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The Next Disaster

Jesse Bogan, Kerry A. Dolan, Christopher Helman and Nathan Vardi 12.22.08, 12:00 AM ET

The Nov. 4 crash of a Learjet in an upper-class Mexico City neighborhood caused a disproportionate amount of destruction. All eight passengers were killed--including Interior Minister Juan Camilo Mouriño, President Felipe Calderón's right-hand man, and José Luis Santiago Vasconcelos, a leading prosecutor against the powerful drug cartels; seven people on the ground died, too.

Hours after the disaster, rumors shot across the capital city like the discharge of automatic weapons: The crash was the work of drug traffickers showing who was boss in this nation of 110 million souls. A preliminary report found no evidence of explosives and strongly suggested pilot error in turbulent conditions. Still, says Larry N. Holifield, former head of the Mexico City office of the U.S. Drug Enforcement Administration, "people won't believe it was an accident. They think everything down there is a conspiracy because half the time it really is." One witness to the crash believes the worst. "A plane just doesn't fall out of the sky," says Guadalupe Rodríguez, 42, a law firm assistant. "The narcos are saying, 'Here we are--and nobody's going to get rid of us.'"

You can forgive Rodríguez for thinking so. This year, through mid-November, there have been 4,300-plus drug-related deaths in Mexico, compared with 2,500 in 2007. Edgar Millán Gómez, who oversaw the joint efforts of the army and federal police, was assassinated in May in his home in Mexico City. Roberto Velasco Bravo, a federal chief of criminal investigations, was shot in the head a week earlier. The *narcotraficantes* have infiltrated the highest levels of law enforcement, including, allegedly, Mexico's principal link to Interpol and its former senior drug czar. Mexico, once again, is battling the ever powerful gangs. "It has been a fierce bloodbath," says Felipe González González, president of the Senate public security commission and former governor of the central state of Aguascalientes. "We have more dead than you have in Iraq."

Is Mexico descending into criminal and economic chaos? "Failed state? That is a very irresponsible remark," bristles Arturo Sarukhan, Mexico's ambassador to the U.S. "The challenge of corruption is being taken on. We are rooting out people who have been infiltrated. Look at the role of the Mexican private sector and civil society. Nowhere can you see signs of anything akin to a failed state."

But there is urgent concern north of the border about a potential strategic threat. "We're fixated on Iraq and Afghanistan, but from a homeland security perspective, right here on our border, isn't this more important?" asks Fred Burton, a former State Department counterterrorism official, now a vice president at Stratfor in Austin, Tex.

Washington, D.C. is fretting, too. "The consequences for both our countries in the near future and the not-so-near future could not be greater," says John Walters, director of the White House Office of National Drug Control Policy, a.k.a. the drug czar. "The consequences if President Calderón fails and the institutions of government, at least in the northern part of his country, become controlled by terrorist mafias--well, we worry about ungoverned spaces far away from the U.S., and this is right next door."

No disagreement from Antonio Oscar (Tony) Garza, U.S. ambassador to Mexico. "The focus of the last couple years has clearly been security," he says. In the so-called Mérida initiative, Uncle Sam has committed $1.4 billion in military hardware to help Mexico battle the cartels. But as of late November no significant transfers had yet occurred.

The explosion of narco terror comes alongside a precipitous drop in oil prices and the crushing effects of a deep U.S. recession. The climate of fear is kicking the life out of the economy. The second wave of the global financial crisis is playing out in the developing world--and right on our doorstep. After expanding by 3.2% in 2007 to $900 billion, Mexico's GDP growth will slow to 1.5% this year and tumble to somewhere between zero and 0.7% in 2009, predicts Raúl Feliz, an economist at CIDE, a Mexico City think tank that specializes in economics and politics. While some of that meager expansion will come from government stimulus spending, its hands are tightly tied because state-owned oil monopoly Pemex (Petróleos Mexicanos) contributes 37%--$80 billion in 2008--of federal revenue. Next year analysts expect a plunge in petrodollars. Unemployment will jump from its current 4.1%. Throw in part-time workers, who account for roughly one-third of GDP, and the jobless figure soars to 10%. Feliz expects that number to reach 12% next year.

