By George Friedman

STRATFOR argued March 13, 2008, that Mexico was nearing the status of a failed state. A failed state is one in which the central government has lost control over significant areas of the country and the state is unable to function. In revisiting this issue, it seems to us that the Mexican government has lost control of the northern tier of Mexico to drug-smuggling organizations, which have significantly greater power in that region than government forces. Moreover, the ability of the central government to assert its will against these organizations has weakened to the point that decisions made by the state against the cartels are not being implemented or are being implemented in a way that would guarantee failure.

Despite these facts, it is not clear to STRATFOR that Mexico is becoming a failed state. Instead, it appears the Mexican state has accommodated itself to the situation. Rather than failing, it has developed strategies designed both to ride out the storm and to maximize the benefits of that storm for Mexico.

First, while the Mexican government has lost control over matters having to do with drugs and with the borderlands of the United States, Mexico City's control over other regions — and over areas other than drug enforcement — has not collapsed (though its lack of control over drugs could well extend to other areas eventually). Second, while drugs reshape Mexican institutions dramatically, they also, paradoxically, stabilize Mexico. We need to examine these crosscurrents to understand the status of Mexico.

Mexico's Core Problem

Let's begin by understanding the core problem. The United States consumes vast amounts of narcotics, which, while illegal there, make their way in abundance. Narcotics derive from low-cost agricultural products that become consumable with minimal processing. With its long, shared border with the United States, Mexico has become a major grower, processor and exporter of narcotics. Because the drugs are illegal and thus outside normal market processes, their price is determined by their illegality rather than by the cost of production. This means extraordinary profits can be made by moving narcotics from the Mexican side of the border to markets on the other side.

Whoever controls the supply chain from the fields to the processing facilities and, above all, across the border, will make enormous amounts of money. Various Mexican organizations — labeled cartels, although they do not truly function as such, since real cartels involve at least a degree of cooperation among producers, not open warfare — vie for this business. These are competing businesses, each with its own competing supply chain.

Typically, competition among businesses involves lowering prices and increasing quality. This would produce small, incremental shifts in profits on the whole while dramatically reducing

prices. An increased market share would compensate for lower prices. Similarly, lawsuits are the normal solution to unfair competition. But neither is the case with regard to illegal goods.

The surest way to increase smuggling profits is not through market mechanisms but by taking over competitors' supply chains. Given the profit margins involved, persons wanting to control drug supply chains would be irrational to buy, since the lower-cost solution would be to take control of these supply chains by force. Thus, each smuggling organization has an attached paramilitary organization designed to protect its own supply chain and to seize its competitors' supply chains.

The result is ongoing warfare between competing organizations. Given the amount of money being made in delivering their product to American cities, these paramilitary organizations are well-armed, well-led and well-motivated. Membership in such paramilitary groups offers impoverished young men extraordinary opportunities for making money, far greater than would be available to them in legitimate activities.

The raging war in Mexico derives logically from the existence of markets for narcotics in the United States; the low cost of the materials and processes required to produce these products; and the extraordinarily favorable economics of moving narcotics across the border. This warfare is concentrated on the Mexican side of the border. But from the Mexican point of view, this warfare does not fundamentally threaten Mexico's interests.

A Struggle Far From the Mexican Heartland

The heartland of Mexico is to the south, far from the country's northern tier. The north is largely a sparsely populated highland desert region seen from Mexico City as an alien borderland intertwined with the United States as much as it is part of Mexico. Accordingly, the war raging there doesn't represent a direct threat to the survival of the Mexican regime.

Indeed, what the wars are being fought over in some ways benefits Mexico. The amount of money pouring into Mexico annually is stunning. It is estimated to be about $35 billion to $40 billion each year. The massive profit margins involved make these sums even more significant. Assume that the manufacturing sector produces revenues of $40 billion a year through exports. Assuming a generous 10 percent profit margin, actual profits would be $4 billion a year. In the case of narcotics, however, profit margins are conservatively estimated to stand at around 80 percent. The net from $40 billion would be $32 billion; to produce equivalent income in manufacturing, exports would have to total $320 billion.

In estimating the impact of drug money on Mexico, it must therefore be borne in mind that drugs cannot be compared to any conventional export. The drug trade's tremendously high profit margins mean its total impact on Mexico vastly outstrips even the estimated total sales, even if the margins shifted substantially.

