Banking history of Mexico and
The 1982 nationalization of banks

Alejandro Serrano,
The University of Texas,
College of Business Administration, USA.
E-mail: alejandro.serrano@utrgv.edu

Abstract
The current conditions of the banking sector in Mexico present a scenario where foreign banks control most of the banking assets but they have not allocated commercial credit. The government was hoping that foreign banks would not only stabilize the banking sector after the 1994 crisis but would also provide the necessary capital for growth. However, the relationship between domestic banks and the government has not been straightforward neither. There have been periods were a clash of interest have been impeded an efficient allocation of capital. During critical times, even the government will demand domestic capital in detriment of the productive segment of the economy. This paper presents the symbiotic but uneasy relationship between banks and the government from 1929 to the late 1980s.

Keywords: Economic development, Bank nationalization, Mexico
1. Introduction

Mexico has suffered several financial crisis since its independence. This paper presents the historical evolution of the banking sector in Mexico and finishes with a description of the 1982 banking rescue program. This paper is relevant because it provides a comprehensive explanation of why foreign banks dominate the banking sector in Mexico. However, even though foreign banks are mostly concerned with the benefit of stockholders in their home countries, this paper shows that even domestic banks have been reticent to follow the economic agenda of the government since the 1920s.

This paper presents a historical analysis of modern Mexico from the revolution to the lost decade of the 1980s. The revolutionary war in Mexico at the beginning of the 20th century gave rise to a political establishment that launched the most impressive modernization efforts in Latin America. The ruling elite envisioned a functional yet subservient financial system that would become instrumental in the implementation of the state’s economic strategy. Nevertheless, the relationship became quite complex given the conflicting interests between the state and the financiers. Furthermore, the revolution generated a universe of new segments within the population. One of the most important groups that emerged was the Cardenista alliance, whose interest focused on land redistribution and access to credit for small and medium enterprises. The collision between the financiers and the Cardenistas permeated the bureaucracy, which through the implementation of contradictory public policies reflected the struggle.

The paper is divided as follows. Section 2 provides a brief literature review. Section 3 describes the institutional construction in the beginnings of the regime from 1925 to 1940, along with the birth of the Cardenista coalition and its unavoidable clash with the bankers’ alliance. Section 4 presents the details from of the draconian measures imposed on the population to achieve the capital formation necessary for the country’s industrialization. This section covers from 1940 to 1958 and describes the inflation-devaluation cycle that created political pressure to achieve macroeconomic stability in the subsequent years. Section 5 includes the years between 1958 and 1970; during this period there was an expansion of the financial system amidst stable growth that was unable to close the inequality gap. Section 6 lays the foundations of Mexico’s economic woes at the end of the 20th century. From 1970 to 1982, the country experienced macroeconomic stability with indebtedness that eventually halted economic growth. The last section from 1970 to 1982, analyzes the government’s economic transformation and the nationalization of the banking sector.

2. Related Literature

The literature of banking and economic development compares the specific characteristics of the banking sector that make them a catalyst in the economic development of a country.
Banks are different from the stock market because they can finance short term projects with low risk as long as the borrower possesses the required collateral. Also, if a country has problems enforcing regulation and therefore there are corporate governance problems at the company level, then it is better for a company to borrow than to issue stock. If the company borrows, it would have the pressure of creditors to make interest payments or it would risk bankruptcy. However, if the company issues stock to finance its project there is not that much pressure and management can pursue private benefits instead of seeking to maximize shareholder wealth.

Demirgüç-Kunt and Maksimovic (1998) study differences in legal and financial systems and its impact on lending. After looking at 30 developing and developed countries, they find that both a strong stock market and functional judicial system are important to foster firm growth. Interestingly, they also find that government subsidies do not increase the number of firms increasing their external financing. Therefore instead of providing economic benefits to encourage external financing, governments should focus instead on facilitating the enforcement of contracts and recovery of collateral.

Demirgüç-Kunt and Maksimovic (1999) use a sample of 30 countries between 1980 and 1991 and find that in those countries where there is a high volume of stock transactions, large firms also incur in long-term debt. For small firms in countries that have a large banking sector, their debt has longer maturity. There are other differences between countries, developed countries have more long-term debt and a long term maturity is the principal component of their debt. Afterwards, the authors explain the differences in maturity across countries based on institutional development. They find that where there is a strong legal system, large firms have more long term debt relative to assets and they substitute short term debt for long term debt.

Levine and Zervos (1998) study if functional stock markets and banks are helpful in the economic development of a country. They find that both sources of capital can predict growth, capital accumulation, and higher productivity. They confirm previous results that state the importance of a marketplace where ownership can be traded as an important instrument for efficient allocation of resources, capital formation, and economic growth.

Levine (2002) main analysis lies in stating that deciding whether the stock market or banks are more important for a country’s development is immaterial. The banking point of view states that when a country is beginning to grow, banks are better than the markets at screening borrowers and allocating capital. The financial services perspective takes a holistic approach of the financial sector and does not distinguish between banks and markets. Both institutions are fundamental for monitoring, controlling management, and attracting savings from the population. The last perspective is the law and finance view which states that the legal system
is the main driver of financial development. Levine finds evidence that supports the last two views and finds no evidence that banks are important in the growth of an economy.

Demirgüç-Kunt, Feyen and Levine (2011) analyze the importance of stock markets and banks as an economy grows. They find that stock market play a more important part of the economy as the country grows. The importance of banks tends to diminish as the economy grows. These results carry three important implications. First, banks differ from the stock market in the services they offer to creditors; second, the optimal mix of banks and financial markets is not static because countries rely more on stock markets as they grow; third, government should not interfere with the natural institutional adaptation to the country’s needs.

Given the current importance of foreign banks in Mexico, it is also relevant to include literature that explores the costs and benefits of foreign banks operating in developing countries. Goldberg, Dages and Kinney (2000) argue that foreign banks can facilitate capital flight and create instability. This argument proved to be true during the financial crisis of 2007-2008. Foreign banks cherry pick their clients, which further increases the weaknesses of the domestic banks. Because foreign banks primary responsibilities are towards their shareholders and home government, they are more likely to ignore the economic development agenda of the home government. However, if the regulatory institutions of the home country are weak, the government of the home country can improve oversight of financial institutions in the host country. This phenomenon has been observed when the Federal Reserve exercised pressure on Citibank for the fraudulent activities of its subsidiary Banamex. Del Negro and Kay (2002) argue that because foreign banks main capital comes from international sources they are less likely to initiate or exacerbate a financial crisis caused by domestic factors.

