabilization of the peso in late 1976. The government policy is ambiguous, and probably deliberately so. The government may well want to have slight



## Trade breakdown
(US $ billion)

| | 1978 | 1979 |
|---|---|---|
| **Total exports** | **6.2** | **8.9** |
| Agro | 1.5 | 1.8 |
| Crude oil | 1.8 | 3.8 |
| Mining | 0.2 | 0.3 |
| Manufactures | 2.7 | 3.0 |
| **Total imports** | **8.1** | **12.1** |
| Transport and insurance | 0.4 | 0.6 |
| Consumer goods | 0.5 | 0.7 |
| Intermediate goods | 5.3 | 7.4 |
| Investment goods | 1.9 | 3.4 |
| **Trade deficit** | **1.9** | **3.2** |

Source: *Banco de Mexico*

## The trends in trade
(billions of U.S. dollars)



pressure taken off the peso without locking itself into an official policy of minidevaluations.

U.S. policy, currently focused on retaliation for Mexico's March decision not to join GATT, is aiding the devaluation bugs. "We will make Mexico pay," is the way a top aide to Senator Jacob Javits put it to a reporter last week.

Various trade war measures are in the works which will complicate Mexican development plans. The so-called Tuna War (see Dateline Mexico this week) has been seen in Washington as a favorable opportunity to heighten tensions.

Most serious of all, there are strong indications that Washington pressure played a role in Japan's back-off from substantive deals with Mexico during Ohira's early May trip to Mexico—deals including crucial steel and port projects.

While helping to sabotage aspects of Mexico's supply side inflation control strategy, the U.S. is promoting the Friedmanite "demand side" approaches. The U.S. embassy in Mexico reported to the Commerce Department at the beginning of the month that "Inflationary-pressures are increasing and could require corrective measures which, in turn, would set back the rate of economic growth." A recent Citibank report and articles in *Business Week* and *Newsweek* have all promoted the devaluation scenario.

### Drought and electricity cuts

The government has faced—and faced down—devaluation campaigns in the past. When López Portillo returned from his mid-May 1979 trip to Cuba, suddenly the air was abuzz with the need for a devaluation. The six-month futures market in pesos in Chicago was quoting the peso at 25 to the dollar and lower. In November 1979—just before everyone who had speculated on the Chicago market took a bath—the *Latin American Newsletters* of London were suddenly telling their readers that "Mexican Peso Faces Devaluation after Prolonged Stability."

This time again, the government has moved energetically to deflate the devaluation rumors. Said Bank of Mexico chief Gustavo Romero Kolbeck after the national bankers' convention a month ago: a run on the peso "won't last an hour" because government intervention would halt it.

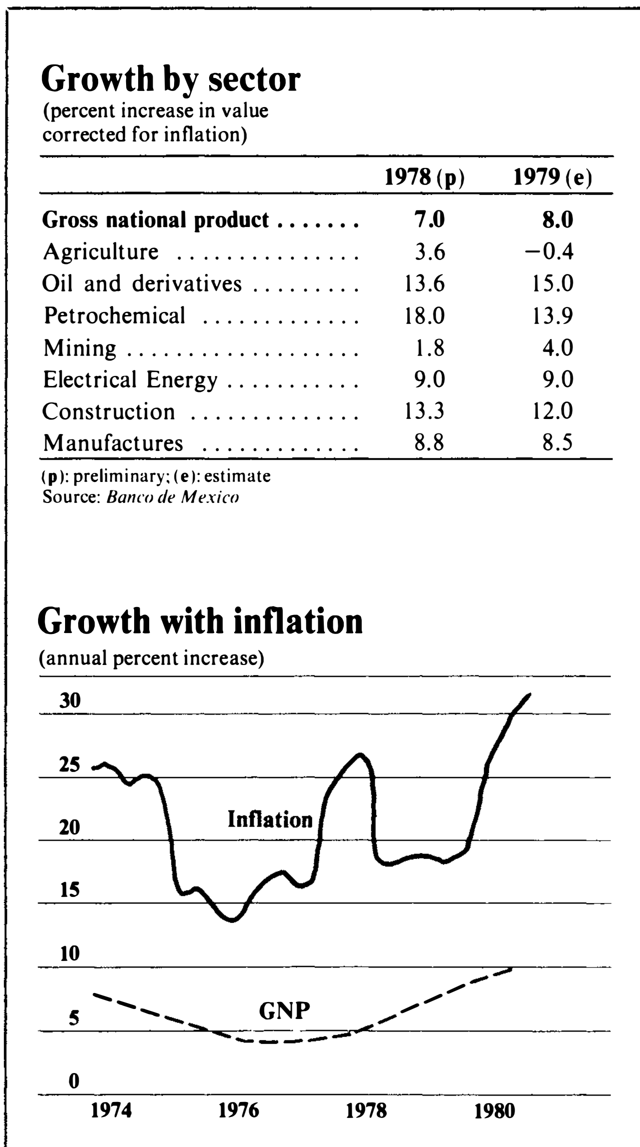
What encumbers the government's maneuvering room this time around is the combination of severe drought and mismanagement in the government-owned electricity sector.