Credit-rating agencies are taking notice. In November Fitch put Mexican government foreign and local currency debt on "negative outlook" (though the ratings are still investment grade). It said that Mexico's ability to absorb global shocks was limited.

To say nothing of internal shocks. Eighty percent of Mexican exports--$240 billion this year, up 10% from 2007--go to the U.S., where shoppers aren't spending. You can see the effects in Ciudad Juárez, just across the border from El Paso, Tex. Roughly 223,000 people work at 330 companies in the maquiladora sector, assembling auto parts for the likes of Lear and Delphi, set-top boxes for Cisco's Scientific Atlanta unit and medical devices for Johnson & Johnson, among others. But 22,000 people have lost maquiladora jobs this year, most of them since August, says Sandra Luz Montijo-Dubrule, president of the Maquiladora Association of Ciudad Juárez. "Seventy percent of our industry here is U.S.-owned factories. Now that the recession has hit, we don't have the consumers in the U.S.," she laments. Worse: Every maquiladora job supports four other jobs in the city.

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Drug-related violence pervades all segments of life in Mexico. "The cartels have an extraordinary capacity for corrupting and intimidating," says U.S. Ambassador Garza. The drug lords operate through most of the country *(see map)*. In Ciudad Juárez the body count is 1,100 this year--200 or more of those deaths in August.

The cartels are also taking a big toll on business. "U.S. companies are worried about the safety of their workers," says Maria Luisa O'Connell, president of the Border Trade Alliance in Phoenix, Ariz. "Drugs have become such a big problem." As they have for the business community throughout Mexico. As a result of many high-profile kidnappings and murders, one of the most vibrant businesses in the nation is security--bodyguards and armored vehicles. An executive can shell out as much as $500,000 a year to protect himself and his family, reports Stratfor.

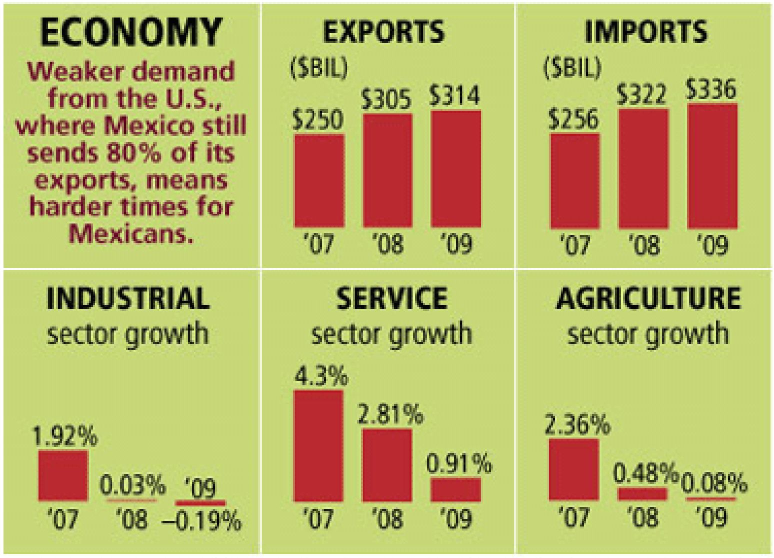
Many Mexicans believe the problem originates in the U.S., and that the cartels could be wiped out tomorrow if gringos wrestled seriously with the demand side of drugs. But the Mexican government realizes what it's up against at home. "The state is fighting against an opponent with no limits on arms or financial resources," says Jorge Gonzalez, a professor of international economics at Trinity University in San Antonio, Tex. and a native of Monterrey, Mexico. Throwing 25,000-plus troops at the U.S. border and other hot spots like the northwestern state of Sinaloa, President Calderón has scored a few headline-grabbing wins. He first targeted the powerful Gulf cartel and its infamous enforcement arm, a group of army deserters known as Los Zetas. In late January special forces arrested Alfredo Beltrán Leyva (El Mochomo, or "Red Ant"), a reputed deputy of Joaquín (El Chapo, "Shorty") Guzmán Loera, Mexico's most wanted man. The last of the five brothers who allegedly ran the Tijuana cartel, Eduardo Arellano Félix, was arrested in October. Most Mexicans, however, believe the cartels are winning the war.

