

José López Portillo and the Crash of 1976

by Kate Doyle | March 25, 2004

The death of former President José López Portillo on February 17 unleashed a torrent of public rage and bitter obituaries in the Mexican press. Prominent opinion makers called him a Machiavelli, a megalomaniac, a gambler, a disaster; mere hours after he passed away, politicians were lining up before the television cameras to offer scathing critiques of his government and his personality. He did not receive a state funeral.

The anger stemmed not only from the actions—or inactions—of López Portillo during his administration. Yes, he squandered the wealth of the country's newly discovered oil reserves through mismanagement and corruption. Yes, he engineered the perpetuation of the PRI's "perfect dictatorship," while masquerading as a political reformer. Yes, he led Mexico by the nose into the most spectacular economic failure of the western hemisphere at the time, with fiscal policies that culminated in the country's humiliating bankruptcy and debt crisis of 1982.

But López Portillo also had the singular misfortune of donning the presidential sash of a nation already on the brink of economic and political crisis. Through his own flaws he came to personify what were in fact deeper, mostly hidden cracks emerging in the regime's structure. Thus he has come to represent more than the sum total of his regime's bad management—JLP is a symbol for the end of prosperity as Mexicans once knew it, and the inauguration of a prolonged disaster that continues to resonate in Mexico today.

The political crisis of the JLP era has its roots in the policies of repression promoted by Díaz Ordaz and Luis Echeverría. But the first signs of real economic trouble came in 1976, when the fragility of Mexico's financial system was exposed by the devaluation of the peso and the debt crisis that followed. We know today that 1976 was only a prelude to the real crisis, an ominous warning of what was soon to come. It signaled the end of Mexico's "economic miracle"—the decay of the country's industrial plants, the failure of import substitution to stimulate domestic production, the sustained political resistance to carrying out tax reform, and the regime's increasing reliance on foreign borrowing to promote growth.

For this month's article, *Archivos Abiertos* takes advantage of a set of extraordinary documents—most of them held in the Gerald R. Ford presidential library in Ann

Arbor, Michigan, others obtained through the National Security Archive's Freedom of Information Act requests—to explore the crash of '76. The documents offer a rare look behind the closed doors of Washington's economic policy establishment as it struggled to come to terms with the unraveling of the "Mexican miracle."

The evaporation of Mexico's economic miracle stunned not only the Mexican public, but also even the most seasoned analysts of the Mexican economy. Although the peso's over-valuation was increasingly obvious during Echeverría's last year in office, many observers assumed that the regime would continue its costly foreign borrowing in the hope that oil revenues would eventually correct the country's enormous trade imbalances and stabilize the economy.

The profligate domestic spending program of the Echeverría government, aided and abetted by López Portillo's Finance Ministry, had sent inflation spiraling into the high double-digits and sparked an unprecedented wave of capital flight, as the private sector sought to protect its profits. When the peso was finally allowed to "float" in late August 1976, it went into a rapid free-fall.

United States opinion of the man who would succeed Echeverría was generally upbeat at the time, although the people in charge had only a sketchy understanding of his style or his policies. Shortly after he took office in December of 1976, the State Department's Bureau of Intelligence and Research wrote a secret report on the new president that emphasized the positive: "López Portillo brings a variety of experience and skills to the job. A former professor and Secretary of Finance, he is an intellectual, a pragmatic, and a skilled administrator whose personal style is to stress reason and compromise rather than rhetoric and ideology."

In response to the economic chaos created by the devaluation, the U.S. government put together a rescue package of funds from the Treasury Department and the



Federal Reserve Bank, and supported the International Monetary Fund in designing a stabilization program and \$1.2 billion loan for Mexico, the country's first in almost two decades.

Capital flight began to accelerate as the Echeverría administration entered its final months and market anxieties rose with the country's inflation rate. In early April 1976, Mancera Aguayo, then Deputy Director of the Bank of Mexico, contacted the Federal Reserve to request a drawdown of the full \$360 million available to it under its swap arrangement with the Fed. The move was intended to counter the rapid dwindling of Mexico's foreign reserves that was underway, as depositors scrambled to take millions of dollars out of the country daily, a flight of capital fueled by fear and increasingly untenable government policies.

The Federal Reserve considered the request briefly and agreed to the swap the next day. In addition to the repeated assurances they had received from senior economic officials about the government's intention to slow the outflow of capital by bolstering market confidence, they looked to the incoming López Portillo administration to adopt the tougher measures required to improve the economy.

"For the longer run," wrote Mexico expert Yves Maroni of the Fed's International Finance Division in a study of economic developments in Mexico dated April 14, "there are reasons for somewhat more optimism. A new Administration will take office in December, following the expected election of former Finance Minister José López Portillo as President in July. The change in Administration may be the occasion for the adoption of stronger anti-inflationary measures if, as seems likely, the new President's Finance Ministry experience leads him to attach more importance than his predecessor to the financial consequences of his political decisions."

