

CARNEGIE

P A P E R S

**DEVELOPMENT
AND FOREIGN
INVESTMENT:
Lessons Learned
from Mexican
Banking**

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**Trade, Equity, and
Development Project**

Global Policy Program



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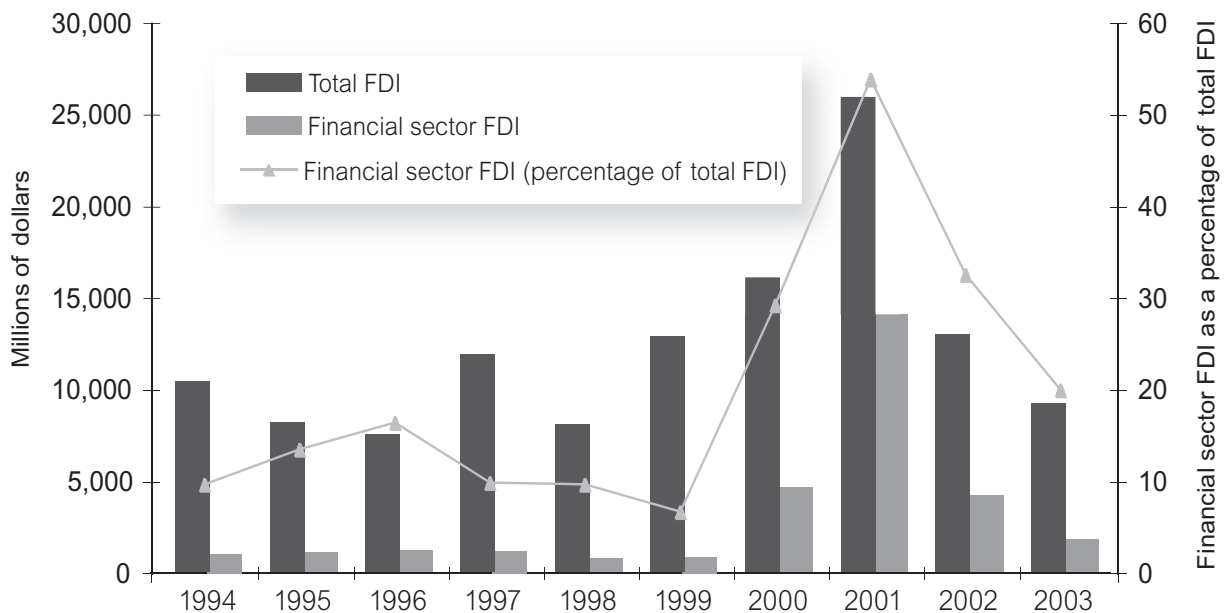
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INTRODUCTION

FOREIGN DIRECT INVESTMENT (FDI) HAS TRANSFORMED MEXICO'S BANKING SYSTEM during the past decade, making it the second largest in Latin America with \$165 billion in commercial assets in 2003.¹ In the past four years, Mexico received \$25.3 billion of FDI into its financial sector. This composes nearly 40 percent of total FDI inflows into the country (figure 1). As a result of FDI flowing into the country's financial sector, the Mexican banking system has the highest ratio of foreign ownership in Latin America (figure 2).²