Still, Calderón's assault has disrupted the cartels' business in the U.S. It's reflected in the rising price of cocaine, recently $123 a gram on America's streets, up 27% since early 2007, notes Michael Braun, managing director at Spectre Group International in Alexandria, Va. and recently retired chief of operations at the DEA. Cocaine purity is down 16%.

On the economic front Mexicans like to point out how they are in better shape to weather tough times than they were 14 years ago, when the U.S. and others had to intervene to save the peso. Some of that is true. The federal deficit is down to 0.2% of GDP. Short-term interest rates on government debt, while still high, are 8.3%; inflation is at a manageable 5.8%. Solid companies like Wal-Mart de México (68% owned by the Bentonville, Ark. giant) and América Móvil, the wireless services provider, are still forging ahead with precrisis capital expenditures. There's still hiring going on at the factories in Guadalajara, Chihuahua and Reynosa operated by contract manufacturer Jabil Circuit. PepsiCo recently decided to spend up to $3 billion to expand its snack and drink business.

Mexico's other Nafta partner, Canada, has been investing. Two years ago Bombardier Aerospace, lured by tax breaks and a new university to train people in the industry, opened a wire harness factory in the state of Querétaro. Recently it unveiled a $250 million plan for another factory to make wings and fuselages. Canada's Goldcorp is spending $1.5 billion for a gold, silver, lead and zinc mine in Zacatecas State that will employ 1,000 people. That's on top of the three mines it already operates and the $80 million it's spending to drill for gold.

But these investments hardly make a dent in Mexico's economy. There is plenty of grim news to darken the bright spots. The three leading sectors of the economy--services, industrial and agriculture--are slowing; manufacturing is expected to contract next year *(see charts)*.



Figures for 2008 and 2009 are estimates. *Source: Jaime Ascencio, Actinver.*

One silver lining is that the banking system is well capitalized, at least for now, says Deborah Riner, chief economist for the U.S. Chamber of Commerce in Mexico. As a recent imf report points out, there is little exposure to U.S. subprime assets and no hint yet of a credit crunch. That's because the nation hasn't yet developed an addiction to debt. "In times of crisis, cash is king," says Ricardo Salinas Pliego (net worth: $6.3 billion), who controls TV Azteca, mobile phone provider Iusacell and home electronics retailer Grupo Elektra. Salinas recently spent $41 million buying a 28% stake in the bankrupted chain Circuit City.

Salinas' Banco Azteca makes loans to street vendors, cabdrivers, bricklayers and plumbers--at average annual interest rates of 50%. Vice-Chairman Luis Niño de Rivera indignantly defends the usurious rates, which he claims are the market rates. "There used to be no hope for low-income people who barely had access to credit," he says. "We have changed the history of all these people," as well as allowed them to buy goods and services from Salinas enterprises. With 1,530 branches, Banco Azteca has $4 billion in deposits and $2 billion in loans on its books. Borrowers pay weekly--often handing over small sums to one of Azteca's 5,500 collections officers, who show up on motorcycle. That keeps loan losses down to 5.5%.

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Default rates will rise in a degrading economy. Already there are bleak signs in the $85-billion-a-year auto industry. While Toyota North America insists it's sticking to its schedule next year, Ford of Mexico says it will "adjust our plans accordingly." Nissan Mexicana recently halted production for six days at its Aguascalientes plant and canceled a planned third shift in Civac. General Motors has cut 660 of its 13,000 workers, discontinued its line of GMC Kodiak medium-duty trucks in Toluca and slowed production of SUVs and pickups in Guanajuato. "Everyone is worried about the future," says a spokesman. Chrysler Mexico laid off 400 of 6,000 people in October and is culling 20% of its 1,200 white-collar employees. Delphi has 55,000 workers at 48 Mexican plants, down from 65,000 at 54 factories two years ago. The auto parts maker is asking some employees to take a voluntary reduced workweek at 50% pay.

