The Mexican financial system is now more liberalized than at any previous time in its history. It has changed from a complex to a more simple system. In the last ten years, Mexican banks have been nationalized and then reprivatized. The results of these reforms cannot yet be fully evaluated.

The Mexican financial system

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The evolution and structure of the financial system

In the 1980s, the aggregate macroeconomy suffered severe crises that modified its previous pattern of growth. From the 1940s to the early 1970s, monetary and fiscal policy had been used to achieve constantly high rates of economic growth.

Excessive public sector indebtedness after 1971 led to two successive crises, one in 1976 and a worse one in 1982. Poor macroeconomic management and the abandonment of fixed exchange rates in 1976 stimulated the economy at first, but then led to the worst recession of this century.

This resulted in a shift in economic policy and the adoption of a long term national development plan. Immediate policy actions aimed at containing the rate of inflation (which was reaching unprecedented levels) by reducing the fiscal deficit and controlling foreign exchange. In 1988, the government announced the first of several economic pacts to lower inflation and recover the economy's ability to grow.

The most important event of the last decade was the decision to change the import-substitution industrialization strategy, that had been the core of development policy in Mexico for many decades, to an outward-oriented strategy. The first step was to enter the General Agreement for Trade and Tariffs (GATT) in 1986, after Mexico had refused to do so in 1980.

Since then, Mexico's economy has been thrown into a competitive spree which has resulted in far-reaching changes in its exports, which were traditionally dependent on oil.

The exchange rate had remained fixed at 12.5 pesos per dollar for more than 20 years, from 1954 to 1976. Thereafter, exchange rate policy responded more to antiinflationary criteria than to export promotion or balance

Martín Salas / Imagenlatina.

Monetary controls prevented the banks from becoming more efficient and competitive.

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of payments policy. At times, our currency has been overvalued, and convertibility has been hampered.

For most of its existence, the Mexican financial system has operated under financial repression. Such controls and restrictions as legal requirements on commercial banks, selective credit allocation and control of interest rates applied to a wide variety of financial instruments. Real interest rates were not always negative, however. From 1962 to 1972 interest rates were positive and encouraged domestic savings. This policy led to a constant increase in the deepening of the financial ratio from 20% of GNP in 1962 to 36% in 1972.

Financial repression was increased during the 1970s because of the growing fiscal deficit which reached 9.3% of GDP in 1975. This decade marks the end of a long period when the primary goal was the control of inflation.[1] To achieve this end, public finances were generally kept in equilibrium and international credit was used to cover small deficits in current accounts by means of development project financing.

One of the principal causes of the growing fiscal deficit in the 1970s was the expansion of the public sector. Many enterprises were transfered to the public sector and others were created in the hope that employment would remain high. The government created the so-called *fideicomisos* (trusts) in order to develop particular regions of the country or sectors of the economy. This added pressure on public expenditure was not met by tax reforms or other increases in public revenues. The result was high inflation, an overvalued currency and balance of payments crises. (Table 1)

Table 1
Public fiscal deficit 1970-1992
(as percentage of GDP)

Year	Financial deficit	Primary balance	Operational balance
1970	3.4	1.3	2.6
1971	2.3	0.4	1.3
1972	4.5	2.2	3.3
1973	6.3	3.5	2.5
1974	6.7	3.7	3.1
1975	9.3	6.0	6.8
1976	9.1	4.6	4.1
1977	6.3	2.2	2.6
1978	6.2	2.2	3.4
1979	7.1	2.7	3.8
1980	7.5	3.0	3.6
1981	14.1	8.0	10.0
1982	16.9	7.3	5.5
1983	8.6	-4.2	-0.4
1984	8.5	-4.8	0.3
1985	9.6	-3.4	0.8
1986	15.9	-1.6	2.4
1987	16.0	-4.7	-1.8
1988	11.7	-8.1	3.5
1989	5.6	-8.3	-1.7
1990 p/	3.5	-8.0	1.8
1990 a/	1.9	-6.9	2.8

Source: Treasury Department.
p/ Preliminary.
a/ Projected.
Financial deficit = public sector borrowing requirements.
Primary balance = central government expenditures minus revenues, net of all interest payments.
Operational balance = PSBR minus inflationary component of domestic interest payments.