FIGURE 1. Total and Financial Sector FDI Inflows to Mexico, 1994–2003

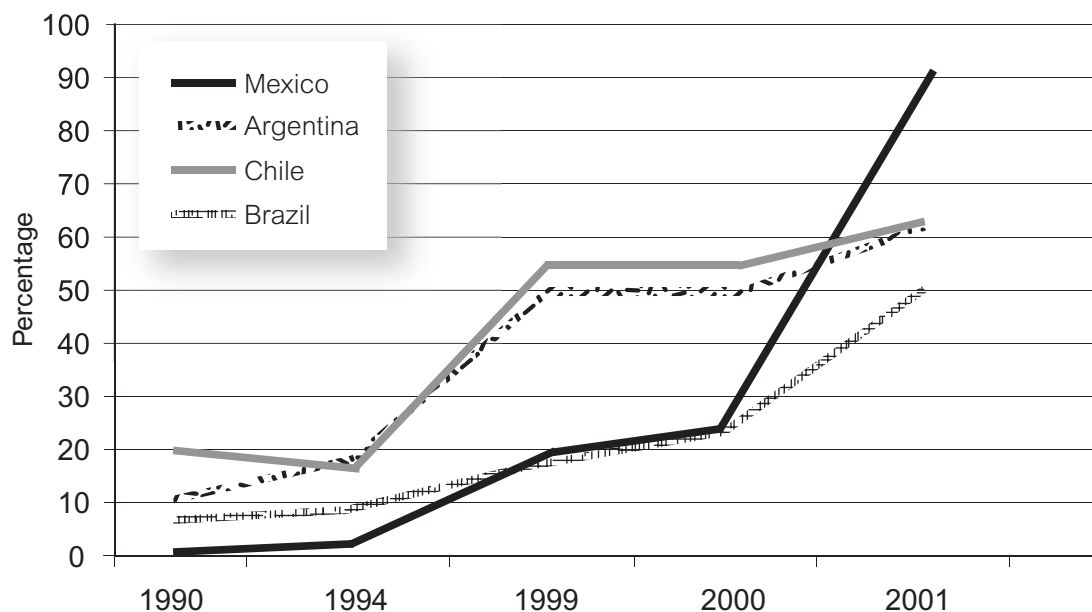


Source: Mexican National Institute of Statistics, Geography, and Information (INEGI), www.inegi.gob.mx.

Mexico's unsuccessful responses to financial crises in 1982 and 1991 set the stage for opening the sector to FDI. In 1982, Mexico nationalized its banking system. In 1991, Mexico began a privatization process. Banks sold for high prices, which encouraged them to overlend in an attempt to obtain high returns on their own investment. Excessive lending, as well as poor economic and political conditions, contributed to the financial crisis of 1994–1995. After the peso crisis, the

Mexican government opened its banking sector to FDI to a greater degree than initially permitted under the North American Free Trade Agreement (NAFTA). These regulatory changes, improved macroeconomic conditions, and growing competitive pressures in the global banking industry attracted foreign banks to the market potential of the Mexican banking sector. Foreign banks that were previously prohibited from functioning in the Mexican market saw this opening as an opportunity to purchase assets at extremely low valuations and invest in an expanding market likely to produce profit margins greater than in their home countries. Through mergers and acquisitions, the number of foreign banks participating in Mexico has continued to grow. Each foreign entrant has also raised its equity stake in Mexico through acquisitions that have become increasingly larger in size.

FIGURE 2. Foreign Share of Mexico's Banking Assets, 1990–2001



Source: United Nations Economic Commission for Latin America and the Caribbean (ECLAC), *Foreign Investment in Latin America and the Caribbean*, 2002, www.eclac.org.

The sector's transformation has been extremely profitable for foreign banks, primarily because the banking industry remains relatively uncompetitive, permitting banks to enjoy rents. As foreign banks eliminated merger-related duplications, reduced employment, improved past-due loan portfolios, and transferred better risk assessment and management systems, their profits soared.

Foreign banks have helped strengthen Mexico's overall banking system by restoring financial solvency and stability. Increased participation of foreign banks reduced the government's burden of recapitalizing the banking sector after the 1994–1995 financial crisis. Asset levels, sector capitalization, and the percentage of nonperforming loans have all improved since 1997. By improving microeconomic efficiency and profitability, each foreign bank has had a positive impact on the Mexican financial system's health from a macroeconomic perspective.

Despite the positive benefits of FDI for the banking sector, however, Mexico still suffers from many of the financial problems plaguing the developing world—shortage of finance for housing,

poor access to credit in rural areas, and difficulty for small and medium-sized enterprises (SMEs) to borrow money. Although these problems predate the transformation of Mexico's banking sector, many indicators have worsened during the past decade, even as FDI has grown.

