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Chase Manhattan's Emerging Markets Group memo

By Riordan Roett, *Mexico-Political Update*, 13 January, 1995

SUMMARY

The greatest threat to political stability in Mexico today, we believe, is the current monetary crisis. Until the administration of President Ernesto Zedillo identifies the appropriate policies to stabilize the peso and avoid uncontrolled inflation, it will be almost impossible to address issues such as Chiapas and judicial and electoral reform. Moreover, a prolongation of the crisis, with its negative impact on living standards, raises the issue of labor unrest, specifically, and societal discontent, in general.

THE ZEDILLO GOVERNMENT

The inauguration of Ernesto Zedillo on December 1, 1994 as president of Mexico appeared to open a new chapter in the effort to modernize national politics. In his inaugural address, Zedillo stressed the importance of resolving outstanding political scandals such as the assassinations of 1994; as a guarantee of transparency and he appointed as Attorney General a member of the opposition National Action Party (PAN). The new president called for judicial and electoral reform and for a peaceful resolution of the year-old insurgency in the southern state of Chiapas. He stressed the need for transparency in government and the need to educate and train the Mexican people. Zedillo's cabinet, drawn from the same pool as that of his predecessor, Carlos Salinas de Gortari, gave the impression of competence and commitment.

On December 20, Finance Minister Jaime Serra Pueche, the successful negotiator of the NAFTA during the Salinas years, suddenly announced the devaluation of the peso. In the fall out from that decision, not shared with the international financial community or foreign investors, Serra Pueche resigned and was replaced by Guillermo Ortiz. Ortiz had been number two in the Finance Ministry in the Salinas government and had been appointed as the Secretary of Communications and Transport by Zedillo.

Ortiz is now in charge of the government's recovery strategy. In our opinion, until the government is successful in stabilizing the peso, avoiding a sharp increase in inflation, and

Elections will be held this year in the states of Jalisco, Guanajuato, Yucatan, Michoacan, and Baja California. three will hold both state congressional and gubernatorial elections. Michoacan will vote only for a state congress and Guanajuato only for a governor. In all of the states, the opposition is historically strong and has a history of reacting strongly to electoral fraud, real or perceived.

The government's electoral strategy in 1994 was based on holding together core PRI supporters with the prospects of employment, an increase in real wages, and more spending on public works. The monetary crisis makes it highly unlikely that the PRI can adapt that strategy to the 1995 electoral cycle. Moreover, while the PRI probably won over some opposition votes with its perceived economic success story in 1994, it is unlikely that they will gain any opposition ballots in 1995. The Zedillo administration will need to consider carefully whether or not to allow opposition victories if fairly won at the ballot box. To deny legitimate electoral victories by the opposition will be a serious setback in the President's electoral strategy. But a failure to retain PRI control runs the risk of splitting the governing party. We believe that the ability of the Zedillo administration to resolve the inherent conflicts in the 1995 electoral agenda will be instrumental in determining whether or not the government will be able to fulfill its pledge to liberalize Mexican politics.

THE LABOR MOVEMENT

The labor movement has been the backbone of the PRI for decades. The willingness of labor leadership to take its cues from the PRI has been a fundamental part of the stability in Mexico since the 1930s. The current monetary crisis threatens to undermine that support because of the negative impact on living standards and wages. The fall in value of the peso severely under cuts the capacity of the average Mexican worker to purchase the bare necessities of life each day.

In preparing the emergency economic program announced by President Zedillo on January 3, 1995, the most difficult negotiations were apparently with the labor unions who feared the impact on their membership of the hardships required if the program is to be successful. In September 1994, the unions had signed an agreement with the government and business that allowed a seven percent wage increase for 1995. That agreement also included income-tax credits for the lowest-paid workers and some productivity bonuses in contracts.

The seven percent wage package was considered a fair deal then because the government estimated that inflation would be only four percent in 1995. With the loss of purchasing power and rises in prices resulting from the peso's devaluation, government economists now think inflation might reach fifteen percent in 1995, and some economists say it will exceed twenty percent.