The banking sector was subject to many regulations on interest rates for deposits and credit allocation. When distortions became evident, a new leading rate emerged which was termed the "Average Percentage Cost" (CPP). The CPP was a rate charged on credit which considered all costs born by the lending institutions. The regulations covered maximum, but not minimum deposit rates. Thus, the regulations were tilted in favor of credit users and against depositors.

It has been argued that monetary controls prevented the banks from becoming more efficient and competitive. However, at least two important liberalizing measures were adopted. Banks were allowed to expand operations almost everywhere and multiple banks were created.[2] This allowed the integration of different financial institutions into one bank.

In 1978, the issuing of new Treasury Certificates made possible a new way of financing the fiscal deficit. The traditional reserve requirements on banks, previously used to draw funds from the private into the public sector, were abandoned.

The 1980s were difficult times for the Mexican economy. The first two years of the decade were marked by capital flight, currency devaluation, external short term indebtedness, exchange controls and the nationalization of the banks. In the following years, growth stagnated and inflation increased from 27% in 1981 to 115% in 1983. This was accompanied by high fiscal deficits in an adverse international environment which was characterized by rapidly rising real interest rates, falling oil prices and deteriorating terms of trade.

Aggregate demand, measured in logarithmic terms, was driven from its long term structural trend during the late 1970s. In 1973, there were already signs that the economy was growing too fast. In 1976 and 1977, an

[1] This strategy was known as *desarrollo estabilizador* (stabilizing development).

[2] Multiple means that a bank may perform deposit, savings, mortgage and other activities in the same office.

attempt was made to check this long-term tendency, but without significant results. Monetary and fiscal policy were atuned to attain high growth rates.

By 1981, the economy was well above its natural trend, with government spending being the principal factor. Private consumption decreased from more than 80% in the early 1940s to 62% in 1984. A restrictive economic policy was necessary to stop the economy's high rate of growth.

The economic crises Mexico's economy experienced during the 1980s demonstrate how informal credit markets arise when there are liquidity constraints in the financial system.

The nationalization of private banks in 1982 marked a complete break from the past. From then on, big brokerage houses began to compete with banks to finance business needs. This had a positive result for capital and money markets since they were now more important and stable.

These reforms in the financial system were part of the government's response to the new international environment in which the economy is operating. From 1954-1970, the years of the stabilizing development strategy, real interest rate policy encouraged savings through positive rates.

In the 1970s and 1980s, there have been wide movements and negative real interest rates in all maturities. Emerging capital and money markets created pressures to raise negative interest rates in the banking sector and resulted in the creation of new competitive instruments.

There are now many more instruments to finance the fiscal deficit. Open market operations have changed the legal requirements and the CPP has been replaced by the "Treasury Certificate Rate" (CETES).

Financing public deficit during most of the 1980s led to high public sector net requirements components which forced up the rate of inflation. Public sector net financing requirements rose after nationalization of the banks because of the need to pay indemnization to the former owners.

Public preference for the newly-issued certificates and government bonds was enhanced by a positive differential interest rate in comparison with deposit certificates issued by banks. This differential interest rate reached a high of 20% in 1988. (Figure 1)

These new instruments, new financial intermediaries and growth of capital and stock markets led to high levels in the financial deepening ratio as measured by the broadest monetary aggregate. (M4)

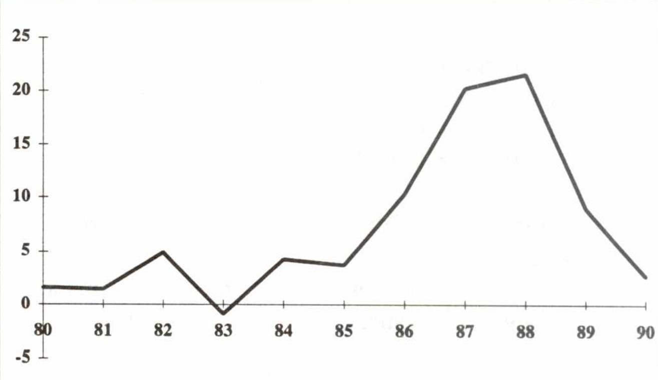
This ratio is 44.1% of GDP, wich compares favorably with the 26% at the end of the 1970s. This policy continued through the 1980s, helping to create and develop money and capital markets.

