Mexico: Financial Fragility or Structural Crisis?

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Orthodox interpretations of Mexico’s 1995 crisis have centered on (1) exchange rate policies, (2) the timing, magnitude, and missteps of the devaluation of the peso, and more recently, (3) the failure of monetary policy in setting an interest rate that would continue to attract external funds as events within Mexico became increasingly turbulent in the course of 1994. The role of structural factors, such as the profound fragility of the Mexican financial system, and the endemic weaknesses of the IMF/World Bank model of a market-led/export-led economy have, perhaps understandably, received little attention. This paper, while primarily concentrating on the details of the crisis in the banking sector, attempts to take the discussion of the 1994 crisis one step further: it is hypothesized that the fragility of the banking system was one major result of Mexico’s failed experiment in ultra-laissez faire policies, which began in 1982.

Institutional Economics and Credit Instability

As Thorstein Veblen argued in Absentee Ownership [1923], modern capitalism holds within its structure a volatile set of forces that can explode into economic convulsions—and these forces tend to be centered within the financial system:

The fabric of credit and capitalization is essentially a fabric of concerted make-believe resting on the routine credulity of the business community at large. It is therefore conditioned on the continued preservation of this prevalent credulity in a state of unimpaired tensile strength, which calls for eternal

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vigilance on the part of its keepers. The fabric, therefore, is always in a state of unstable equilibrium, liable to derangement and extensive disintegration in case of an appreciable disturbance at any critical point . . . [Veblen 1923, 383].

Hyman Minsky’s work, and that of his followers, demonstrates that profit-maximizing banks will engage in increasingly risky activities in a system that is inherently unstable—thereby unleashing forces over the course of a cycle that build toward the outbreak of a financial crisis [Dymski and Pollin 1994; Minsky 1982]. Ultra-laissez faire economic structures, in the view of both Veblen and Minsky, are inherently unstable and require agile oversight through an evolving institutional structure designed to counter the predictable excesses of a market-based economy.

**Mexico’s Structural Crisis**

In contrast, neoliberalism—as currently practiced in Mexico, as well as at the World Bank and the IMF—idealizes the market system as inherently stable and socially optimal. In this formulation, regulatory functions need to be kept to a minimum, while market forces should operate in an ever-widening sphere. Basic to this model is the policy to diminish the role of the state primarily through privatizations—the largest of which have been bank privatizations. It is this perspective that constitutes the basis for Mexico’s structural crisis. The crisis of financial fragility needs to be interpreted within the context of a deeper crisis of accumulation. Mexico’s ultra-laissez faire/neoliberal model has precipitated a structural crisis that entails economic stagnation, increasing inequality of income distribution, precipitously falling wages,1 deindustrialization, a structural balance of payments deficit, and a rapid shift toward speculative finance that eventually led to a collapse of the banking system.

Under policies of state-led development from 1940 to 1980, Mexico’s real GDP expanded at an annual rate of approximately 6 percent. From 1983, when the neoliberal experiment began, through 1994, real GDP expanded at a 1.6 percent annual rate—well below the rate of population growth. From 1984 to 1992, the top 10 percent of the income recipients expanded their share of total income from 32.8 percent to 38.2 percent (without calculating the additional income accruing to this strata via their capital flight funds ensconced in the United States and Europe) [OECD 1992, 110; 1995, 101]. Industry’s share of GDP shrunk from 22 percent in 1980 to 20 percent in 1993, while finance and real estate expanded from 8.6 percent to 14.9 percent in the same period [OECD 1995, 176]. Meanwhile, the policy of export promotion faltered—export performance fell by 15 percent in 1991-1994 as Mexico failed to maintain its market share with its major trading partners [OECD 1995, 18].
Mexico's Devaluation and the Banking Crisis

In a representative orthodox account of the crisis, U.S. Federal Reserve economist David Gould argued that Mexico should have increased interest rates in 1994 and probably should have devalued in 1993 [Gould 1995, 9]. Yet, in 1993 there was little open pressure on Mexico to devalue—nor did devaluation seem in order, with growth falling to near zero, inflation falling below 10 percent, and the trade deficit declining to 6.4 percent of GDP (compared to 7.4 percent in 1992) [OECD, 1995 19, 164, 169]. Nor would a serious devaluation have helped Mexico in its NAFTA negotiations, because Mexican policymakers understood that U.S. acceptance of the trade agreement hinged on the perception that the United States would increase its exports to Mexico in the aftermath of the agreement. Thus, for the orthodox analyst, the remaining alternative was to raise interest rates in 1994 in order to maintain the inflow of "hot" money into the Tesobono market (government debt issued in pesos but indexed to the U.S. dollar) and into the Mexican short-term financial markets. Yet, to do so would have been to push the Mexican banks deeper into a then silent crisis.