Are Mexicans better off since this transformation? Domestic credit to the private sector as a percentage of gross domestic product (GDP) fell in Mexico from 17.5 percent in 1990 to 12.6 percent in 2002. This is extremely low compared with the global average, which expanded from 97.5 percent to 118.1 percent from 1990 to 2002, and the developing-country average, which increased from 39.3 percent in 1990 to 55.9 percent in 2002. Furthermore, domestic credit provided by the banking sector as a percentage of GDP also fell from 46.5 percent in 1994 to 26.6 percent in 2002. Is there a connection between the rise of FDI in the banking sector and the fall in domestic credit to the private sector as well as domestic credit provided by the banking sector?

Answering these questions is important not only for Mexico's development strategy, but also for strategies of other developing countries that are contemplating loosening regulations on FDI in their banking sectors unilaterally or through other means, such as multilateral trade negotiations.

From a development perspective, it is important to understand the impact foreign banks have had on access to consumer, commercial, and mortgage credit, employment in the sector, and competition among banks to improve the price and quality of their products and services. Efficient financial intermediation is extremely important in mobilizing resources and allocating capital to areas of growth. Without access to credit, businesses cannot grow and economic development will be held back. Furthermore, without adequate competition and the ability to manage risk effectively within the financial sector, consumers are susceptible to unfairly high borrowing costs and exposure to risk from financial shocks. Taxpayers pay for bailouts of inefficient and unregulated banks that disregard lending risk because the banks know the government has no other choice but to clean up the mess. Other countries also feel the effect of a financial meltdown. For example, the United States, along with the World Bank and the International Monetary Fund (IMF), provided Mexico with approximately \$52 billion in financial aid in 1995 to recover from the crisis.

As other developing countries move toward greater global integration in financial services, understanding Mexico's experience is increasingly relevant. Mexico has been one of the leaders in economic liberalization during the past decade, especially in its banking sector.³

Many developing countries will experience financial crises and trade agreement obligations and will face choices similar to Mexico's. China, for example, must allow foreign firms increased access to its banking sector in the coming years in accordance with its World Trade Organization (WTO) obligations. Negotiations in the WTO, either in the Doha Development Round or the General Agreement on Trade in Services, may also lead toward greater financial sector liberalization and integration.

This paper's first section will highlight some of the main structural changes in Mexico's banking sector before the peso crisis began in 1994. The second section will discuss the motivations behind the government's decision to open up its banking sector to FDI. The third section will describe the factors that influenced foreign banks' calculations that the potential benefits of investing in Mexico's banking sector outweighed the risks. The paper will then detail the strategic moves made by Citibank, BBVA, Santander, HSBC, and the Bank of Nova Scotia (Scotiabank) in buying Mexican banking assets. The positive and negative impacts these changes have had on the banking sector will

be analyzed in the fifth section. The sixth section describes the development impact of FDI on access to credit by Mexican consumers, businesses, and taxpayers and on banking sector workers. The seventh section will provide key findings and a development balance sheet summarizing the impact FDI in the banking sector has made in Mexico.

HISTORICAL OVERVIEW OF MEXICO'S BANKING SECTOR: NATIONALIZATION TO INTERNATIONALIZATION

Mexico's banking system experienced drastic change in the twelve years leading up to the financial crisis in 1994–1995. The system was nationalized and reprivatized in fewer than ten years. Both restructurings of the sector were driven by severe economic crises that have defined Mexico's transformation from a closed, import-substitution industrialization (ISI) economy to one marked by economic liberalization, privatization, foreign investment, and export-led growth.

Similar conditions were present in Mexico in 1982 and 1994–1995: economic decline, capital flight, an ensuing debt crisis, and pressure on the peso. Mexico, however, chose two distinct paths: in 1982 it moved toward a closed, nationalized system, but in 1994–1995 toward a more open, privatized system. In 1982, President Lopez Portillo nationalized fifty-eight of Mexico's sixty banks, amending the constitution in the process.⁴ Thirteen years later, Mexico's government bailed out its banking system with the help of \$52 billion in multilateral aid from the United States, the World Bank, and the IMF. In addition, Mexico began to seek greater foreign participation in its banking sector, in part as a consequence of its NAFTA obligations but also as a way to recapitalize its troubled banks.