Prior to the bank nationalizations in 1982, there were 60 commercial or multiple banks. Private banks held a large share of more than 300 Mexican businesses in all sectors of the economy. Many of these are still leading companies. Fourteen development banks were created between 1926 and 1975. Seventeen development trusts were set up to support various sectors of the economy.

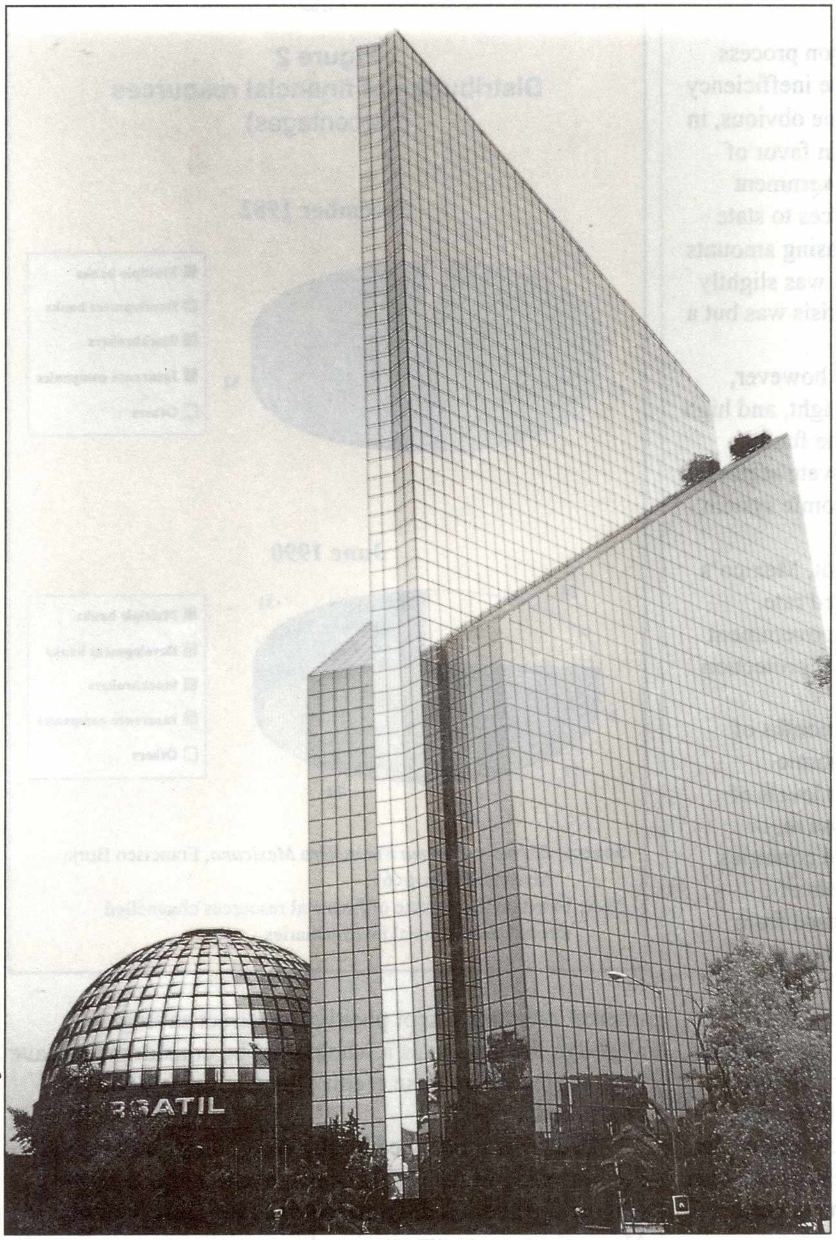
The Mexican banking system now consists of privatized commercial banks, a central bank (*Banco de México*), and the development banks. There are eighteen commercial banks. Six are national, seven are