It wasn't only the Fed that was optimistic. The Treasury Department also considered Mexico generally sound. That misunderstanding was based in part on its ignorance about how the Echeverría administration was managing the economy. It was also a result of Mexican officials' attempts to minimize the mounting crisis in conversations with U.S. officials. The United States was all too willing to believe what it wanted to believe—that all was well.

When Treasury Secretary William Simon traveled to Latin America in May 1976 to discuss U.S. economic ties with Chile, Brazil, and Mexico, Mexican Finance Minister Mario Beteta and other officials easily convinced him of their fiscal prudence. He described his talks in a memo to President Ford:

The Mexican officials explained to me the measures they are taking to bring public sector spending under

better control. This, along with limiting wage increases, is the key to Mexico's current economic program. They indicated that the increase in public sector expenditures had slowed, revenues had risen and the budget deficit had been reduced in the first four months of 1976. [...] I believe the Mexican government knows what needs to be done economically, and I think the prospects are good for a significant reduction in the level of inflation and in the current account deficit.

The bubble burst on August 31, when the government—reeling from an unprecedented capital outflow that it had been unable to staunch—permitted the peso to "float" against the dollar. Echeverría was forced to repeat the float two months later, and the peso dropped to half of its original value, causing havoc in Mexico's private sector. The tempered optimism among U.S. circles after the first float sank to gloom as the reality of what now faced the country sank in: severe austerity measures, drastically reduced public spending, a freeze on wage increases. The CIA produced a dark analysis of developments in Mexico, stamped secret ("DESTROY WITHIN 90 DAYS") and dated October 30:

President Echeverría has lost the confidence not only of the business sector as such but also of virtually everyone who has savings in Mexico. It is not believed that Echeverría can restore any degree of confidence and therefore stabilization cannot become effective as long as he remains in office. [...] In the final analysis, some form of stabilization must work, the only alternative being a rigid dictatorship which would impose its policies by force as in the Soviet Bloc. We do not foresee this for Mexico within the time frame of the next several years, but we do expect further deterioration and high inflation. [...]

Although López Portillo was on the campaign trail and resolutely silent about the devaluation, the agency pointed out that he was certainly talking to the president:

López Portillo's private secretary insists his boss is not exerting any influence at this time. López Portillo is quoted as saying that Echeverría's authority must not be diluted and that he, López Portillo, does not want a piece of an action which he cannot control. On the other hand, Echeverría and López Portillo have several private meetings each week, and it is difficult to imagine that there would be no give-and-take during these get-togethers.

On November 16, members of the Federal Reserve met in secret to discuss what they called "the Mexican situation." Chairman of the Federal Reserve Board, Arthur

Burns, opened the session with a rueful explanation as to why the Fed had agreed to the swap of \$360 million in April, without foreseeing the devaluation to come.

“The original loan to Mexico of \$360 million was not made by us with due deliberation, with due care. We acted, I think, a little mechanically,” Burns commented. “The fact of the matter is that we were poorly informed about Mexico’s financial condition, and I’m not proud of the way in which we conducted ourselves.”

The repercussions of refusing to aid Mexico were, however, dangerous, said Burns. Not only were U.S. private banks highly vulnerable through their loans Mexico (which, by November, were estimated to be in the neighborhood of about \$12-\$15 billion), but in the event that Mexico might be forced to halt payments, a move that might ripple around the globe with lasting damage to the world economy.

Burns: Now I haven’t found anyone who anticipated a depreciation of the Mexican peso of 50 percent or over. The financial policies conducted by that country have been scandalous; we were inadequately informed. [...] The long and the short of it is that Mexico may be very close to bankruptcy. I mean by that the enormous foreign debts Mexico has contracted—it is by no means clear that Mexico will be able to service those debts and the moratorium may need to be declared. [...] Now that would be a most unfortunate development because our banks are heavily involved in lending to Mexico. And of course it could set off moratoria elsewhere around the world.

With the advice of an internal subcommittee of members designated to negotiate the details of the U.S. loan package to Mexico, the Fed agreed to provide up to \$150 million, matching another \$150 million from the Treasury.

Burns: Now you might wonder why we should make a loan in a case of a country the prospects of which are so gloomy. [...] The factor that led me finally to conclude that it was desirable—I believe that other members of the sub-committee were governed by similar thoughts—was that if Mexico were to declare a moratorium in the near future, having received no help at all from this central bank, then we would inevitably share a certain responsibility for the collapse and for the difficulties that would be caused to our commercial banks. [...] But there is—a new government will come into power and that of course influenced our thinking to a degree and if a reflow of capital took place Mexico could straighten out its affairs; if a

reflow doesn’t take place then I am afraid Mexico will go down the drain.

Although little was known about the incoming president, the Fed looked to his inauguration with anticipation, hoping for relief from Echeverría’s unwillingness to adopt the austerity measures considered necessary to reverse the tide. Henry C. Wallich, member of the Board of Governors and a negotiator on the Fed’s Mexico subcommittee, described that hope, perversely citing López Portillo’s experience as Finance Minister as reason for optimism.