The nationalization of the banking system in 1982 greatly affected bank lending in the 1980s. Banks, now controlled by the government, had to meet high reserve requirements but were able to do so only by purchasing large amounts of government debt. For example, in 1986, more than 60 percent of net bank credit flowed to the government.⁵ In addition to crowding out lending to the private sector that could have helped drive economic growth, disproportionate lending to the government created inefficiencies and low profitability for the banks.

After nationalization in 1982, President Miguel de la Madrid, who replaced Portillo that year, began the liberalization process. Measures included reducing the amount of assets controlled by banks, expanding the securities market, and formally entering into the global trading system in 1986. The government began to sell many of the banks' nonbanking components to the private sector.⁶ Mexico also greatly expanded its securities markets, increasing the issuance of short-term bonds (*cetes*) and the market capitalization of the stock market (*Bolsa de Valores*). Finally, and the most significant symbol of Mexico's opening to the rest of the world, came Mexico's signing of the General Agreement on Tariffs and Trade (GATT), which later became the WTO.

Salinas de Gortari, who became president in 1988, continued the liberalization process by privatizing the financial sector, further developing capital markets, and negotiating NAFTA, which included provisions that allowed greater foreign participation in the financial sector. Owing to sector consolidation in the 1980s, only eighteen of the original fifty-eight banks that were nationalized remained to be privatized. Despite a constitutional amendment that allowed the sale of banks to Mexicans only, a bank was sold, on average, every three weeks from June 1991 to July 1992.⁷ This

left Mexico with a concentrated, uncompetitive, and profitable industry.⁸ For example, the three largest banks held nearly three-fifths of Mexican banking assets.⁹ This explains why investors were willing to pay, on average, 3.49 times a bank's book value and nearly 15 times its previous year's earnings, allowing the government to earn close to \$12 billion from the sale of the banks.¹⁰ This suggests that investors believed the industry would remain concentrated and uncompetitive in private hands, leading to greater profitability and a quicker return on investment.

From a business perspective, banks benefited greatly from these policy changes. In 1992, the net return on assets for Mexican banks was approximately 1.45 percent, versus 0.91 percent for U.S. banks. Much of the profitability came from the widening spread between the average cost of funds and the average lending rate. In 1991, the spread was between 5.31 and 6.29 percentage points; in 1992 the spread increased to between 8.09 and 10.69 percent, even though inflation rates were lower in 1992.¹¹ As a result of this wide spread, high expectations for economic growth, inadequate expertise in evaluating credit risk, and a struggle for greater market share, banks overlent considerably. Bank credit to the private sector rose from less than 10 percent of GDP in 1989 to about 40 percent in 1994.¹² Between 1988 and 1994, domestic commercial lending to the private sector grew at an annual rate of 25 percent, mortgage loans expanded by 47 percent, direct store credit for consumer durable goods ballooned by 67 percent, and credit card liabilities increased by 30 percent.¹³ Banks lent so much that their marginal cost exceeded their marginal revenue.¹⁴

FOBAPROA, the deposit guarantee agency, insured 100 percent of deposits. As a result, banks had little incentive to restrict lending, and depositors felt their money was in safe hands. Furthermore, an inadequate consumer credit report system and a lack of properly designed regulations to monitor the quality and quantity of Mexican bank capital made loan defaults much more common. Commercial banks' ratio of past-due loans to total loans and discounts rose from 5.5 percent in December 1992 to 8.3 percent in September 1994.¹⁵ In addition, nonperforming loans, a measure of asset quality, increased from an already high 7.3 percent of all loans in 1993 to 9 percent by the end of 1994.¹⁶ The Mackey Report, a report commissioned by the Mexican Congress that examined the performance of the banking system for the most recent two decades as well as the government rescue program, highlighted these weaknesses in supervision and regulation:

The weak supervisory environment in which both the new and privatized banks found themselves, coupled with the implicit guarantee given by the government that all liabilities, including deposit liabilities, would be met, gave the banks the opportunity, and possibly the incentive for excessive risk taking, and removed the incentive to put in place proper management structures. The regulatory authorities have agreed that, in hindsight, the privatization process should have been conducted in a more prudent manner.¹⁷

Because of high concentration and lack of competition within the industry coupled with weak regulation, privatization of the banking system did not bring lower prices and improved services to consumers.

Mexico took two concrete steps in 1993 to increase competition in the sector. First, it granted permission in 1993 for new domestic banks to enter in the industry. By 1994, the number of banks increased in Mexico from twenty at the time of privatization to thirty-five.¹⁸ In addition, beginning on January 1, 1994, NAFTA allowed greater, although still minimal, foreign participation in Mexico. NAFTA allowed U.S. and Canadian banks to acquire Mexican counterparts, so long as each bank did not account for more than 1.5 percent of total Mexican bank capital.

The existing problems in the banking sector grew worse as the factors leading to the peso crisis intensified. For example, Mexico was pursuing an exchange-rate-based inflation stabilization policy, known as the crawling parity band, which pegged the peso to the dollar at a very slowly depreciating rate. This led to overvaluation of the peso. Imports became cheaper in relation to exports. Exporters, however, were unable to raise their prices on tradeable products because of intense international competition. Because exporters faced higher input costs, their profit margins narrowed. This led to greater difficulty for borrowers, especially those dependent on exports, to pay back their loans.¹⁹

When the United States began to raise interest rates in 1994, the premium for investing in Mexico was reduced, and investors started to pull money from Mexico into U.S. securities. In an ill-fated decision, the Mexican government switched some of its public debt out of pesos and into dollar-based securities (*tesobonos*), assuming the exchange rate risk.²⁰ To defend the value of the peso and keep it within the parity band, the government used its foreign reserves to buy pesos. Foreign currency reserves fell from \$29.3 billion in February 1994 to \$6 billion in December 1994, a fall of almost 80 percent.²¹ Unable to defend the peso any longer, the government decided on December 22, 1994, to end the currency peg at 3.47 pesos per dollar and let the peso float. The peso lost 55 percent of its value in the following ten days. Realizing Mexico would be unable to pay the \$17 billion it owed already on dollar-indexed Mexican bonds, investors pulled even more of their money from Mexico, reducing the amount of foreign reserves to \$4.44 billion by the end of January 1995.²² Mexico was faced with multiple dilemmas, including the collapsing banking sector.

MEXICAN GOVERNMENT MOTIVATIONS TO OPEN THE BANKING SECTOR TO FDI

When Ernesto Zedillo became president in 1994, he encountered one of the most severe financial crises in Mexican history, of which the banking sector collapse was an important element. The government had to restore financial solvency and sustainability to the banking system. It had to restore the role of banks as financial intermediaries. Zedillo's administration quickly established two programs to boost banks' capitalization and remove bad loans from their balance sheets.

The first of the two main programs established by the Mexican government was the five-year Temporary Capitalization Program (PROCAPTE), which helped banks increase their capital-to-assets ratio (capitalization) above the required 8 percent. Under this short-term program, troubled banks were allowed to sell five-year bonds to the nation's deposit insurance authority (Bank Fund for the Protection of Savings, or FOBAPROA) in exchange for capital.²³ By selling these bonds to FOBAPROA (now called IPAB, the Bank Savings Protection Institute), many banks improved their capital-to-assets ratio and stayed solvent. The second program, the ten-year Loan Purchase and Recapitalization Plan, exchanged bad bank loans for ten-year, government-issued bonds.²⁴ In other words, the government exchanged bad loans made by banks for new government bonds that would pay the banks interest over a ten-year period. The government assumed the risk of the banks' bad loan portfolios, while it spread its costs over a ten-year period. The government cleaned the banks' balance sheets and improved their asset quality at virtually no immediate cost to the banks.²⁵ In addition to the Temporary Capitalization Program and the Loan Purchase and Recapitalization Plan, the government also enacted many programs for mortgage holders, rural farmers, and SMEs. These were designed to increase the likelihood that these

borrowers could repay their loans, preventing even more past-due loans from appearing on the banks' balance sheets.