In general, these papers point towards the importance of banks in the economic growth of a country. Interestingly, there is no evidence that supports the role of the government in promoting the utilization of banks. Finally, foreign banks have benefits and costs when it comes to the promotion of benefits. They can provide stability and capital but they also displace domestic banks due to cherry picking. Table 1 provides a summary of the literature.

Table 1: Literature and findings on banks and economic growth

<table>
<thead>
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<th>Authors</th>
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<tr>
<td>Demirgüç-Kunt and Maksimovic (1999)</td>
<td>In developed countries, large firms incur in long-term debt and they substitute short term debt for long term debt.</td>
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Levine (2002) States that both banks and financial markets are important in the economic development of a country. Also, the legal system is necessary for growth.

Demirgüç-Kunt, Feyen, and Levine (2013) State that there is a dynamic evolution of the importance of banks and markets as the economy grows. In the beginning, banks are more relevant but then the stock markets become the primary source of capital. Governments should not interrupt this evolution.

Goldberg, Dages and Kinney (2000) Foreign banks can create instability by facilitating capital flight. Foreign banks cherry pick clients, which increase the fragility of domestic banks. Foreign banks more concerned by the demands of their home country than of the host country.

Del Negro and Kay (2002) Foreign banks reliance on international capital can help stabilize any instability arising from domestic instability.

3. 1925-1940 Reconstruction

From a methodological perspective this is an important period to study the symbiosis between the Mexican government and the banking sector. Demirgüç-Kunt, Feyen, and Levine (2013) state that when an economy is just starting to grow, the most important financial group is the banking sector. During this period, the government had a strong control of the banking sector and with a growing economy it was able to satisfy the necessities of the population after the revolution.

The Mexican revolution exploded in 1910 after the departure of President Porfirio Diaz and the assassination of President Francisco Madero. The waves of violence that reverberated throughout the country did not settle down until the late 1930s. It was a period when the dismantling of the ancient regime and the consolidation of the warlords’ establishment created an environment in which the banking sector almost vanished. In order to finance the revolution, the contending parties squeezed the banks up to the point of bankruptcy. By the late 1910s, banks stocks traded for less than ten percent than before the revolution (Maurer, 2002).

When Venustiano Carranza took power in 1915, the revolutionary movement started to implement institutions to regulate public life. Although the most important document was the Constitution of 1917, the laws and institutions created in the mid-1920s to normalize the financial sphere became an important element in the restoration of the country’s economic activity. The Mexican financial system that emerged in this period had two main objectives: to allocate credit as a political instrument that could integrate the different regions of a feudal archipelago with the emerging center and to develop, in conjunction with the bankers, a dynamic financial system that could modernize the country. The final product became a convoluted structure that integrated both objectives. The resources allocated to the financial
machine served to foster the political goals of the regime. However, the machine created by the government and the bankers did not fulfill its economic role until the 1940s.

In order to integrate the different political forces to the central government, the state’s financial institutions made loans to political figures for their economic enterprises. The Banco Nacional de Credito Agricola (BNCA) became one of the main venues in the allocation of credit. Alvaro Obregon, a former warlord and president, was the major recipient of funds that enabled him to become the biggest producer of chickpeas in Sonora (Maurer, 2002). Other political figures also received loans; even President Plutarco Elias Calles received loans from the central bank for his sugar refining business (Maurer, 2002). The BNCA also gave funds to peasant organizations that were loyal to the government. When the Cristero rebellion erupted in 1926, the central bank of Mexico (Banxico) limited the prevailing anxiety by providing cheap credit to producers.

The Mexican government wanted to create a financial system along with the bankers. Yet the trust that prevailed between both parties all through the Diaz regime was shattered during the revolution. To regain their trust, the government invited the financiers to formulate together the laws and institutions of the nascent economy. The banking convention of 1924, promoted by the finance secretary Alberto Pani, sought to make use of the budget surplus to create a central bank that could regulate the financial system (White, 1992). Finally, in 1925 Banxico was established under the supervision of the Ministry of Finance. A symbol of the connivance of interests between the state and the bankers’ alliance was “… the temporary installation of the central office of the central bank in the headquarters of the Banco de Londres” (White, 1992). The Banco de Londres was the largest private bank since the Porfirian era. However, the bank was a hybrid between a central bank and a commercial bank. Banxico obtained the monopoly of money supply and of establishing exchange rates between the peso and foreign currencies (Brothers and Solis, 1966). In addition, it distributed loans to the government and private sector through the expansion of the monetary base, which increased inflation and reduced real interest rates. This condition created a competitive system that alienated some of the private firms.

The banking alliance itself was not a unified community; there was a division between the large banks of the Porfirian era that were allied to the industrial groups situated in the northern state of Monterrey and smaller banks that operated in secondary economic regions. However, they shared the ideological precepts of the Austrian school of economics. Some of their shared interests were free exchange convertibility, conservative monetary policy, and low taxes (Maxfield, 1990). The bankers’ alliance had access to the government through the Ministry of Finance. By allocating loans to members of the government, the bankers gained confidence that the state was not going to change a structure that benefited its creators. Other elements were
included in the construction of the financial system. First, during the banking conventions, former Porfirian technocrats participated in order to produce a conciliatory atmosphere between government and financiers (White, 1992). Second, the Comision Nacional Bancaria (CNB) was established to serve as a forum where both parties could harmonize their interests (Maurer, 2002). Third, Banxico became an institution where private lending was coordinated with government actions. If the government did not fulfill its promises, private lenders could punish it through Banxico (Maurer, 2002). Fourth, the central bank redeemed private banks’ with gold. If the government wanted to expropriate these receivables, the bankers could take the gold out of the country. Fifth, the central bank also operated as a commercial bank. Therefore it had the same incentives as private banks in maintaining an exclusive banking system. If the government wanted to liberalize the financial system, it would lose profits obtained through Banxico. Sixth, it favored domestic financiers over foreign bankers by abrogating the government’s external debt incurred by Presidents Porfirio Diaz and Victoriano Huerta (Maurer, 2002). Finally, the Banxico law reform of 1932, under President Calles, established new regulations specifically targeting foreign banks. After the implementation of these norms, only three of the six foreign banks stayed in the country (White, 1992).