Figure 1
Differential Interest Rates, 1980-90
Treasury Certificate (CT) minus Deposit Certificate (CD)
(three month rates)

Year	CT	CD	CT-CD
1980	27.73	26.15	1.58
1981	33.23	31.82	1.41
1982	57.44	52.54	4.90
1983	53.75	54.70	-0.95
1984	49.18	44.90	4.28
1985	74.15	70.41	3.74
1986	105.55	95.25	10.30
1987	133.04	112.79	20.25
1988	51.47	29.90	21.57
1989	40.19	31.18	9.01
1990	25.84	23.12	2.72



Source: *Indicadores Económicos,* Banco de México; *La Economía Mexicana en Cifras,* Nacional Financiera.


Marco A. Cruz / Imagenlatina.

The Mexican Stock Exchange's new building.

multiregional, and five are regional. At the time of nationalization, there were 60 private and semiprivate banks. In 1972, there were 250 specialized banks.

The main purpose of the development banks is to finance and assist productive activities in training, use of technology, commercialization and distribution. The *Banco de México*, founded in 1925, sets monetary policy. It is the only institution allowed to print and mint money, regulate interest and exchange rates, and act as a reserve bank.

Finally, there are a number of supervisory institutions: the National Banking Commission, the National Insurance and Bond Commission, and the National Securities and Exchange Commission.

In addition to the structural changes[3] in the economy, the financial system has also been reformed to render it more modern and efficient. Banks are now allowed to determine interest rates and maturities on deposits and to choose the best investment alternatives for such resources.

Non-banking financial intermediaries, such as brokerage houses, and leasing, insurance and factoring companies, have also benefitted from several liberalization measures aimed at increasing domestic savings. Direct investment in the stock market is now possible through investment funds similar to those created abroad.

One of the most important measures taken to promote the modernization was reestablishment of private ownership of commercial banks. President Salinas de Gortari's reprivatization decree of May 2, 1990, includes other weighty elements as well. It permits minority foreign investment in financial intermediaries in order to promote capitalization and the use of advanced technology. Foreign investments may be made by purchasing Certificates of Ownership Shares on a maximum of 34% of marginal capital. These certificates convey corporate rights. Foreign investment is also permitted in financial leasing companies, and insurance and other financial intermediaries. Foreign partners are excluded from ordinary capital investment in commercial banks, stock brokerages, foreign exchange transactions and financial group holdings.

As of June 1990, the three largest Mexican banks held 64.8% of total financial system deposits. Although the system is highly concentrated, resources are now better distributed among financial intermediaries. Multiple banks held 51.9% of the resource structure in December 1982, as compared with 30.8% in June 1990. Development banks also show a significant reduction in their participation. Stockbrokers and investment funds have become important. (Figure 2)

[3] Another important aspect of the structural reform initiated in the Mexican economy is related to state owned enterprises. Since 1982, 908 of a total of 1,155 public enterprises have been sold, merged, liquidated, closed or transferred to the state governments or the private sector.

Financial policy and resource allocation

The growing complexity of the industrialization process resulted in big distortions in the economy. The inefficiency of overintervention in financial matters became obvious, in part, because of a bias in resource allocation in favor of public enterprises. Until very recently, the government channelled subsidized credit and fiscal resources to state enterprises in ever-increasing amounts. Increasing amounts of external debt were contracted. This pattern was slightly altered after 1982, as it was thought that the crisis was but a temporary phenomenon.

This relative optimism started to change, however, with the drying-up of foreign credit, capital flight, and high debt payments. This reduced to a minimum the funds available for investment by the public and private sectors. It was finally realized in the 1980s that the economic system had to be liberalized.

In 1985, Mexico joined GATT. As a result, Mexico's trade regime began to open up at an accelerated rate. Between June 1985 and December 1988, the government substantially reduced the average level of tariff protection from 23.5% to 11.0%.

Similar measures were taken in the first months of 1988 in connection with the associated "Economic Solidarity Pact." This further reduced average levels of protection to less than 10%. This figure is close to, or perhaps less than, that prevailing in developed countries.