The drought, coming on top of shortfalls in production in the previous agricultural cycle, has necessitated increased imports of food—up to $1 billion worth. This

has both drained oil revenue out of the needed supply side productive investment within the country, and increased pressure on the overloaded transport system. Special U.S. Negotiator with Mexico Robert Kreuger reports up to 4000 box cars, a large number filled with corn and sorghum, backed up at the Brownsville and Laredo border crossing alone.

More disturbing, because it involves a pillar of the National Industrial Development Plan (PNDI), are the sudden revelations of mismanagement in the Federal Electricity Commission.

When rotating electricity cuts were first instituted in mid-June, the CFE attempted to lay the blame on low water levels in the country's hydroelectric system, which accounts for approximately 30 percent of total generating capacity. But the calculations of surplus capacity—



## Growth by sector

(percent increase in value corrected for inflation)

| | 1978 (p) | 1979 (e) |
|---|---|---|
| **Gross national product** ....... | **7.0** | **8.0** |
| Agriculture ............... | 3.6 | −0.4 |
| Oil and derivatives ......... | 13.6 | 15.0 |
| Petrochemical ............. | 18.0 | 13.9 |
| Mining ................... | 1.8 | 4.0 |
| Electrical Energy ........... | 9.0 | 9.0 |
| Construction .............. | 13.3 | 12.0 |
| Manufactures ............. | 8.8 | 8.5 |

(p): preliminary; (e): estimate
Source: *Banco de Mexico*

## Growth with inflation

(annual percent increase)



on paper—should have covered the shortfall. And the area with the most large dams—the Southeast—was the area least affected by the devastating drought.

Finally it came out that equipment breakdowns and poor design in substations at a number of sites around the country had caught up to the CFE, with the drought the final straw. CFE head Cervantes del Rio was axed. New chief Alberto Escofet Artigas immediately announced that real generating capacity showed only half the margin above average demand that had existed on paper.

Major new facilities, such as the Chicoasen dam project (2,000 MWe) and the Laguna Verde nuclear plant (1300 MWe) are well toward completion. So there is no fundamental crisis of future supply. But far greater revenues will have to be directed at maintaining and refurbishing existing plant and equipment. And in the fallout from the scandal, the Monterrey Group has secured "temporary" approval from the Natural Resources and Industrial Development Ministry to expand one of the only privately-held generating plants in the country, a coal-fired plant in Monterrey dubbed PEGI, its Spanish acronym. This is a significant psychological victory in a country where government-private sector animosity runs deep.

### Shift in investment

The broad government strategy is to shift more resources into the bottleneck areas of agriculture and transportation now that the initial enormous demands of the oil expansion program have been met. Pemex, by the end of this year, will have reached the "platform" of 2.5-2.7 million bpd set by the President. There may be further small increases later, but nothing to compare with the extraordinary effort of the 1977-1980 period.