Far overshadowing the debates over the sustainable exchange rate and the refinancing of the Tesobonos were two institutional factors that have received scant attention. First, capital flight in 1994, prior to the December turbulence, has been estimated at from $17 to $20 billion—although the term capital flight is usually not employed [OECD 1995, 21, 38; IMF 1995a, 56-61]. Second, given the extent of the collapse in the banking system, of necessity the lion's share of the approximately $40 billion rescue program created in early 1995 would go either to rebuilding foreign currency reserves drained by capital flight or to socialize the banks' debts. 2 Neither the exchange rate dispute nor the dissection of the refinancing of the Tesobonos touches the core of the Mexican crisis. At its core the crisis was (and is) one of state autonomy—including regulation of the capital flight option so often exercised by the Mexican elite, and regulation of the banking system where speculation and loan pushing ran rampant after the re-privatization of the banks in 1991-92. 3

The Banking Crisis

With interest rates climbing, sometimes to more than 100 percent following the IMF’s stabilization program beginning in early 1995, the crisis in the banking sector spilled into the open. Figure 1 records the spectacular increase in non-performing loans within the Mexican commercial banking system through September 1995. Reported non-performing loans as a share of total loans in the banking sector rose precipitously in 1995—from 7.4 percent of total loans in 1994 to nearly 17 percent by September 1995. 4 By international standards, a banking system with overdue loans of 4 percent is considered to be in a "poor" situation. The non-performing loans as
of September 1995 were estimated to exceed the equity capital of the commercial banks by a factor of two to three. In addition, the Mexican commercial banks owed more than $25 billion to foreign creditors—most very short-term, necessitating refinancing in 1995. (Some estimates place the commercial banks’ exposure much higher—$38.6 billion, or 3.5 times equity capital [Gonzalez 1995, 1, 45].) That the commercial banking system was in a virtual state of collapse was not debatable. The crisis of 1995, then, is not a result of monetary policy errors relating to the exchange rate, nor is it limited to a sectoral crisis in finance, although the financial crisis was a major manifestation of the structural crisis.

**Background to the Banking Crisis**

The commercial banks served as a conduit for capital flight in 1982, and the financial elite through the powerful Mexican Bankers Association challenged the autonomy of then President Lopez Portillo. In a bold move to undercut this challenge, to reassert the leadership of the state, and to gain control over the financial sector, the banks were nationalized in late 1982 [Cypher 1990; Maxfield 1990]. Although speculation was rife regarding the possible re-privatization of the banks under President de la Madrid (1982-88), he both maintained the official posture of the
government—the banks would remain the property of the Mexican people—and allowed for the creation of the "parallel banking system" of stock brokerage firms, which began to play the role of non-bank banks in Mexico [Maxfield 1990]. Under pressure from large creditors such as the World Bank, and in accord with the economic philosophy of his cabinet, President Salinas (1988-94) gradually expanded the province of the private sector in the financial sphere, and during 1991-92 he rapidly sold the 18 banks that had been nationalized in 1982. This re-privatization was hailed throughout the globe as a further example of the neoliberal era in Mexico—and it created a windfall of $12.4 billion (U.S.), which the government could use to build-up reserves and pay down foreign debt. At the time, proponents of the ultra-laissez faire policy of the Salinas administration proclaimed the bank privatization as a momentous step toward increasing the efficiency of the Mexican economy. Even as the profound magnitude of the bank debacle was beginning to be understood in December 1994, the Secretary of the Treasury, Dr. Pedro Aspe, continued to laud the financial sector:

The Mexican financial sector has confronted the challenge of modernization and it has consolidated its presence within Mexico’s economic strategy in order to respond to current global circumstances, which demand a competitive integration within the international economy, as well as improved efficiency and balance in all financial activities. The financial system of today is imbued with both characteristics and instruments which will promote a growing savings level and channel foreign financial flows to the most productive and efficient use for the benefit of society [Aspe 1994, 1048].