Equally important is the reduction in levels of dispersion among nominal tariffs. This decreased from 25.5% to 7.8% between June 1985 and December 1988, pointing to a much greater uniformity of tariff rates by sector.

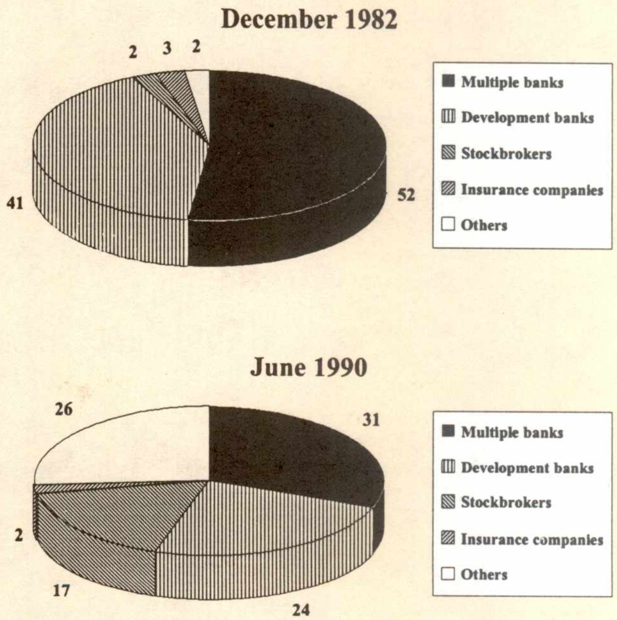
In 1989, the Law on Foreign Investment was modified, considerably reducing the number of activities in which foreign participation is banned. In other activities, new legislation has relaxed many regulations which limited the percentage of equity interest that foreign investors can own. Many legal formalities for foreign investors have been greatly simplified.

As a result of these measures and the reprivatization of the banks, Mexico's direct foreign investment policies are now no more limiting than Canada's before the Free Trade Agreement with the United States, nor than those of other developed nations.

According to theoretical criteria, a financial system is repressed if real interest rates are negative, financial deepening is low, and financial savings as a percentage of total savings remain low. A report by the World Bank (1989) defined the Mexican financial system as highly repressed, at least for the period 1974-1985.

It is the hypothesis of this paper that the study of the Mexican financial system should be divided into different periods. During the stabilizing development years, real interest rates were kept positive to attract savings although the system as a whole may be considered to have been repressed because credit allocation was tightly controlled.

Figure 2
Distribution of financial resources
(percentages)



Source: *El Nuevo Sistema Financiero Mexicano*, Francisco Borja Martínez, FCE, p. 61.
Note: based on the volume of financial resources channelled through are financial intermediaries.

The years mentioned by the World Bank correspond to the beginning of the period of macroeconomic instability. (Figure 3) Inflation differentials with the United States, Mexico's main commercial and financial partner, reflect the discrepancies in economic policy in both countries. Real interest rates in Mexico began to swing to the negative side in a recurrent manner.

Of course, the upward trend in the ratio of financial deepening (M4/GDP) immediately decreased after 1972. It fell from 36% to 22% in five years. The financial imbalance caused by this policy was capitalized by other non-banking intermediaries.

During and after the 1970s, development funds and banks were considered to be a basic instrument of economic policy. Although many of them were of a general type, others were specialized institutions which financed particular activities. Hence, credit policy was used to achieve financing objectives set by structural, sectoral and regional development policies. Many of these institutions merged with other development banks or disappeared altogether in the 1980s.

Commercial and development banks shared equal percentages of credit disbursements during the 1950s and early 1960s. This was a period when large infrastructure projects were undertaken, such as the development of energy resources and steel, roads and transport facilities. In 1965, there was a departure from this trend when the share of private banks increased and that of national banks decreased. This pattern was reversed during the early 1970s. For almost a decade, the share of both types of banks remained at equal percentages. This occurred during the years of the debt crisis when both increased at the same rate. In recent years, the share of private banks in total credit allocation has increased substantially and that of development banks has decreased.

Development banks financed a high proportion of public sector activities, although some funds channelled resources to private areas which needed promotion to foster productivity gains. Commercial banks primarily financed private sector activities, although this proportion decreased with the debt crises, when the growing fiscal deficit demanded extra funds from the private sector.