Wallich: Now as to the future, the Chairman has described the situation, a new government is coming in and the President López Portillo is a former Finance Minister. It is hoped that he will inspire confidence. His views are not 100 percent known and there is some apprehension [that] they might lean in the direction of agricultural reform and other things that would certainly not add to confidence. [But] the [International Monetary] Fund thinks that the situation is manageable, if they decide to do the right things, that is, cut down on government expenditures and keep wages from rising unreasonably. On both fronts so far they have not performed very well.

Members of the Fed remained concerned about the exposure of the U.S. private banking sector in Mexico, and the possible interpretation by commercial banks of the Board’s willingness to intervene in the crisis. Philip E. Coldwell of the Dallas Federal Reserve Bank raised the issue with the Chairman:

Coldwell: Was there a consideration that our participation as an official body might have encouraged other people to lend?

Burns: No, no, oh no, but—well, we thought long and hard about that and the last thing we would have wanted to do or did do was to give Mexico a loan and have Mexico use that as a basis for borrowing from the commercial banks and therefore be indirectly responsible for drawing in the commercial banks. We did not fall into any such trap... We could advise the banks to—and we could advise them strongly—to cut back on their foreign lending. If we did that we run the risk [of provoking] the very crisis in international finance that we are seeking to prevent. I’m not talking about Mexico; I’m talking about all around because our banks have in my judgment been rather imprudent once again in lending abroad. [...] In some meetings with private bankers I tried to deal with the question lightly and indicated this is an area that bankers must consider carefully. [...] I have never said to anyone—to answer

your question specifically—that banks should not lend to Mexico. I haven't singled out Mexico.

Paul Volcker, president of the Federal Reserve Bank of New York and soon to become Chairman of the Fed—where he would preside over the 1982 crisis—was given the last word during the meeting. He explained that the Mexican crash took place within the context of broader financial strains worldwide, as the United States and other nations struggled with global recession.

Volcker: I think what we are seeing here is the symptom of general strains and tensions around the world that are going to be difficult to manage. They will be difficult in this case, they may be difficult in other cases, and I feel strongly there is nothing we can walk away from and we will be called upon from time to time for this kind of difficult operation—in Mexico, in this case—maybe there won't be any others, but I suspect there could be. It seems to me a very modest kind of effort on our part. [...]

Burns: I would second that comment—that it's a situation we can't walk away from.

The decision to devalue fatally undermined the credibility of the Echeverría administration, which had made repeated public assurances that there would be no devaluation. In the wake of the float, it was clear that Echeverría was also unwilling to implement the austerity policies required to stabilize the country's fiscal standing. As Robert Hormats, an economic analyst on the staff of President Gerald Ford's National Security Council, pointed out two weeks after the devaluation, "The measure can only improve Mexico's international economic position if followed by appropriate corrective domestic policies. But such policies do not appear to have been devised as yet. The burden will fall on President-elect López Portillo."

It was a burden the López Portillo could not bear. He proved incapable of marshalling the political and economic courage required to stabilize the country. By the time he left office six years later, Washington's opinion of the "skilled administrator" had plummeted into dismay and open contempt. Reviewing his most spectacular failure—the collapse of the Mexican economy—the CIA could barely contain its disgust in describing the contribution that the former president made to the country's near-bankruptcy. In a secret intelligence assessment produced just over a year after Miguel de la Madrid took office ("The Outlook for Mexico," April 25, 1984), the agency observed:

Pressures on former President López Portillo to increase public spending became irresistible after Mexico became a net oil exporter, but the former President's tendency toward grandiose scheming contributed significantly to the disastrous boom and bust cycle that followed. [...] Virtually all social and economic groups have had to accept declining standards of living, scale down their expectations, and compete for benefits and opportunities in a negative sum economic environment. De la Madrid has struggled to preserve social equilibrium and to restore public confidence in the political system. In particular, he has endeavored to distance himself from the egregious corruption and failures of López Portillo and other senior officials of the last government.

The legacy would outlive the man, as the cascade of negative obituaries in the Mexican press would prove after he died last month.

Kate Doyle is director of the Mexico Project of National Security Archives and a regular contributor to the Americas Program (online at www.americaspolicy.org) of the Interhemispheric Resource Center (IRC, online at www.irc-online.org).

Published by the Americas Program of the Interhemispheric Resource Center (IRC, online at www.irc-online.org). ©2004. All rights reserved.

The Americas Program

"A New World of Ideas, Analysis, and Policy Options"

Recommended citation:

Kate Doyle, "Prelude to Disaster: José López Portillo and the Crash of 1976," Americas Program (Silver City, NM: Interhemispheric Resource Center, March 25, 2004).

Web location:

<http://www.americaspolicy.org/columns/doyle/2004/0403portillo.html>

Production Information:

Writer: Kate Doyle

Editor: Laura Carlsen, IRC

Layout: Tonya Cannariato, IRC