This air of triumph was echoed at the October meeting of the commercial bankers where they resurrected the Mexican Bankers Association while claiming that the banks (and the Mexican government under Salinas and Aspe) had been recognized worldwide for their "majestic performance." Majestic was the rate of growth of bank profits: from $1.3 billion in 1991 to $1.9 billion in 1992, to $2.7 billion in 1993, and—annualized on the basis of September 1994 returns—$2.5 billion in 1994 [Acosta 1995, 21]. Bank profits were so high in relation to the return on equity found elsewhere (Figure 2, records the ROE for Mexico, the United States, and Canada) that there can be little doubt that the financial sector was draining the industrial sector of the Mexican economy of its ability to expand its productive base.

Behind the facade of official accolades and self-congratulations, however, the data revealed a banking system permeated by high-risk finance methods of the most fragile type. Bank lending soared—the six largest banks (which controlled 70 percent of the commercial bank loans) increased their lending by 230 percent in the six-year period from 1988 to 1993, with the most rapid growth coming in the 1990s. Profits for these banks, meanwhile, increased 137 percent in the same period [Giron 1994, 1072]. Foreign borrowing was a favored stratagem of the banks, creating external debts that rose from $9 billion in 1989 to $23 billion in 1993 and to an amount esti-
mated between $25 billion and $38 billion in 1995 [OECD 1995, 20; Gonzalez 1995, 1, 45]. By late 1994, the OECD estimated that one-third of the loans extended by the Mexican banks were in foreign currencies and that 25 percent of these loans were to businesses and individuals who had no income in foreign currencies.

The OECD has linked the official explanation of Mexico’s structural crisis—the collapse of domestic savings (from 24.7 percent of GDP in 1983 to 16 percent in 1994)—to loan pushing on the part of the commercial banks: "... financial deregulation contributed to the decline in the ratio of private saving to GDP... as banks competed to gain market shares, often extending consumer credit and housing loans without adequate risk assessment. This led to a deterioration of private sector balance sheets and poor quality of banks’ loan portfolios" [OECD 1995, 4].

Overall, bank credit to the private sector from 1988 through 1994 (expressed as a percentage of GDP) rose from 14 percent to 55 percent—a 400 percent increase in only seven years [OECD 1995, 36]. As the OECD stressed, the bulk of these loans were for consumer credit, including auto loans, mortgage loans, and credit card loans, and secondarily to the business sector to finance real estate and construction activities (which were primarily linked to speculation activities in office buildings and shopping centers). Conspicuous for its absence was any mention of the credit
explosion being linked to industrial activities or to any other economic activity that would point to the expansion of the productive base of the Mexican economy.

**The Socialization of the Private Banks' Losses**

With non-performing loans estimated to be more than double the value of the equity capital of the entire Mexican banking system by late 1995, it perhaps comes as no surprise to state that the government was engaged in a massive and ongoing effort to socialize the banks' losses. This process was exceedingly complex, and will only be traced here.6

**FOBAPROA:** One response has been the outright takeover of failed banks. These takeovers are conducted by a deposit guarantee fund known as Fobaproa. Thus far, Fobaproa has taken over, or is scheduled to take over, 12 banks, including 9 of the 18 banks privatized in 1991-92. As the banking crisis commenced, most observers assigned a minor role to Fobaproa, arguing that it had taken over small banks, particularly those that had engaged in fraudulent activities. This perspective changed drastically in late 1995. In September, two banks were taken over, in October two more, and in December Banco Inverlat, the fourth largest in Mexico, failed. Meanwhile, in November Banco Obrero was scheduled to be absorbed by Fobaproa. Nearly as significant as the takeover of Inverlat was the intervention in Banco Bital (the 6th largest) and Banco Atlantico (the 7th largest). Fobaproa bought $640 million (U.S.) of non-performing loans from Atlantico and $150 million from Bital. (Table 1 details the partial re-nationalization process.)

By socializing these banks' speculative losses, the government hoped to resell them to foreign banks. Thus far, Spain's Banco Bilboa Vizcaya has purchased Probusa, A.G. Alemania (Germany) has acquired Banoro and Bancracer, Bank of Nova Scotia (Canada's eighth largest) bought Inverlat, and Canada's third largest bank, Bank of Montreal, took over a 16 percent share of Mexico's second largest bank, Bancomer.