As of 1981, *EIR* expects some substantial flows of money will begin to support development in other priority areas, such as the ports.

But it will require a mobilization of the country's will and capacities, on the order of the Pemex effort, to do this in the short time frame available. Much will depend on whether foreign co-investment and trade can be expanded and accelerated in the proper spheres, especially with Japanese, European and U.S. entities that have viewed Mexico's industrialization as serving the mutual interest. Without such a Mexican mobilization, the pressures of inflation combined with political destabilization efforts throw the situation over to the control of the "demand side" followers of Milton Friedman.

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Next week: Part II of The Mexican challenge: Managing the boom—the fight over agricultural policy.

# Three areas with growing pains

## 1. Steel

Steel is a growing trouble spot in Mexican basic industry. Production last year increased only 4.7 percent, to approximately 7.0 million tons. The rest of the 9.0 million ton demand was made up by imports, at a cost of over $1 billion.

This year, according to early-July statements by Jorge Leipen Garay, director of the state steel holding company Sidermex, it will be necessary to surpass production records "by 20 to 25 percent" during the second half of 1980 to even equal the 7.0 million tons of last year.

Leipen cited the recent electricity rationing imposed by the Federal Electricity Commission as an important factor in the production problems.

Laminated products have suffered a 30 percent drop in output at the Las Truchas plant on the Pacific Coast since the electricity cuts began in mid-June, and a 40 percent drop at the northern Altos Hornos complex.

A costly 50-day strike at Altos Hornos earlier in the year also contributed to the bleak first-half picture. Ahmsa is the largest of the "big three" which make up Sidermex, and the state-owned plants as a whole produce approximately two-thirds of the nation's steel.

U.S. customs officials at the border report Mexican imports of steel during the first four months of 1980 running 25 percent over last year.

But the problems do not stop there. The big long-term projects are backed up.

Leipen made his remarks concerning current production problems at ceremonies initiating infrastructure work for the giant Phase II of the Las Truchas plant. The expansion is slated to raise capacity from the existing 1.3 million tons to 3.3 million, at a cost of $2 billion.

Phase II construction was originally slated to start at the beginning of the López Portillo term, but was axed by the IMF as part of the conditions for the three-year stabilization loan provided to Mexico by the IMF in October of 1976. Then in the summer of 1979, in accordance with the National Industrial Development Plan (PNDI), steel production goals were raised considerably, and the Las Truchas program was back on the track.

However, it took until February to resolve the question of which basic technology to use (the planning authorities opted for the HyL direct reduction method with natural gas). And then in early May the Japanese, who were at the sage of advanced negotiations involving a packet of co-investment loans and supply of technology, suddenly pulled back—reportedly under pressure from Washington, which sought to put a damper on Mexico's potential.

Because of these delays, Leipen announced, only a first section of the plant would be completed by the target date of 1982; full operation is now foreseen for 1984.

Private sector investment began to move with the June announcement that 10 private sector semi-basic steel firms were joining forces to build a 750,000 ton per year sponge iron plant at Altamira, near Tampico on the Gulf Coast. Investment by the group, calling itself Pre-Reducidos Mexicanos (Premexsa), is pegged at $307 million, and inauguration is projected for 1983.

The move had been eagerly sought by government planners. Altamira/Tampico is one of the priority areas for development in the PNDI, and the government plans a later steel complex of its own at the site.

But Mexico is still behind in its drive to have 15 million tons capacity installed and production at 13 million tons by 1985. And for 1990, it is estimated that demand will have surged to some 25 million tons. "Growing pains" for the steel industry will be a fact of life for a number of years to come.

## 2. Ports

The recently announced government industrial ports project is one of the most ambitious city-building plans in the Third World. But its actual implementation, operating in the budgetary shadow of the massive Pemex expansion, has so far been minimal. The urgency of a crash ports program can no longer be deferred, as reports of backed-up vessels loaded with grain, machinery or Pemex equipment in the outmoded port of Veracruz or other deficient port facilities appear almost daily in the Mexican press.