Mexican workers still have not recovered the standard of living they had in 1980, now three devaluations ago. The new agreement signed January 3, 1995 retains the seven percent wage increase. In exchange, the government pledged to minimize price increases and keep inflation from spiraling. Under the agreement, the lowest-paid workers will get a tax credit equal to as much as three percent of income. The government has promised to expand to 700,000 people government-funded scholarships for worker training.

regaining investor confidence, it will be difficult for Zedillo to address the agenda of reforms identified on December 1. There are three areas in which the current monetary crisis can undermine political stability in Mexico. The first is Chiapas; the second in the upcoming state elections; and the third is the role of the labor unions, their relationship to the government and the governing PRI.

CHIAPAS

The uprising in the southern state of Chiapas is now one-year old and, apparently, no nearer to resolution. The leader, or spokesman, of the movement, sub-commandante Marcos, remains adamant in his demand that the incumbent PRI governor resign and be replaced by the PRD candidate who, Marcos argues, was deprived of victory by government fraud in the recent election. Marcos continues to lobby for widespread social and economic reform in the state. Incidents continue between the local police and military authorities and those sympathetic to the Zapatista movement, as the insurgency is called, and local peasant groups who are sympathetic to Marcos and his cronies.

While Zedillo is committed to a diplomatic and political solution to the stand-off in Chiapas, it is difficult to imagine that the current environment will yield a peaceful solution. Moreover, to the degree that the monetary crisis limits the resources available to the government for social and economic reforms, it may prove difficult to win popular support for the Zedillo administration's plans for Chiapas. More relevant, Marcos and his supporters may decide to embarrass the government with an increase in local violence and force the administration to cede to Zapatista demands and accept an embarrassing political defeat. The alternative is a military offensive to defeat the insurgency which would create an international outcry over the use of violence and the suppression of indigenous rights.

While Chiapas, in our opinion, does not pose a fundamental threat to Mexican political stability, it is perceived to be so by many in the investment community. The government will need to eliminate the Zapatistas to demonstrate their effective control of the national territory and of security policy.

STATE ELECTIONS

President Zedillo, in his inaugural address, restated his commitment to opening the electoral system to opposition parties. This has been a principal issue between the PRI-dominated government and the PAN and the PRD in recent years. The more conservative wing of the PRI has opposed political liberalization while the Zedillo group has argued that an opening is both inevitable and justified. The current monetary crisis opens the question of whether or not Zedillo and the reformers will have the capacity to honor the outcome of local elections in 1995. The conservatives will argue that the crisis justifies the continued one-party rule even if it must be maintained by fraud. The opposition, which generally contests PRI electoral victories regardless of the validity of PRD claims, will be emboldened to continue to do so. Zedillo will be faced with a difficult situation in which he will need to neutralize the conservative members of his own party while maintaining his commitment to allow the opposition to win when they do so legitimately.

In our opinion prolonged continuation of the current crisis will result in pressures to reopen the agreement and compensate Mexican workers for their loss of purchasing power prolonged continuation of the current crisis will result in pressures to reopen the agreement and compensate Mexican workers for their loss of purchasing power. The first indication of this occurred on January 11, when the Mexican Confederation of Labor called on its affiliates to demand an immediate 15.3 percent salary increase for January and a 56 percent increase for the rest of 1995. The strong corporatist links between government and unions have weakened in recent years. While the administration still retains influence, it does not have total control. If the crisis continues, the Zedillo administration may be faced with the options of either rejecting worker demands for higher wages and facing the possibility of demonstrations or yielding to worker demands which will further aggravate the economic situation.

CONCLUSIONS

The Mexican monetary crisis has overshadowed the commitment of the Zedillo administration to a new wave of political reforms that include political negotiations to resolve the Chiapas crisis and to guarantee fair elections at the state and municipal levels. It also raises the issue of whether or not the Mexican working class will accept a prolonged period of wage losses and diminished living standards. These social and political questions, which are of high priority to the President, will inevitably be postponed until the economic situation is clarified. To the degree that the Zedillo government is unable to stabilize the peso and avoid inflation, in our opinion, it runs the risk of social and political uncertainty.