**PROCAPTE:** In addition to Fobaproa's role, the government created Procapte to temporarily capitalize banks. Procapte's funds have gone to solvent banks. By mid-1995, Procapte had injected more than $6 billion in hard currencies and pesos into the banking system in exchange for the banks' subordinated debentures. Banks with capitalization rates below the mandatory 8 percent (measured as equity capital as a share of assets) have received these funds. Procapte's role greatly expanded in December 1995 when, backed by a new $1.64 billion drawdown from the IMF, it acquired $2 billion in non-performing loans from Banamex (the largest bank) and $1 billion of Bancomer's bad loans. (Banamex was Mexico's largest bank privatization and the chief example of the rise of stockbroking capital within the financial system—in 1995 it held 21 percent of the total assets of the banking system.) In all, the December operation will inject a total of $4 billion into six banks. Banca Serfin (the
Table 1. Mexico, Bank Intervention/Re-Nationalization

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<thead>
<tr>
<th>Bank</th>
<th>Capital Base</th>
<th>Asset Rank</th>
<th>Date</th>
<th>Intervention/Acquisition</th>
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<tbody>
<tr>
<td>Inverlat</td>
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<td>4</td>
<td>12/95</td>
<td>Fobaproa/Nova Scotia</td>
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<tr>
<td>Atlantico*</td>
<td>St</td>
<td>7</td>
<td>11/95</td>
<td>Fobaproa</td>
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<tr>
<td>Obrero**</td>
<td>n.d.</td>
<td>17</td>
<td>11/95</td>
<td>Fobaproa</td>
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<tr>
<td>Oriente</td>
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<td>18</td>
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<td>Interstatal</td>
<td>n.d.</td>
<td>25</td>
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<td>Bital*</td>
<td>In</td>
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<td>9/95</td>
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<td>Banoro</td>
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<td>9/95</td>
<td>Fobaproa/A.G Alemania</td>
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<td>Probusa</td>
<td>St</td>
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<td>6/95</td>
<td>Fobaproa/Bilboa Vizcaya</td>
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<td>Banpais</td>
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<td>3/95</td>
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<td>Union</td>
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<td>Fall/94</td>
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<td>Cremi</td>
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<td>Fall/94</td>
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* Denotes intervention, not a complete takeover.

** Anticipated takeover, announced by The National Banking Commission (CNBV).

St = the majority of the bank's capital derives from a stockbroking and investment group.

In = the bank's capital derives from an industrial group.

Tr = the bank's capital derives from transportation/commerce.

n.d. = no data.

Sources: *El Financiero International* [various issues], *La Jornada* [various issues], Garrido, [1994, 171].

third largest) shifted $670 million of bad loans to Procapte in June 1995 and is scheduled to do the same with $1.1 billion of non-performing loans in 1996, thereby socializing nearly 21 percent of its total loans.

UDIs: Under the UDI scheme, the government has refinanced 163 billion pesos of bank loans (23 percent of the total loan portfolio of the commercial banks). In essence, the government has exchanged its bonds (riskless assets for the banks) for the banks' loans (assets of the banks' which are extremely risky). Debtors were allowed a longer pay-back period in inflation-indexed debts. UDis were extended to that part of the banks' portfolio devoted to business loans and state and local government loans and mortgage loans.

ADE: The ADE program is similar to the UDI program but directed at some 2.1 million debtors who were extended credit by the banks for credit card and other forms of consumer debt. The ADE program was created in September 1995 both as a reaction to public opposition to the banks' attempt to push variable interest loans
to more than 100 percent and to the rising level of non-performing consumer loans. The Finance Minister has announced that the ADE program will cost the government $84 billion pesos—an amount equivalent to roughly 12 percent of the private banks' portfolio of loans.