Despite the harmony of interests there was not much capital after the revolution. Foreign lenders disappeared after debt default by the government. In addition, the 1929 stock market crash and subsequent depression evaporated any possibility of obtaining international capital. As a method to activate lending for economic purposes, the government created additional state owned institutions to allocate credit. It invited private banks to participate in the lending process. Nevertheless, most of the capital distributed through these organisms came from government sources.

One of the main benefits of the Mexican revolution was the redistribution of land under communal property known as ejidos, which are an integral part of the 1917 Constitution. Land was distributed in the form of ejidos at 504,293 hectares per year from 1915 to 1935. By 1961, 23 percent of the land area of Mexico had been redistributed (Bennett, 1965). However, peasants did not have capital to invest in their lands. Therefore, the government created additional agricultural banks to channel credits to this segment of the economy. The ejidos differed from the Porfirian agriculture industry in their scope, which limited their profitability. Because ownership of land involved significant amount of people; there was not enough residual capital to distribute. Therefore, private banks were not involved in providing credit to the ejidos. Furthermore, since communal lands could not be mortgaged under the article 27 of the Constitution, banks were legally unable to claim land as collateral. A new set of interest opposed to the bankers’ alliance was fermenting and did not come into fruition until President Lazaro Cardenas took over in 1934.
The Cardenas administration succeeded in pacifying the country and in solidifying the presidency as the most important political institution in the country. State governments, Congress, and the judicial system remained under the influence of the president. The main event that signaled this transformation was the expulsion of President Calles from Mexico in 1935 whose official term was from 1924 to 1928, but remained the principal political figure during the period known as Maximato from 1928 to 1934.

The economic agenda of Cardenas was to industrialize the country while providing enough financial resources to the agricultural sector to lessen an already abrupt migration towards the urban areas. From 1935 to 1940 the annual average of land distributed increased to 2,934,856 hectares (Bennett, 1965). By 1940, half the rural population was employed in ejidos, which encompassed half of Mexico’s crop land (Vernon, 1963). Although there was an increasing need for capital, the government proved to be quite inefficient in collecting tax revenue. Given the lack of capital from external or internal sources, the government had no choice but to finance its debt by increasing the money supply.

The economic interests that emerged in the late 1930s gave birth to the Cardenas coalition, which was an alliance that opposed the financial interests of the bankers. The coalition was composed of the agricultural industry, small and medium manufacturers, and labor. They had access to the president through the agricultural ministry. The Cardenista coalition’s main interest was to foster growth and employment at the expense of higher inflation. Maxfield (1990) states that Cardenas advisors favored agrarian reform and labor rights but they also pursued a loose monetary policy. Cardenas implemented an aggressive strategy of public investment that averaged an annual increase of eleven percent during his government (Thompson, 1979). This investment helped to stimulate internal demand. The main episode in the economic involvement of the state was the expropriation of oil in 1938. The revenue obtained through the extraction of oil proved to be an important source of capital for the government that halted the urgency of tax reform. The availability of cheap oil and low taxation were among the most important ingredients in the development of Mexico’s economic industry during the following decades. If the 1920s were a decade in which the bankers imposed their views, the 1930s became a reversal in influence for three reasons. First, the absence of international capital evaporated the main source of leverage available to the bankers’ alliance. Second, Cardenas elevated industrial development as the top priority in his agenda. Third, the war of 1939 increase the demand for Mexico’s products, which diminished the threat of capital flight.

In 1938, capital outflows occurred after the expropriation of oil and railroads. Furthermore, depression in the United States in 1937 and 1938 generated pressure in Mexico’s balance of trade. As the central bank’s reserves kept on falling up to 38 percent in 1937, the capital flight
spiral (Maxfield, 1990). Finally, in March, the central bank let the peso float. The new parity was 4.85 pesos per dollar and continued increasing (Thompson, 1979). The 1937 episode outlined an important element in the Mexican financial system: sharing a 2000-mile border with the U.S. became an insurmountable obstacle in the application of exchange rate controls. This incapacity increased the leverage of the bankers’ alliance because the threat of capital flight was credible. In the late 1930s, amidst a negative environment given oil expropriation, 900 million pesos fled between 1935 and 1939 (Maxfield, 1990). This event proved that capital flight was an expensive tool for the bankers to use, because banking assets fell from 12 percent of GNP in 1925 to 10 percent in 1940 (Maxfield, 1990).

In this period, the government was establishing the rules of engagement with the banking sector. The government had a heightened level of legitimacy after the revolution and was able to persuade the banking sector with its own goals.

4. 1940-1958 development and inflation

After the reconstruction period was stabilized, other financial groups such as investment banks started to emerge. However, given that the country was beginning the industrialization period, the banking sector remained a fundamental instrument of the government’s economic policy.

This period encompasses the administrations of Manuel Avila Camacho (1940-1946), Miguel Aleman (1946-1952), and Adolfo Ruiz Cortinez (1952-1958). The political framework remained stable for the next decades, leaving the government with the sole task of developing the country. In the international sphere, the involvement of the US in World War II created economic conditions that served as a catalyst in the country’s effort to industrialize. The US imported commodities and imposed limits on its exports. Suddenly, Mexico needed to substitute imports through domestic production, which resulted in a current account surplus during the war.

To legitimize its economic agenda, the revolutionary state formulated the industrialization myth “… the idea that development and modernization are attained through industrialization” (White, 1992). Furthermore, the unequal distribution of income and the increasing disparities in social classes were alleviated with increasing opportunities of social mobility provided by the new economy. In addition, even though the relative income of the poorer classes diminished, their absolute wealth increased during this period. Overall, the industrial sector grew from 25 to 34 percent of GDP from 1940 to 1970 (Adams, 1997). The government adopted an active role in the economy. It did not relegate growth to the private sector but participated in solving structural bottlenecks and in creating public enterprises that required enormous amounts of capital and expertise that the private industry was not capable or willing to undertake.
Furthermore, given the unattractiveness of investing in the agricultural sector, the government acted as the main provider of capital to farmers.