The Mexican government also needed to improve its banking laws and regulatory framework. In 1995, new legislation was enacted that addressed some shortfalls of the existing banking system that had contributed to the financial crisis. Consolidated financial reports became required so that linkages and money flows among related entities would be more transparent and easier to see. The same year, the government established the Mexican National Banking and Securities Commission (CNBV) to provide stronger bank supervision and oversight. This addressed one of the culprits of the financial crisis, weak and ineffective bank supervision. The CNBV has made continuing improvements in its regulations and reporting, strengthening the banking sector. For example, it changed its reporting methodology in 1997, requiring banks to adopt new accounting practices. The new system, known as Mexican GAAP, requires the value of a past-due loan to be reported as the total unpaid balance of the loan, unlike the old accounting system, which recorded only missed payments as past due.²⁶

Why did the government view foreign bank participation as part of the solution to the banking crisis in 1995, when just over a decade earlier it chose nationalization of the banking system? NAFTA played a significant role, opening the door slightly to banking FDI and making more drastic changes in the future more politically viable. NAFTA allowed foreign-owned banks to operate in Mexico for the first time since restrictive legislation had been signed in 1966.²⁷ In February 1995, the government enacted a new law that voluntarily expanded some of NAFTA's liberalizing provisions. Foreign banking organizations were permitted to purchase Mexican banks that accounted for less than 6 percent of total Mexican bank capital, rather than the 1.5 percent established under NAFTA. Even though this increase might seem small, the earlier provision made only two banks eligible for acquisition, but the new law permitted purchases of all but Mexico's three largest institutions. The 1995 law also raised the limits on total bank capital that all foreign-controlled banks could hold; the limit was raised from 9 percent to 25 percent.²⁸

But beyond NAFTA, the financial crisis left the Mexican government with little choice but to open up its banking sector to FDI. The severe financial crisis greatly reduced the capitalization of Mexican banks, increased the burden on the government and taxpayers to pay for the bailout, and forced the government to enact many restructuring programs in order to save an insolvent system. Banks were extremely undercapitalized as past-due loans soared and, as interest rates rose to unforeseen levels, debtors increasingly could not pay back the interest on their loans. The impact of the devaluation on already overextended banks was also a factor, increasing past-due loans from 9 percent in 1994 to 12.3 percent in 1995. Despite economic growth from 1996 to 1998, past-due loans remained over 11 percent until 1999.²⁹ The combination of bad loans and depositors unwilling to put their money into the banking system greatly reduced the capitalization of many banks and their ability to serve as financial intermediaries. The government, which was already under significant debt pressure in its own right, now found itself with the added burden of rescuing the country's banking system out of fear of an even worse outcome. The government's programs, which had mixed results, saved the system from drowning but left the government and the banking system with no capital to survive. Two recent studies estimate the cost of the bailout at between \$100 and \$105 billion, approximately 16 percent of Mexico's GDP in 2003.³⁰ Since domestic programs could not fully recapitalize the system, the government looked outside its borders for additional resources and funding.