On the whole, Mexico is a tremendous beneficiary of the drug trade. Even if some of the profits are invested overseas, the pool of remaining money flowing into Mexico creates tremendous liquidity in the Mexican economy at a time of global recession. It is difficult to trace where the

drug money is going, which follows from its illegality. Certainly, drug dealers would want their money in a jurisdiction where it could not be easily seized even if tracked. U.S. asset seizure laws for drug trafficking make the United States an unlikely haven. Though money clearly flows out of Mexico, the ability of the smugglers to influence the behavior of the Mexican government by investing some of it makes Mexico a likely destination for a substantial portion of such funds.

The money does not, however, flow back into the hands of the gunmen shooting it out on the border; even their bosses couldn't manage funds of that magnitude. And while money can be — and often is — baled up and hidden, the value of money is in its use. As with illegal money everywhere, the goal is to wash it and invest it in legitimate enterprises where it can produce more money. That means it has to enter the economy through legitimate institutions — banks and other financial entities — and then be redeployed into the economy. This is no different from the American Mafia's practice during and after Prohibition.

The Drug War and Mexican National Interests

From Mexico's point of view, interrupting the flow of drugs to the United States is not clearly in the national interest or in that of the economic elite. Observers often dwell on the warfare between smuggling organizations in the northern borderland but rarely on the flow of American money into Mexico. Certainly, that money could corrupt the Mexican state, but it also behaves as money does. It is accumulated and invested, where it generates wealth and jobs.

For the Mexican government to become willing to shut off this flow of money, the violence would have to become far more geographically widespread. And given the difficulty of ending the traffic anyway — and that many in the state security and military apparatus benefit from it — an obvious conclusion can be drawn: Namely, it is difficult to foresee scenarios in which the Mexican government could or would stop the drug trade. Instead, Mexico will accept both the pain and the benefits of the drug trade.

Mexico's policy is consistent: It makes every effort to appear to be stopping the drug trade so that it will not be accused of supporting it. The government does not object to disrupting one or more of the smuggling groups, so long as the aggregate inflow of cash does not materially decline. It demonstrates to the United States efforts (albeit inadequate) to tackle the trade, while pointing out very real problems with its military and security apparatus and with its officials in Mexico City. It simultaneously points to the United States as the cause of the problem, given Washington's failure to control demand or to reduce prices by legalization. And if massive amounts of money pour into Mexico as a result of this U.S. failure, Mexico is not going to refuse it.

The problem with the Mexican military or police is not lack of training or equipment. It is not a lack of leadership. These may be problems, but they are only problems if they interfere with implementing Mexican national policy. The problem is that these forces are personally unmotivated to take the risks needed to be effective because they benefit more from being ineffective. This isn't incompetence but a rational national policy.

Moreover, Mexico has deep historic grievances toward the United States dating back to the

Mexican-American War. These have been exacerbated by U.S. immigration policy that the Mexicans see both as insulting and as a threat to their policy of exporting surplus labor north. There is thus no desire to solve the Americans' problem. Certainly, there are individuals in the Mexican government who wish to stop the smuggling and the inflow of billions of dollars. They will try. But they will not succeed, as too much is at stake. One must ignore public statements and earnest private assurances and instead observe the facts on the ground to understand what's really going on.

The U.S. Strategic Problem

And this leaves the United States with a strategic problem. There is some talk in Mexico City and Washington of the Americans becoming involved in suppression of the smuggling within Mexico (even though the cartels, to use that strange name, make certain not to engage in significant violence north of the border and mask it when they do to reduce U.S. pressure on Mexico). This is certainly something the Mexicans would be attracted to. But it is unclear that the Americans would be any more successful than the Mexicans. What is clear is that any U.S. intervention would turn Mexican drug traffickers into patriots fighting yet another Yankee incursion. Recall that Pershing never caught Pancho Villa, but he did help turn Villa into a national hero in Mexico.

The United States has a number of choices. It could accept the status quo. It could figure out how to reduce drug demand in the United States while keeping drugs illegal. It could legalize drugs, thereby driving their price down and ending the motivation for smuggling. And it could move into Mexico in a bid to impose its will against a government, banking system and police and military force that benefit from the drug trade.

The United States does not know how to reduce demand for drugs. The United States is not prepared to legalize drugs. This means the choice lies between the status quo and a complex and uncertain (to say the least) intervention. We suspect the United States will attempt some limited variety of the latter, while in effect following the current strategy and living with the problem.

Ultimately, Mexico is a failed state only if you accept the idea that its goal is to crush the smugglers. If, on the other hand, one accepts the idea that all of Mexican society benefits from the inflow of billions of American dollars (even though it also pays a price), then the Mexican state has not failed — it is following a rational strategy to turn a national problem into a national benefit.

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