After reaching a peak when almost 62% of the credit from commercial banks went to the public sector in 1986, this share has decreased every year since and in 1990 amounted to only 29%. This has led to a 60/40 percentage structure of credit channelled to the private and public sectors, respectively.

In real terms, credit supplied by national and private banks has shown a steady upward trend for most of the past three decades. Nevertheless, financing has generally been available only for large enterprises or big projects. Small and medium-sized businesses have had to turn to informal markets and other sources of financing. This has prevented them from integrating with large companies that control an important market share, and has made them less efficient.

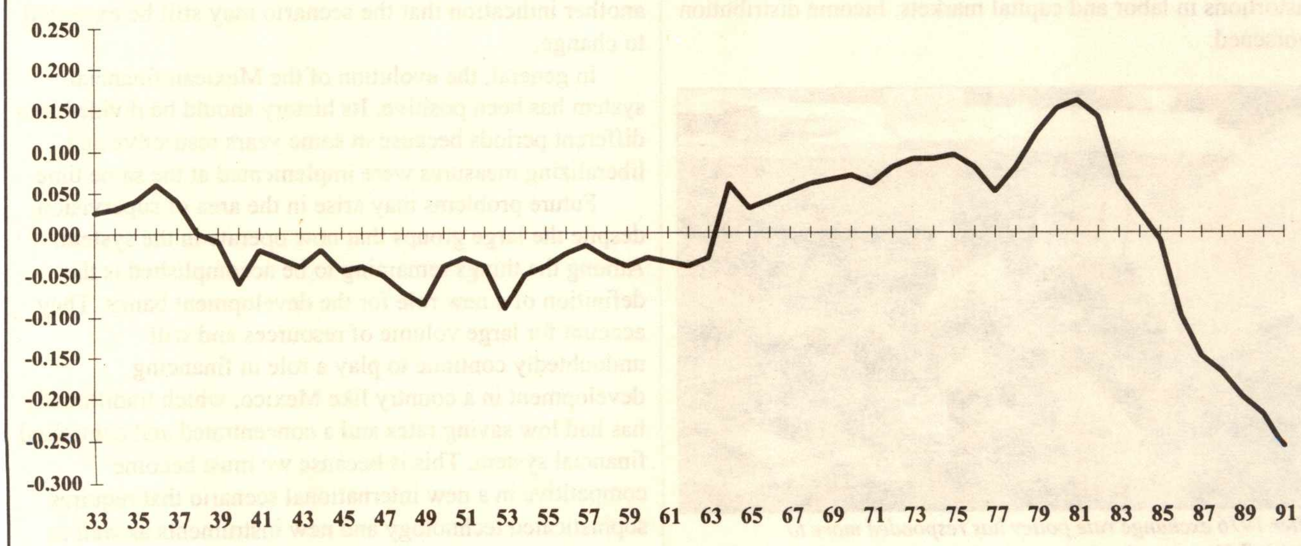
Monetary policy during the 1980s was consistent with the goal of bringing inflation under control. The reduction in net financial requirements by the public sector, combined with the use of non-inflationary resources, reduced the pace of price increases. Restrictive monetary and fiscal policies also reduced the growth rate of the money supply. (M1)

Financial liberalization resulted in big increases in credit to all economic activities, particularly at the end of the 1980s. Deregulation and the redirection of resources from development banks to small and medium-sized businesses helped to change the historical trend of credit allocation.

Capital formation and the efficiency of credit policy

Development and industrialization in Mexico had been financed by a concentrated and controlled financial system for almost fifty years, well into the 1970s. During most of that period, financial deficits and the rate of inflation remained low by international standards. As long as the degree of industrialization and division of

Figure 3
Real GDP growth rate minus trend, Mexico 1933-1991



labor were not very high, the state administration was able to manage the relatively uncomplicated decision-making process.