In order to involve the private sector in the government’s economic agenda, new financial laws were instituted in 1941. First, the central bank upgraded its functions by regulating monetary policy through reserve requirements. Second, the Nacional Financiera charter was modified and it became the most important institution in the money market (Bennett 1965). Nacional Financiera was created in 1933 to organize a market for public bonds and it was reorganized in 1941 as a development bank. Its importance grew over time, as it became the guarantor of public and private enterprises. Third, the General Law of Credit Institutions defined the specialization of financial markets in two major areas: money market and capital market (Cardero, Quijano, and Manzo, 1983). In order to facilitate the production cycle, monetary institutions (deposit and savings institutions, and financieras) would provide short-term credit (less than 180-day maturity). In contrast, the capital markets (capitalization societies and fiduciary institutions) would finance long-term operations, by providing capital with maturity greater than 180 days (White 1992).

Amongst the monetary institutions, one of the most important groups were the financieras, which were created in 1932 and were basically investment banks with little regulation over their financial policies, a feature that enabled them to grow rapidly during the 1950s. They were able to supplement capital for industrial enterprises that were unable to obtain funding through commercial banks. Financieras were not required to maintain reserves and did not have a limit on liability growth (Maxfield 1990). In addition, they were not regulated in the amount of interest rate they paid and they also offered financial instruments in dollars. The differences in government regulation fostered the development of financial networks composed of commercial banks and investment banks. This feature enabled financial groups to circumvent regulation. Regarding their credit allocation, financieras were required to maintain close to 13 percent of uses of funds in government securities (Bennett, 1965). Fifty percent of financieras’ credit was for production and 40 percent for commercial activities (White 1992). At the end of the 1940s, other financial intermediaries supplied one fifth of these sources by the end of the 1950s they increased considerably their participation (Bennett, 1965).

Starting in 1936, reserve requirements for commercial banks were seven percent of their deposits (Brothers and Solis, 1966). The logic behind reserves in marginal increases in deposits is threefold: first, it enables the government to exercise control on credit expansion; second, reserve requirements can be revised without forcing banks to change their reserve requirement position when the revisions are introduced; finally, marginal reserve requirements penalizes aggressive banks (Brothers and Solis, 1966). In the mid-1940s, reserves on checking accounts were eliminated whereas reserves on deposits increased to 10 percent. Additional reforms
occurred during the 1940s including more rigidity for accounts denominated in foreign currency. In the late 1940s, given the government’s desire to funnel credit to certain sectors of the economy, a policy of directed credit supplemented the reserve requirements in cash. The central bank forced the private intermediaries to acquire less appealing securities. These securities were government bonds or issues of public companies (Brothers and Solis, 1966). Even though the return was lower than for products with similar risk, it was a step forward from an unprofitable cash requirement system. Furthermore, Banxico also required banks to grant credits from their portfolios towards specific borrowers (Maxfield, 1990). A final instrument was the marginal cash reserve requirement, which established two options: maintain 100 percent cash reserves with respect to increase in deposits or keep a lower marginal reserve requirement.

Despite the government’s careful instrumentation of financial and institutional mechanisms to regulate credit allocation, the business structure of the banking system impeded the fulfillment of the state’s economic agenda. First, banks were allied to industrial conglomerates, which enabled a credit policy based on tacit agreements that escaped the government’s supervision. Financial-industrial conglomerates known as grupos became the main beneficiaries of the stabilizing development policy of the 1960s. Second, even with the financial system there is a diversification of holding companies under the same parent institution, which enables intra-system lending. A financiera (with less strict reserve requirement) could lend capital to a commercial bank, of the same parent company, to allocate credit in short term speculative endeavors, thereby circumventing the central bank’s policy designs.

The government attempted to influence the behavior of banks but banks were not helpful in allocating credit according to the government’s design, the structure of their obligations matched the financial requirements of the lenders with those of the nascent industry. The bank’s short-term liabilities fostered a short-term allocation of credit by financial intermediaries. Fortunately, Mexico’s industry is labor intensive; it requires short-term capital to finance its productive activities, especially in the manufacturing areas (Brother and Solis 1966). However, the sectors affected by the short-term supply of funds were agriculture and construction. Moreover, the banking system’s exposure to exchange rate risk limited the institution’s lending time frames (Welch and Gruben, 1993).

An unintended consequence of the amendment in reserve requirements was the successful implementation of securities deposit not only as a mechanism to limit excess reserves but also to finance the government. With the acquisition of public securities by the private sector, the government managed to operate without the resources of the central bank. However, an unintended consequence was the greater importance that the bankers’ alliance acquired with this specific financing activity. The government sought to increase its operations without
greatly increasing inflation but in the process it amplified the importance of the faction it wanted to regulate. Furthermore, because the government absorbed a considerable amount of capital, there were fewer resources available for industrial development.

Another aspect that increased the power of the bankers’ vis-à-vis the state was the allocation of credit in profitable enterprises. Since financial intermediaries lent most of their resources to industrial and commercial industries with short-term financial requirements, the state became the only alternative to obtain resources for the less profitable sectors that required a longer time horizon like agriculture and construction. The participation of the government in the economy was required because the economic conditions of World War II created a necessity for import substitution. Some of the manufactured goods that Mexico imported from its neighbor became scarce when the US entered the war. When the war ended, the government formally adopted a policy of industrialization through import substitution, which fostered economic development.

After WWII, the demand for exports diminished and the current account deficit suffered. The net reserves diminished and the typical path towards a balance of payment crisis was underway. President Miguel Aleman obtained loans from the newly created IMF and the US Treasury, which enabled him to support the peso for a longer period. Nevertheless, the pressure became insurmountable and devaluation took place in 1948. Capital flight continued until the government established once again a new peg at 8.64 pesos per dollar in July 1949. The crisis was entirely solved through the current account, which turned into a surplus of 53 million dollars in 1949 (Thompson, 1979). The beginnings of the Korean War kept the demand for Mexican exports at a high level temporarily, yet the structural flaws of the Mexican economy haunted the country a couple of years later. An essential factor that distinguishes this event from previous economic disturbances was the incorporation of Mexico into the international financial system through the Bretton Woods institutions. This flow of money, later augmented through private lending, became a defining feature in Mexico’s economic development. Furthermore, the bankers’ alliance obtained a valuable tool (external capital), which helped them negotiate with the government during the following decades. The importance of international capital in economic decision-making, gave foreign creditors an important role as a bankers’ ally (Maxfield, 1990).