On the other side of the border look for a large drop in remittances from Mexicans living in the U.S. For 2008 they will be down roughly 10% to $21.6 billion. In 2009, predicts Roberto Newell, chief executive of the Mexican Institute of Competitiveness, total remittances may be off by as much as 25% from last year. Of the 11 million Mexicans in the U.S., 60% of them send money home. Perhaps as many as 150,000 will be unemployed by June, says Manuel Orozco, an analyst at the Inter-American Dialogue in Washington. Many more have already been forced out of high-paying construction jobs into jobs paying a lot less. After interviewing migrants, Orozco concludes that 3% to 7% of them will go home next year.

All this pinches the lives of people like Sandra Ruiz Martínez, 36. She lives in a two-room cinder block home that somehow stays pegged to the hillside of Ecatepec, Mexico City's largest suburb, with her seven children and her sister and her sister's two babies. Six years ago Ruiz's husband, an undocumented immigrant, went to San Juan Capistrano, Calif. to find work (and ended up starting a second family). As a cook, he used to send $135 every eight days. Since his hours were cut in August, he's been remitting the same amount every three weeks. Ruiz says she needs $8 a day to run her household. While the government helps pay for high school, she can't juggle finances until the money arrives, and none of her kids has gone past the equivalent of eighth grade. The latest squeeze means no new shoes or clothes for anyone. Still, the tiny house is full of laughter. "Why be broke *and* sad?" she shrugs. "We try to forget."

It may be a lot harder to forget next year, when some government subsidies disappear. Hit by the double whammy of sinking oil prices and lower production, Pemex's contribution to state coffers could drop 20% or more to $65 billion in 2009. This despite only $18-per-barrel production costs, a $22 discount on today's spot price in Mexico.

Pemex is in sorry shape. From a peak of 3.3 million barrels a day in 2004, output is down to 2.8 million barrels. Unless someone figures out how to halt the decline, Mexico may become a net oil importer by 2015, says Allyson Benton, analyst at Eurasia Group, a political-risk consultancy in Manhattan. Pemex vigorously contests the prediction.

The problem isn't a lack of resources. Exploration and production chief Carlos Morales Gil says Pemex has 14 billion barrels of proved reserves, 30 billion barrels of probable and possible oil and another 54 billion barrels yet to be found. The culprit is Mexico's constitution, which stipulates that all oil and gas reserves are the sole property of the people of Mexico. That bars Pemex from selling stakes in oilfields to foreign companies--depriving Mexico of the risk capital and the talent that Western oil companies are instead sending to colder climates and deeper waters.

The Cantarell field was so big that Mexico could afford to be xenophobic about oil production. It's no longer the gusher it was: Production is down from 2 million barrels a day in 2004 to 1 million today. "It made us think we inherited a guaranteed flow of dollars for the rest of our lives," sighs Morales Gil.

A new law passed by the legislature will help to a degree. While the wording of new contracts must still be painstakingly matched to the constitution, the reforms permit Pemex to develop the technology of foreign oil services companies--finally opening Mexico to deepwater exploration of the Gulf--and to pay them incentives based on Pemex's success. Morales Gil can envision a nonequity partnership to produce Mexico's oil via platforms on the U.S. side of the maritime border, where Royal Dutch Shell, bp and Chevron are installing an estimated $6.7 billion spar platform that will be linked to fields as far as 10,000 feet below sea level. "Perhaps in these reservoirs it makes sense to get together with the other guys and plan a joint investment," he muses, but "keep the reserves separate."

Pemex says it must spend $20 billion a year for two decades just to keep output stable. That will be very tough to pull off without outside investment--especially for a company sagging under $100 billion in debt. David Shields, an analyst who has long studied Mexican oil, suggests the government take the liability off Pemex's books by converting it to sovereign debt.