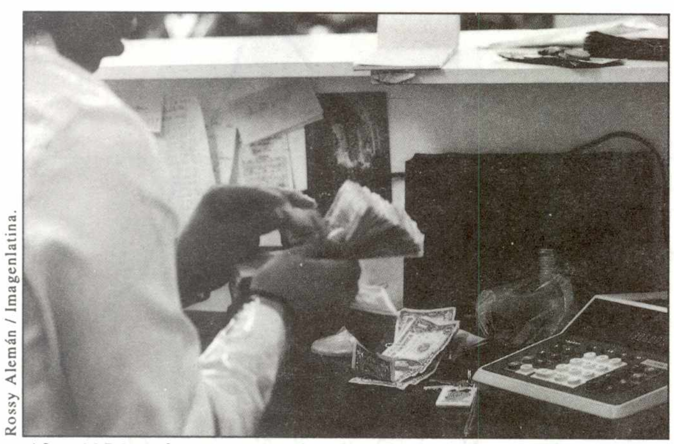
Under these circumstances, the government could easily define priorities for industrial and regional development. Risks of additional production costs due to externalities such as implementation of learning efforts, economies of scale, mass production, incomplete markets or the need for risk capital could be easily absorbed. Static and dynamic comparative advantages could be easily evaluated.

However, the decision-making process and the need for internal coordination became more complex. At the same time, the efficiency of factor and credit allocation worsened, creating oligopolistic structures in many industrial sectors such as the automotive industry, steel, petrochemicals, and heavy machinery.

There was some degree of success in directing credit policy to investment in relatively capital-intensive sectors with rather modern technology requirements. Often, however, modern product standards such as quality, costs and prices, could not be achieved. At the same time, internal and external markets could not be developed.

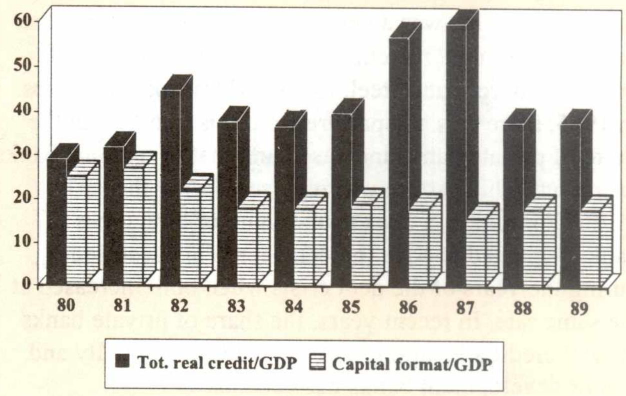
Little attention was paid to downstream and upstream linkages. As a result, productivity remained low while the need for imports increased or remained strong. The low use of productive capacity increased costs, generating further demands for outside protection.

Capital intensive sectors were given high priority and credit flowed into different sectors of the economy because of the low rate of inflation. Credit policy included long repayment periods and negative real interest rates as well as preferential exchange rates. Capital formation and employment grew at a comfortable pace. The industrialization process was accomplished, but with big distortions in labor and capital markets. Income distribution worsened.



After 1976 exchange rate policy has responded more to anti-inflationary criteria.

Figure 4
Real credit & capital formation to GDP
(percentages)



The 1980s brought a different picture, however. Public and private investment decreased substantially. Current public expenses of the federal government and state-owned enterprises, as well as debt interest, were financed with both external and internal credit. As a result, the ratio of capital formation to GDP declined steadily during the 1980s. (Figure 4)

Conclusion

The financial system has changed from liberal interest-rate policy (positive interest rates and credit restrictions) to deregulated credit and real interest rates that swing from positive to negative. This means that the market is still accommodating itself to the new set of policies implemented during the last years. Current spreads on credit and deposit rates fluctuate considerably. This is another indication that the scenario may still be expected to change.

In general, the evolution of the Mexican financial system has been positive. Its history should be divided into different periods because in some years restrictive and liberalizing measures were implemented at the same time.

Future problems may arise in the area of supervision, despite the large groups that now operate in the system. Among the things remaining to be accomplished is the definition of a new role for the development banks. They account for large volume of resources and will undoubtedly continue to play a role in financing development in a country like Mexico, which traditionally has had low saving rates and a concentrated and controlled financial system. This is because we must become competitive in a new international scenario that requires sophisticated technology and new instruments as well as mass-production techniques