The 1948 devaluation ignited the monetarist-structuralist debate. Although a definite policy outcome did not take place immediately, the Ruiz Cortinez administration suffered the political discontent with inflationary policies. In this sexenio (the six-year period of a presidency), the government’s economic agenda had a more conservative slant in its relationship with the private sector. Nonetheless, the government allowed foreign investment to enter the country. Short-term capital flows remained at low levels from 1951 to 1954 and reached 93 million dollars in 1995 (Thompson, 1979). The government attempted to reduce inflation while promoting
industrialization. In order to finance the government’s budget, Mexico relied extensively on foreign loans. When the Korean boom in exports finished and the American economy entered recession, the balance of payments began to reverse. However, given the previous experience with the unplanned devaluation of 1948, the government decided to devalue early. In 1954, the devaluation coincided with an economic recovery in the US, which enabled Mexico to achieve impressive rates of growth during the following years. Nevertheless, the negative effects of the devaluation and inflation created a political outcry that was felt throughout the country. The stage was set for monetarism to become the predominant economic paradigm in Mexico’s development.

5. 1958-1970 Stabilizing development

As the industrialization period matured, the financier as started to play a more relevant role in the economy. The banking sector still remained the most significant financier. Also, the international financial sector started to get involved in the Mexican economy. Unfortunately, as the economy matured, the easy stage of industrialization was over. After 1970, the economy went through a series of economic crises that jeopardized the path of economic growth.

During this period, Presidents Adolfo Lopez Mateos (1958-1964) and Gustavo Diaz Ordaz (1964-1970) pursued an economic agenda that maintained low inflation in combination with high rates of growth. The state still followed an import substitution industrialization strategy, yet the easy stage of consumable goods’ production was maturing. The economic model showed the same signs of trouble with the balance of trade as in previous decades. The current account deficit could only be sustained with foreign loans, given the low levels of taxation in the country (Thompson, 1979). The government’s goal of achieving high rates of growth maintained a budget deficit that now was financed extensively through foreign capital flows (mostly long-term) and domestic savings in fixed-income assets. Ironically, Mexico’s reliance on external capital could turn more of a hassle than an asset. If there is an extensive influx of capital, the country must devote greater proportions of income to service its debt. In addition, the availability of easy foreign capital inhibits to develop an indigenous financial structure capable of increasing domestic savings (Thompson, 1979). Access to foreign capital may inhibit the government’s desire to develop further exports and raise taxes.

Within the structuralist-monetarist debate, the monetarists correctly demonstrated the price sensitivity of lenders with respect to yield. Domestic savings rate increased during the 1960s. This development allowed the construction of a mature financial system, in which inflationary policies were no longer necessary as a tool for capital formation. Although the liability side of banks’ balance sheets increased annually from 13.3 to 29.4 percent, the asset side remained problematic given the threat of inflation and exchange rate risk (Adams, 1997). The allocation of credit followed a similar pattern as in previous decades, the main difference being the greater
importance of the government as a borrower. The GNP growth reached 10 percent in 1964 and even though the government increased its revenue; the amount of expenditures also rose due to investments, subsidies, and welfare programs (Brothers and Solis, 1966). Banking laws were passed in 1995 allowed the private banking sector to become the government's main creditor. This element along with the expansion of the financial sector within the economy greatly increased the power of the bankers’ alliance. Specifically, given the incentives provided by the central bank, the financiers became the most dynamic subgroup in the industry. Nevertheless, the traditional commercial banks still held most of the financial assets. Finally, the government’s involvement in the allocation of credit diminished because of their participation in unprofitable endeavors. Even though the financial sector developed faster than the economy, there was an important element in the central bank's policies that hampered the development of other sub sectors within the financial industry. The state only allowed fixed-income securities to be traded at par. "Because the government proscribed discounting, expected inflation could not be reflected in discount rates, a problem that inhibited the development of a long-term securities market" (Welch and Gruben, 1993). Another important feature in this period was the increasing concentration of resources among a limited number of banks and financieras. The four major banks in this period were Banamex, Bancomer, Banco de Londres, and Comermex (White, 1992). There was also a great concentration of assets within the financial groups. "In 1960, nine bank groups controlled 75 percent of institutions... and 71 percent of profits" (White, 1992).

During Diaz Ordaz's sexenio, the financial sector continued to develop and create new products such as certificates of deposits and commercial paper. In the international arena, Mexico gained access to the Eurodollar and Eurobond markets (Thompson, 1979). Nevertheless, the real side of the economy suffered as the country entered the difficult stage of its economic strategy and switched production from consumer goods to manufactured and durable products. This mature industry required greater domestic markets, which were underdeveloped at the time. Furthermore, given the state's protection of the nascent industry, producers were inefficient by international standards therefore they were unable to compete in foreign markets. High tariffs in consumer goods and low tariffs in capital goods fomented an industry intensive in capital rather than focusing on Mexico's competitive advantage in labor-intensive products. The increase in unemployment created political pressures, which were subdued through authoritarian regimes in other parts of Latin America. In Mexico, the government responded with a massacre of students in 1968. Although protests were controlled for a while, the elite modified the economic strategy to accommodate the demands of other groups.

This period represented a step backwards for the Mexican economy and the relation between banks and the government deteriorated. At the end of the period, the banking sector was bankrupt and the government decided to nationalize this industry to halt the flight of capital.

The difficult stage of the import substitution industrialization model occurred during the presidency of Luis Echeverria (1970-1976). The implementation of tariffs created incentives for the production of goods intensive in capital; however, Mexico has abundant labor. The incoherence between reality and strategy generated underemployment levels as high as 44.5 percent of labor force in the early 1970s (Thompson, 1979). The new goal during these two administrations was to distribute the benefits of economic growth. Nevertheless, the economic agenda consisted in incrementing public spending without a coherent strategy that dismantled the stabilizing development model. Banxico relaxed its monetary stringency, by incrementing the money supply for political purposes (Echeverria wanted to come close to the people hurt by the 1968 uprising), which resulted in high levels of inflation. The increase in prices became larger when inflation rose in the developed world. When inflation reached 25 percent during mid-1974, fearing devaluation, the government reduced spending and public investment fell by 1.6 percent in 1974 (Cypher, 1990).