**Conclusion**

The cycle of bank re-privatization and partial re-nationalization occurred within six years. At the end of the cycle, the government had effectively taken over half the banks it had privatized. It had, furthermore, refinanced and subsidized the remaining banks, in effect socializing approximately 41 percent of the outstanding bank credits in the Mexican banking system. Having received $12.4 billion from the bank privatization, it was forced into the position of extending at least $15 billion in credit to the banking system in 1995. The failure of the market-led strategy in the financial sector should reveal the false premises of the neoliberal project, which makes no distinction between the socially necessary and productive role of industry and the predatory/rentier nature of unregulated (or under regulated) finance. Unfortunately, the currently dominant institutional/ideological force within the Mexican economy, the IMF, appears to have learned nothing about the model that it and the Mexican government so enthusiastically embrace. In October 1995, the IMF's managing director said: "[The Mexican Crisis] has not dented, but, if anything, reinforced the worldwide appreciation that countries need outward-oriented and market-oriented strategies to foster growth" [IMF 1995b, 314].

**Notes**

1. Average wages fell from their pre neoliberal base level of 1980 = 100, to 74 in 1993 [OECD 1992, 256; 1995, 169]. The strongest showing was for manufacturing wages, where drastic cutbacks in the labor force occurred. Nonetheless, average manufacturing wages in 1994 were only 94 percent of the 1980 level. *Minimum wages*, which may represent per worker incomes for 30-40 percent of the population, had fallen to roughly 35 percent of their 1978 level by early 1995 [OECD 1995, 15]. Overriding all other possible computations and adjustments that could be made using Mexico's limited data on wages was the drop in wages in 1995—estimated to be in excess of 10 percent.

2. The United States provided $20 billion, and the IMF $17.8 billion, supplemented by loans from Canada, the World Bank, and the InterAmerican Bank. By July 1995, the Mexican government had drawn $22.5 billion from the United States, Canada, and the IMF, with an additional approximately $2 billion for bank restructuring loans from the World Bank and the InterAmerican Bank. In December, the IMF issued a new credit of $1.64 billion, bringing the total to approximately $26 billion. Of this total, $10 billion was used to replenish reserves, at least $6.3 billion was used to refinance the foreign currency obliga­tions of the banks, leaving approximately $10 billion which apparently was used to rescue insolvent banks and to support the liquidation of the Tesobonos. (In February 1996, the InterAmerican Bank loaned an additional $1.5 billion to aid the banking sector.)
3. In terms of assets, the majority of the banks fell into the hands of an emerging financial elite that had flourished under the "parallel banking system" created in the 1980s. New "financial groups," which centered their capital on the stock market but also owned financial leasing companies, foreign exchange companies, and other financial operations, became the major owners of the newly privatized banking system. This new financial elite had acquired very large sums of money with little effort or acumen in the 1989-92 period when the combined value of the corporate stock on the Mexican exchange jumped from 11 percent of GDP to nearly 50 percent. Much of the ultra-quick profits acquired in this boom were transferred into ownership of the banks, where the stockbroking-based new financial elite expected to make similar spectacular returns via financial alchemy. Particularly attractive was the spread between national and international lending rates—often in the range of 20 basis points—which allowed the banks to skim-off profits by pushing loans. Loans expanded at an average annual rate of 26 percent in 1992, 1993, and 1994.

4. Mexican banks record only the unpaid portion of a non-performing loan as overdue. Under U.S. accounting standards, the entire loan would be registered as non-performing. Under these standards, it is widely estimated, by Salomon Brothers and other sources, that non-performing loans amounted to 30-40 percent of outstanding loans. That is, non-performing loans were the equivalent of 8-11 percent of GDP.

5. The practice of rapid loan expansion was strongly reinforced in the course of 1993, and especially 1994, as fiscal policy turned expansionary. At this point the powerful government-owned development banks, such as Nafinsa and Bancomext, borrowed on the international markets and then made these credits available to the commercial banks for re-lending to the private sector. From 1991 through 1994, the development banks expanded their loans at an average annual rate of 25 percent—development bank loans expressed as a share of GDP soared from 1.4 percent in 1991 to 4.2 percent in 1995 [OECD 1995, 35].

6. In addition to the programs outlined below, the government has established a "dollar liquidity program" whereby the banks' external debt can be paid by the central bank, with the banks then incurring a peso denominated debt owed to the Banco de Mexico. Other features include the alteration of the limits imposed on foreign equity ownership of the Mexican banks and increasing the allowed equity for Mexican industrial "groups." The longer-term effect of these changes will be to restructure the financial sector, rapidly increasing the role of foreign banks, and allowing the "national power groups" in the industrial sector to increase their control of the financial system.

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