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But what foreign investor would be eager to buy that debt when the Mexican public markets themselves are pretty spooked these days? "People don't want to put their surnames on a share listing," Mexican stock exchange president, Guillermo Prieto, recently said. "At least six or seven companies have said crime is a reason [for not floating an issue]." The cartels have left particularly grisly marks, including at least 40 decapitations this year. "You have gangs publicizing that they've killed innocent people to enhance their reputation," says Peter Reuter, professor of public policy at the University of Maryland and a Rand Corp. scholar. On Nov. 3 there were 58 drug-related deaths, including four men burned to death in the beach town of Sinaloa de Leyva. On that same day surgeons in a Ciudad Juárez hospital were ordered out of an operating room as hooded men executed a patient who had shown up with a gunshot wound. With so little faith in his own men, Juárez's mayor fired 400 police officers for failing lie detectors and other tests to root out corruption and started to recruit federal troops to the force.

Chronic fear of kidnapping, or worse, is driving more and more Mexicans north to the U.S. Alejandro Junco, proprietor of one of Mexico's largest dailies, *El Norte*, recently moved his entire family to live in Texas. Pablo Jacobo (Jack) Suneson Bautista, owner of Marti's, a high-end arts and crafts gallery on Guerrero Avenue in Nuevo Laredo, refuses to let his kids come home to work in the business. "No way," he says. "I am just afraid they might be singled out or there might be some kind of kidnapping attempt." No one knows how many Mexicans are fleeing. But Arturo Rolland, a broker at Latin Credit Mortgage & Realty in San Diego, guesses that maybe 100 families a month are moving from Tijuana to the Chula Vista/San Diego area to seek safety. Some because gangsters "are using Facebook and MySpace to track people and their relatives," says a source at the Asociación de Empresarios Mexicanos, an entrepreneurs group in San Antonio.

The *narcotraficantes* have found opportunity in the U.S., too. If the late Colombian drug lord Pablo Escobar had Miami, then Joaquín Guzmán has Atlanta, which has become the East Coast distribution center of cocaine and other drugs for the Mexican cartels. Atlanta's accessibility to key interstates like I-95 and I-85 make it a perfect hub for moving cocaine and marijuana and taking bulk cash back to Mexico. Atlanta's fast-growing Mexican population, lured largely by the region's building boom, has provided excellent cover and resources for the cartel's U.S. emissaries.

Northwestern Georgia is dotted with drug warehouses and money-counting houses, often set up in empty suburban homes furnished with a few tables and laptops. From there cocaine is moved to New York, Pittsburgh, Washington, D.C., Miami and Chicago. The cash can be counted and inserted within 24 hours in sophisticated hydraulic traps built into tractor trailers for the trip to Texas and the southwestern border. No need for cages or safes--the cash at the money-counting houses is kept in closets, and one Gulf cartel moneyman made it clear that the lives of families in Mexico of anyone messing with the efficiency of his money-moving operation were at stake. "I don't know how much more worried I would have to be," says John C. Killorin, director of the Atlanta High Intensity Drug Trafficking Area.

The Gulf cartel has dug its claws into the Atlanta area, as shown by a federal indictment in September of 34 of its members who authorities say were organized into distribution and transportation cells. The feds say the leader, 20-year-old Edgar Rodríguez-Alejandro, was taking orders from the highest levels of the Gulf cartel in Mexico until he was arrested in May with 12 kilos of cocaine and $7.7 million, a slim fraction of the 16,000 kilos of cocaine and 116 weapons recently seized in the U.S. Two cells of Shorty Guzmán's cartel in Atlanta were tracked and 20 indicted in December 2007.

The cartels are getting hard for Americans to ignore. In July a Rhode Island distributor who owed the Gulf cartel $300,000 was lured to an Atlanta suburb and then jumped by three members of the gang, who held and tortured him. He was rescued by the feds. Says Rodney Benson, the DEA's special agent in charge in Atlanta: "My number one concern is that if we don't impact these organizations there may be increased violence down the road."

What about help from the Mérida plan? "The money is going to the wrong side of the border," contends Congressman Ted Poe (R--Tex.). "With the infiltration of law enforcement and so many corrupt officials in Mexico, we don't want that equipment used against us."

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