The government incurred budget deficits that were increasingly financed through international capital. Interest rates were so low, because of the petrodollars, that it seemed a mistake to miss such bargains. Furthermore, the availability of cheap capital enabled the government to avoid tough political decisions. Regardless of the low taxation, Echeverria was able to invest in his social programs. In addition, the increasing importance of private lenders diminished the political obligations incurred when obtaining credit from international institutions or foreign governments. Not only did the government take advantage of the availability of foreign capital, private banks initiated cross-lending operations in different sectors of the economy.

The relationship between the private sector and the government during the 1970s turned difficult. As the import substitution model failed to generate further development, the state increased its involvement in the economy. Regarding its funding, the government diminished its reliance on the banking sector and started open market operations by selling government certificates (CETES) and bonds linked to the oil industry named Petrobonos. The financial community resented this decision arguing that competing with the state for domestic resources would hurt the development of the financial system. Nevertheless, the principal problem for the banking sector was the phenomenon of disintermediation (flow of capital from more regulated to less regulated institutions) (Welch and Gruben, 1993). With interest rate ceilings and higher levels of inflation, savers switched their deposit to less regulated firms. The government
allowed an increase in the interest rates of deposits but it was nonetheless inconsequential (until the following sexenio). This situation changed dramatically with the banking law of 1974, which enabled banks to transform the specific Anglo-Saxon model to the universal banking system that followed a Germanic model. The consolidation and concentration of resources increased even further, and by the end of the decade the number of commercial banks severely diminished.

President Echeverria’s sexenio relaxed the macroeconomic environment and funded it through monetary expansion and foreign loans. These decisions severely affected the balance of payments and the investment conditions at the end of his term. The current account deficit reached 3 billion in 1974, 4 billion in 1975, and another 3 billion in 1976 (Zedillo, 1992). The government believed that Mexico would improve its current account deficit by a surge in exports in 1976. However, only a modest increase in exports occurred and a currency crisis appeared for the first time in more than twenty years. On September 1, 1976, Echeverria devalued and had to sign a loan agreement with the IMF.

The sexenio of Jose Lopez Portillo lasted from 1976 to 1982, he ascended to the presidency as the sole candidate in the 1976 election; the opposition was busy in its internal disputes and did not endorse any contender. The government adopted a rapprochement policy with the business sector, yet maintained an important participation within the economy. Despite all the macroeconomic disequilibria, the President decided to apply the same economic formula that his antecessor did, this time the results would be even worse. There are two basic explanations for this erratic conduct. First, Mexico started to extract oil from its recently discovered reserves in the southeast. The government believed that this extra income would be enough to cover the fiscal deficit and the debt payments. Second, the "...government officials and the top advisers close to the presidency did not believe that the economic policies of the Echeverria administration were mistakes" (Heath, 1999). The structuralist model provided Mexico with its highest levels of growth, acknowledging that such model was not producing more economic growth became a great obstacle for transformation.

The external factors from 1970 to 1976 were perceived as just a transitory pervasive trend. The imported inflation from the United States and the 1973 oil crisis were considered the main culprits for the economic crisis. The government believed that once the international environment changed, the economic strategy would again generate high levels of growth. The exchange rate risk and the high levels of inflation prompted a higher circulation of dollars in the economy. To accommodate this demand, the government allowed deposits denominated in dollars yet convertible to pesos, these deposits were known as Mexdollars. The increase in public bank dollar liabilities from 1981 to 1982 indicates the growing anxiety about a possible devaluation. In order to fight capital flight and to increase domestic savings, the government
increased its exposure to a currency crisis. When the 1982 crisis erupted, the government transformed the Mexdollars at a rate lower than the market value. Another aspect of the internationalization of Mexico's financial system was the introduction of the 1977 banking laws, which allowed the establishment of foreign bank branches. Unfortunately, during the currency's crises, these institutions facilitated the flight of capital. Furthermore, Banxico encouraged Mexican banks to participate in the acquisition of capital obtained through the Eurocurrency market (Maxfield, 1990).

Because of Mexico's impressive average growth rates of 7 percent per annum from 1971 to 1982 and immense oil reserves, the country obtained an advantageous position in the international community vis-a-vis other Latin-American countries, which enabled it to obtain better terms (Babb, 2001). The average spread in the Euromarket was significantly lower for Mexico than other Latin-American countries, yet this situation reversed with the falling oil prices in 1981. The sexenio of Lopez Portillo created incentives for speculation. International firms were able to acquire foreign capital at low or negative real interest rates and allocated it within the national market at higher interest rates. Also, this allocation was highly concentrated. "In 1979, 5 percent of all borrowers consumed 68 percent of all banking system credit" (Maxfield, 1990). In some instances, Mexican banks participated in syndicated loans that were channeled to the following countries: Honduras, Brazil, Chile, Ecuador and Spain (Quijano, 1981). In addition to the differential between foreign and national interest rates, banks profited from the increasing margin between liabilities and assets. The government regulated the rates banks paid for debits, but they did not regulate the credit rate. "The margin increased from 5.35 percent during the fourth quarter of 1979 to 14.3 by the fourth quarter of 1981" (White, 1992).

The situation was sustained until the current account and the negative macroeconomic environment affected the perception of investors. Furthermore, when the U.S. prime rate hit 20 percent, the debt service paid by Mexico increased greatly (Heath, 1999). The economic strategy of Portillo was incongruent due to its dual objective of approaching the business elite and pursuing full employment and wage protection. The resources necessary to support this strategy were momentarily available through foreign capital and exporting oil. Portillo justified its foreign borrowing as a cash flow problem that oil would solve (Cypher, 1990). On the supply side, international banks suffered from an excess liquidity due to deposits from OPEC countries. The banks competed fiercely to allocate credit in Third World countries.

