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Lessons from Mexico The Role of Financial Institutions in Market Crises

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The financial sector promotes a nation's economic growth and performance. By facilitating the transfer of funds from surplus income units to deficit spending units, financial intermediaries foster expansion of the economic system. But do financial markets and institutions merely facilitate the real forces driving development or do they play a more prominent, causative role in the growth process?

Increasingly, economists realize that the development of financial institutions and markets can be critical to the performance of a nation's economy. For years, conventional wisdom held that basic economic indicators (inflation, government budget trends, current account trade balance, level of international reserves) could anticipate or explain an economic crisis. This traditional model has been augmented to allow for domestic political and external economic shocks (an assassination, a key country raising interest rates, an increase/decrease in oil prices) as explanatory variables.

Even this modernized model, however, has proved inadequate for analyses of the majority of economic crises occurring in the 1990s. As a nation's financial sector evolves and interacts with global money and capital markets, a variety of vulnerabilities can develop. Such weaknesses can contribute to or even precipitate a financial sector-driven crisis. This can be the case even when the traditional economic indicators appear to be sound. A review of Mexico's debt crisis in 1982 and the financial crisis of 1994/1995 offers valuable insights into how financial sector conditions, especially in the banking industry, can influence economic performance.

The 1982 Debt Crisis

Prior to 1982, commercial banks in Mexico were privately owned but highly regulated, with interest rates set by the Banco de Mexico. The government established, for example, forced lending programs, requiring banks to loan a specified percentage of deposits to firms in government-determined "priority" sectors, and significant reserve requirements (50 percent or more). Financial innovations—such as working capital and equipment loans and residential and consumer lending—were left to nonbank intermediaries, such as *financieras*¹ and mortgage lending firms. Even with these developments, however, financial markets were very thin, marked by an abundance of short-term deposit and debt instruments and dollar-denominated accounts.²

This financial structure did not, in itself, cause the 1982 debt crisis, but it did increase the vulnerability of an economy already weakened by fiscal deficits and foreign debts. (See table.) When oil prices dropped in 1980 and 1981, the Mexican economy experienced falling export revenues, large and increasing government deficits financed externally or via monetization, and a deterioration in the international reserve position. An overvalued peso generated a flight to the dollar by both Mexican nationals and foreign financial investors. In August 1982, Mexico declared it could not meet scheduled foreign debt obligations, suspended the transfer of "Mexdollar" accounts abroad (and converted them to pesos), outlawed any new dollar-denominated accounts, announced the imposition of exchange rate controls, and nationalized banks. The peso depreciated approximately 95

percent over the 1982-1983 period.

The 1994/95 Financial Crisis

From the 1982 crisis until the late 1980s, general financial repression characterized the banking industry. Although nationalization brought considerable consolidation to the sector, the Mexican government continued to force banks to lend to it, maintained interest rate ceilings on bank assets and liabilities, and mandated lending in high priority economic sectors. At the same time, the government continued to allow growth and innovation in the nonbank institution industry, especially with respect to brokerage firms and insurance companies. The securities market expanded rapidly during the 1980s, due in large part to the government's increased issue of short-term CETES. By the late 1980s, the Mexican money market was quite sophisticated and very liquid.

In 1988-1989, the government relaxed controls over the banking industry, removing interest rate restrictions, eliminating priority lending and reserve/liquidity requirements, and allowing banks to enter into other finance-related areas. The Salinas de Gortari administration reprivatized banks in 1991 and opened banking markets to new domestic entrants in 1993. This deregulation, however, was not balanced with safety and soundness regulation. This, combined with a general lack of accounting/information standards and a weak legal system in the area of debt collection, set the stage for excessive loan volume (funded by short-term and/or dollar-denominated deposits) and credit risk-taking.

Despite this fragility in the banking system, the Mexican economy continued to perform quite well. Real growth was generally strong, a disinflation trend was in place, the government budget appeared to be sound, and international reserves, relative to a rising current account balance (\$7.5 billion in 1990 to \$29.4 billion in 1994), surpassed 100 percent for the most part. An estimated \$95 billion of foreign financial investment poured into Mexico.

While not unambiguously positive, these standard economic performance statistics remained strong in December 1994 when the financial crisis peaked. Other domestic political and key country factors, then, helped drive Mexico into crisis. The Chiapas rebellion, the Colosio assassination, and the nomination and election of Ernesto Zedillo, a relatively unknown political figure, had a cumulative effect: so-called country risk perceptions of the international community increased and international reserves decreased. Further, a series of upward adjustments in U.S. interest rates beginning in February 1994 increased pressure on Mexican interest rates. Finally, financial market participants began to question the credibility of fiscal and monetary policy authorities in the face of a crisis.

The results are well known. The peso depreciated more than 70 percent over the 1994-1995 period. The economy was in recession during 1995, and even now, banks continue to face significant problem, as well as defaulted, loans.

Lessons Learned

As the Mexican experience demonstrates, trends in real and monetary economic variables continue to contribute to the development of economic/financial crises, as do domestic political and external shocks. Increased global financial capital mobility mandates that the financial sector be monitored and managed carefully. In short, policymakers must couple macroeconomic stabilization measures with financial sector stabilization policies to promote sustained economic growth.

These lessons have not been lost on the Mexican government. Since 1995 the Mexican economy has performed well: real GDP has increased at a rate of 5 percent or higher, fairly restrictive fiscal and monetary policies have been implemented, inflation is trending downward, and the international reserve to current account balance is high.³ Legislation has been introduced to grant the central bank complete control over monetary policy and increase its supervisory role. Further, steps have been taken toward adopting generally accepted accounting standards and lengthening the maturity structure of debt obligations. On the other hand, oil prices are depressed, political unrest is still present, the effects of the Asian flu threaten, and the health of the banking sector is of concern. It will be interesting to observe Mexico's ongoing design to achieve macroeconomic *and* financial sector stability.

Notes

1. Development-type institutions making primarily long-term loans to the business sector.
2. For a detailed discussion of the evolution of the Mexican financial sector and banking industry, see John H. Welch and William C. Gruben, "A Brief Modern History of the Mexican Financial System," *Financial Industry Studies*, Federal Reserve Bank of Dallas, October 1993, 1st10.
3. J. P. Trevizo, "Mexico," *WEFA Group Latin America Economic Outlook*, March 1998, 8.1st8.25, provides an excellent discussion.

Basic Economic Indicators, Mexico (percentages)

Indicator	1978	1980	1982	1990	1992	1994
Government budget deficit/GDP	2.9	3.0	12.0	2.8	surplus	0.7
Int'l reserves/current account deficit	n.a.	28.0	14.0	131.0	78.0	21.0
Annual rate of peso devaluation	0.0	2.1	27.1	10.3	1.4	41.7
Mexico v. U.S. annual inflation rate differential	9.7	12.1	53.5	21.2	12.5	4.4
Annual growth in real GDP				4.5	3.6	4.5
Annual inflation rate				26.6	15.5	7.0

Source: International Monetary Fund, *International Financial Statistics. Economic Report of the President.*

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