On July 10, Julio Rodolfo Moctezuma Cid, director of Special Development Projects for the presidency, pushed the project forward by providing the public the first specific review of the program as a whole. He said investments totaling $20 billion have been programmed from both the public and private sectors. The government will directly invest $1.4 billion in the port works themselves over the 1980-82 period.

He reviewed progress in the four principal "poles of development" mandated in the government plans (see

map). These poles of development cumulatively involve enormous petrochemical plants, refineries, steel complexes, capital goods production, Pemex facilities, shipbuilding installations, and other capital-intensive industries.

What Moctezuma Cid did not announce is just who will be Mexico's partner in this city-building effort.

During a visit to Tokyo last April, the Minister of Industrial Development, José Andrés de Oteyza, took several proposals for Japanese investment and technical aid in the ports of Lazaro Cardenas and Salina Cruz. Nonetheless, no deals emerged from Premier Ohira's visit to Mexico days later.

Moctezuma Cid has discussed these plans with the French government in several trips to Paris. According to French diplomatic sources, in his visit to France last May, President López Portillo discussed Mexico's industrial projects, including the ports projects, with President Giscard, who saw in them a concrete example of how a new world economic order based on transfer of technology would work. According to the sources, Foreign Minister François-Poncet promoted collaboration with Mexico, while another cabinet faction represented by Finance Minister Monory opposed it.

## Mexico's planned industrial ports

**LAZARO CARDENAS:** Agro-industries; SIDERMEX steel complex; capital goods; FERTIMEX fertilizer complex; shipbuilding and repair; PEMEX facilities

**TAMPICO:** Basic petrochemicals; Lam-black; refining; capital goods (projected); steel (projected)

**COATZACOALCOS:** La Cangrejas and Pajaritos ammonia plants; refining; fertilizer plants; sulfur plants; methanol plants

**SALINA CRUZ:** Tanker port for vessels of up to 250,000 tons; refining

# 3. Nuclear

On July 12, President López Portillo dismissed Hugo Cervantes del Rio as director of the Federal Electricity Commission. A widely accepted explanation for this move was Cervantes's mismanagement of that state company. Nonetheless, the issues also touches on another important problem in the Mexican government's energy planning: its failure to yet define the future expansion of its nuclear program, and the six-year delay in completing Mexico's first nuclear plant in Laguna Verde, Veracruz. If the twin 650 Mw reactors were operating as initially planned, México would not be suffering the electricity cutbacks it has faced since June.

The López Portillo government has repeatedly stressed that it plans an aggressive nuclear program, since its oil, no matter how abundant, will begin to reach limits toward the end of the century. President López Portillo himself has said that by the year 2000 Mexico will have 20 nuclear plants. Nonetheless, no concrete deals were signed during his May trip to Sweden, France and Canada, countries which have completed optimistic nuclear feasibility studies for Mexico.

Decisive in Mexico's nuclear lag has been the Malthusian environmentalist thinking that permeates some top government energy policymaking circles. Most notorious is the director of the National Commission on Energy, Juan Eibenshutz, known for his connections to U.S. and British zero-growth think tanks. His viewpoint is shared by the Undersecretary for Energy and Mines in the Natural Resources and Industrial Development Ministry, Fernando Hiriart.

In a recent interview with a Mexican journalist, Eibenshutz, who is known to bear a visceral hatred for the director of Pemex, Díaz Serrano, energetically praised one of the main founders of the violent European antinuclear movement, Austrian oligarch Otto von Hapsburg, as a "responsible environmentalist."

On July 18, Industrial Development Minister José Andrés De Oteyza once again admitted that the government has not yet taken a decision concerning what kind of reactors Mexico will be using—light-water or heavy-water. He also stated that Laguna Verde and will not come on line until 1983 and suggested that the government may not define the operating details, including sites, of its nuclear program before 1982.

Behind this indecision is the fact that the government has permitted the debate over light- versus heavy-water reactors to occupy a disproportionate place in the planning debate. Manpower training and uranium development, the aspects on which the government is now focusing, are not enough.