The president gambled that oil would become Mexico's development motor, and he lost. The twin deficits in the fiscal and current account created an unbearable situation. There was a second oil crisis that sent the industrialized countries into a new recession; they demanded less oil and the price of this commodity fell. However, it is important to acknowledge that despite the adverse international environment, the poor policies followed not only by Mexico but also
by the major Latin American countries were the main factors that contributed to the debt crisis. The solution again was to devalue and correct the current account deficit. The stage was set for a major catastrophe and even in the last moments of his administration, Lopez Portillo incurred in several mistakes; the only hope was the arrival of a new presidential team with a different economic agenda. Without this transformation, a rescue package might have never occurred.

In 1981, the decline in oil prices along with a recession created severe tensions in the macroeconomic indicators. The currency was devalued in February 1982, the interest rates were increased considerably (they had already increased in the US), and the cycle of inflation-devaluation started a capital flight that jeopardized the integrity of the financial system. "The capital flight, estimated at over $100 billion dollars, thwarted growth of the Mexican banking sector as interest rates skyrocketed, exchange controls were imposed, and bank deposits fell" (Adams, 1997). Given the impossibility of halting the outflow of resources, the government made the radical decision of nationalizing the banking sector. In addition, deposits in dollars were transformed to an exchange rate below the market rate but the decision jeopardized the public's confidence in the banking system. The cross lending between American banks and the Mexican government created serious difficulties for the banks when Mexico was unable to service its debt.

"On August 13, 1982, the Secretary of Mexico's Treasure, Jesus Silva Herzog, went to Washington to confirm personally that the country run out of reserves and that if an agreement was not reached that weekend, the Mexican government would announce publicly that it would suspend payments" (Lustig, 1998). Immediately an alarm was set up in Washington. Paul Volcker, the Federal Reserve President, acknowledging the huge harm that this might cause in the U.S. banking system, given the debt's composition, arranged bridge loans just to gain enough time to structure a stable agreement. The Treasury Department searched for money within the American administration so that Mexico could avoid a moratorium. One billion dollars was obtained from the Agriculture Department in exchange for Mexico's promise that it will buy corn from this agency. This agreement was easy to achieve since Mexico is highly dependent on this product. The second billion came from the ESF (Exchange Stabilization Fund), which is an emergency fund that the Treasury has at its disposal for maintaining stable currencies in the international system. However, this loan had to be backed up by guarantees; the only item that Mexico could provide was oil. A representative from the Treasury Department, Tim McNamar organized a triangular loan with the Strategic Oil Reserve, which obtained the fuel at considerable low prices (Lustig, 1998). "For these funds, Treasury Secretary Don Regan proposed that Mexico pay an implicit rate of interest of 38 percent" (Gurria Trevino, 1996). The Mexican negotiators were infuriated with the proposed price of oil, which generated
controversies in the Mexican political circle. The American explanation for the low prices was that it would be polemic for the Reagan administration if oil went far below the market price.

The United States responded to Mexico’s crisis because the American banking system was highly exposed in cross-lending operations "...Mexico’s debt was fifty percent of the capital from the nine largest American banks" (Lustig, 1998). Therefore Volcker and McNamar were quite concerned with Mexico’s crisis. Fortunately, Volcker was able to employ the institutional power of the Federal Reserve and persuaded the banks to roll over Mexico’s payments for 90 days. The involvement of the Agriculture and Energy Department was fundamental in the loan. The United States knew Mexico’s necessity of maintaining its alimentary reserves or the threat of social instability could increase. In addition, the Energy Department was able to extract an excellent bargain from Mexico. Nevertheless, the United States did not organize a more comprehensive framework with the inclusion of other aspects in the bilateral relationship. A possible explanation is the lack of credibility of Lopez Portillo.

The solution for this crisis, which spread through Latin America, was the implementation of bridge loans that only covered the most immediate financial needs of the debtor countries; the conditions were so stringent that the region did not experience any growth for a decade. This period is formally known as the lost decade. From 1982 through 1990, Mexico engaged in several negotiations until the Brady Plan was finally implemented. The poor economic management of the Latin American economies and the immense debt in which they incurred were the main culprits for the lost decade. However, the industrialized countries did not implement a comprehensive settlement for the debt problem; they just eliminated the short-term risks. In addition, due to its vicinity with the US, Mexico suffered from the hike in US interest rates and the disinflationary policies of Volcker. The most transcendental consequence of the period was the formal elimination, through the IMF, of the structural economic model. Now, it was time for neoliberalism.

7. The banking rescue of 1982 and the lost decade

Demirgüç-Kunt, Feyen, and Levine (2013) assume a monotonic pattern of growth where banks become less relevant as the economy grows. They also suggest that the government should not get involved to enhance the importance of either banks of financial markets. In the Mexican case, after a series of financial crises the government interrupted the process in 1982 and nationalized the banking sector.

The state was quite infuriated with the speculative behavior of the banking sector. In 1982, 49 percent of banks’ profits came from exchange operations (White, 1992). On September 1, 1982, the government nationalized 58 of the existing 60 banks, inspired in the French bank nationalization. Before the nationalization, banks were quite profitable especially from exchange operations. However, the upcoming crisis affected many industrial groups that had
strong ties with the banks. When the government decided to nationalize, many of the banks had solvency problems. Furthermore, after banks were nationalized, the government tried to resell the banks' industrial holdings. However, the attempted sale failed because these enterprises were overleveraged (Maxfield, 1990). The decision to nationalize lay in the government's failed attempt to halt capital flight through conventional means as devaluation (White, 1992). The two institutions that remained independent were Citibank and the union-owned bank Obrero. Afterwards, the lack of confidence in the financial system was felt immediately. In 1983, Citibank estimates there was a 7,000 percent increase in accounts opened (Maxfield, 1990). The bankers did not respond radically, not only because they were divided but also because they hoped the incoming administration would be more responsive to their interests. However, they remained highly active in negotiations behind scenes in order to advance their interests in three main topics: indemnization plan, reprivatization, and exchange rate controls (Maxfield, 1990).

In the beginning, the rules to reimburse the bankers were going to be organized by three ministries: finance, budget and public works. The circumstances changed in 1983, when the finance ministry (sympathetic to the bankers' plight) announced itself as the sole agency responsible for the indemnization (White, 1992). The indemnization was going to be determined by the amount of countable capital; however, the situation improved significantly for the bankers when a technical committee headed by the ministry of finance switched to "...an unspecified formula using adjusted countable capital" (White, 1992). The three major banks more than doubled their amounts received to 18 billion, when the government changed the accounting principles. Furthermore, "...capital gains resulting from the indemnization were tax-exempt "(White, 1992). The changes in the indemnization procedures had as a main objective the rapprochement between the government and the old bankers who would still participate in the financial system through brokerage houses.

The reprivatization of certain financial assets in 1984 signified a de facto return to the Anglo-Saxon banking model. The state operated the commercial banks whereas the former bankers acquired the insurance, brokerage houses and diverse companies that operated under the same holding company. Furthermore, the bankers were allowed to reacquire up to 34 percent of the share from the nationalized banks (Maxfield, 1990). The auction of these companies was skewed to benefit their former owners. "Ex-bankers were given the first opportunity to purchase shares owned by their former banks. They were also allowed to use indemnization bonds to pay for the shares. Next in sequence were the general shareholders of the company or companies being sold. Ex-bankers were the next group allowed to buy the stock of companies belonging to any bank. "Finally, the private sector and labor organizations were permitted to purchase any leftovers” (White, 1992).
Regarding exchange controls, the negotiations were far easier for the bankers because the recently signed agreement with the IMF limited their implementation. Furthermore, the traditional arguments regarding the imposition of exchange controls surfaced again and even Lopez Portillo was reluctant to implement them (Maxfield, 1990). The incoming President Miguel de la Madrid also opposed such policy. An important phenomenon that exemplifies the power of the bankers' alliance was the institutional permanency of the board of directors in the nationalized banks. The banking institutions remained operated by the same personnel and only the directors were removed. In addition, the incoming Treasury Secretary, Silva Herzog, negotiated the designation of new bank directors trained at Banxico or Nacional Financiera (White, 1992). Although, one of the government's goals was to punish the banking community, the measure proved beneficial for the bankers for two reasons. First, they were able to institute a parallel financial system through the operation of financieras. Second, during the 1970s, the financial-industrial conglomerates were severely over leveraged. When the investment climate worsened in 1981, their asset-to-liability ratio (current ratio) threatened them with bankruptcy; as a result, the government bailed out the banks with the nationalization (Maxfield, 1990). After 1982, the number of commercial banks was halved.

8. Conclusions

Since 1925, the institutional transformation of the country benefited the banking sector. An exceptional feature of Mexico's geography is the 2,000-mile border with the United States. This proximity makes the imposition of exchange rate controls quite difficult. The bankers have taken advantage of this situation to increase their negotiating leverage vis-a-vis the state. Nevertheless, in the 1930s, the lack of access to international capital diminished their influence. As a consequence, the Cardenista coalition acquired significance from the 1930s to the 1940s. Furthermore, the structuralist agenda that they pursued remained intact until the late 1970s. As the country suffered the vicissitudes of the inflationary development strategy, the support for monetary stringency grew. This phenomenon was amplified with the increasing availability of foreign capital distributed through the Bretton Woods’ institutions and private firms. The bankers’ alliance reached its peak in the 1960s, when a decade of growth and macroeconomic stability served as catalyst in the acquisition of financial assets. Along with the traditional commercial banks, the investment banks known as financieras benefited from the disintermediation within the system to become the most dynamic segment in the financial industry. Despite the strengthening of the financial system, the allocation of credit remained concentrated in the financial-industrial conglomerates. Even though the government implemented measures to circumvent these links, the conglomerates applied informal lending patterns that escaped the state’s supervision.
In the 1970s, the secondary effects of the import substitution strategy appeared. The production of intermediate goods required mature markets, which were nonexistent at the time. Moreover, the pattern of industrial protection created an inefficient industrial sector that was noncompetitive in the international sphere. The government broke the monetary stringency and pursued expansionary policies. Even though these policies generated a 7 percent annual increase in GDP during the 1970s, the growth was financed through international capital. In the early 1980s, a combination of interest rate increase and falling oil prices created an untenable position. In 1982, the government was forced to devalue and only through emergency short-term loans, was Mexico able to pay interest.

Even worse, the banks participated in a capital flight trend that further deteriorated the balance of payments. Thus, they were nationalized in 1982. This strategy did not solve the scarcity of credit for industry. As the government incurred high public deficits during the 1980s, there was competition for capital that created a crowding out effect that made interest rates higher than in previous decades. Nevertheless, the most important phenomenon of the 1980s was the transformation of the economic model from import substitution industrialization to the export-oriented model. The return to monetary stringency resembled the policies adopted during the stabilizing growth period, yet the high indebtedness of the country created a negative outflow of capital that slashed economic growth.

The Mexican government has continuously sought the implementation of a banking sector that would be aligned to its main goals of economic growth. However, the relationship has always been fraught by shifting alliances and interests. Rather than seeking a political alignment between the government and the financial sector it would be in the best interest of the country if the Mexican government just focused in providing an institutional environment where banks could operate with more certainty. The Doing Business Survey by the World Bank shows that the Mexico is not placed among the best countries for conducting business. This may be the primary factor behind the timid support of the financial sector to the economic goals of the government. As the 1994 peso crisis unfolded, a new reality has permeated the role of banks in the Mexican economy. Now foreign banks dominate the economic scene and even though they were fundamental in the injection of capital that was necessary to avoid a systemic failure of the banking sector, they have not provided sufficient funds for economic growth. Interestingly, the argument for the lack of commercial credit by foreign banks is that there is a weak judicial system that does not enforces contracts. Therefore, foreign banks are very active in providing consumer and housing loans where it is relatively easy to repossess the asset in case of default. My suggestion based on the literature review, the historical analysis, and the current situation with the banking sector in Mexico is that the government should create an environment that facilitates enforcement of contracts. In addition, given that the economy has grown significantly
since the revolution, the government could put more emphasis on the stock market and other financial institutions rather than focus on banks as a main source of external financing. Perhaps microcredit and crowd funding can serve as instrument for economic growth at the small business level whereas venture capital can promote the development of more risky enterprises.

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Verea Campos Monica, and Sidney Weintraub: 443-490. Mexico City: ITAM, UNAM, CISAN, and FCE.