FACTORS INFLUENCING FOREIGN BANKS TO INVEST IN MEXICO

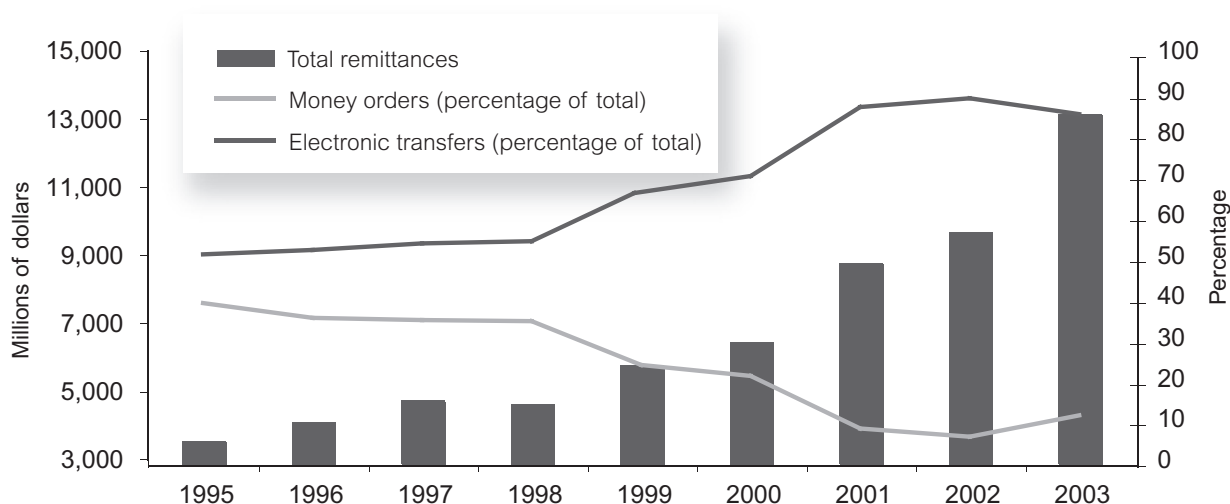
Foreign banks had their eyes on Mexico for many years. The country's close proximity to the United States, as well as its market size and growth potential, attracted investors in a range of industries, including retail banking. The law, however, prevented FDI in the banking sector. When Mexico signed NAFTA, restrictions on FDI were reduced, but not to the point where foreign banks could take enough stake in the market to make investments attractive.

The forces described in the previous section changed the Mexican government's incentives, but major policy changes were also required. Foreign institutions needed to be able to take a greater equity stake in Mexican banks. Banks also wanted macroeconomic stability and lower country risk. The Mexican government needed to repair the banking system to a condition in which it could sell its assets as an attractive investment. Finally, the purchase of Mexican banking assets needed to make logical business sense. This required low asset valuations, the opportunity for growth, and pricing power within the market.

Mexico's monetary and fiscal policies reined in inflation and lowered interest rates, reducing the country's risk. In addition, as Mexico signed numerous free trade and investment agreements with the rest of the world, investors and producers were assured that the country was going to continue to liberalize its economy, embrace market principles, and use trade as a tool for economic growth.

Many attractive features of the Mexican banking sector were not dependent on government policy. First, despite being one of the largest banking sectors in Latin America, credit penetration by the banking sector in Mexico was and still is one of the lowest in the region. Second, Mexico was extremely underbanked relative to developed countries in terms of branches per capita. Mexico's 1991 branch-to-population ratio was one branch per 18,000 people, while in the United States and Europe, it was one branch per 4,000 and 2,000 people, respectively.³¹ Third, the degree to which savings are channeled through the financial system to provide financing for investment (financial penetration) was low compared with other nations. In 1992, financial penetration in Mexico was only 46.1 percent, while Canada, the United States, and Italy reached 97, 93, and 71 percent.³² The financial crisis and the high degree of undercapitalization lowered the sector's asset valuation so severely that foreign investors chose to buy banking sector assets speculatively.³³ Finally, the banking sector's low level of competition (see discussion in the historical overview) and gap with best practices provided an opportunity for foreign banks to improve cost structures and revenue models without losing pricing power. This increased the attractiveness of the sector, as potential investors could expect to enjoy continued rents. Foreign banks were only interested in moving into Mexico through acquisitions and joint ventures. Greenfield investment in new banking facilities was not considered due to the costs of acquiring new customers, building branch networks, and implementation time.

Two other factors came to play an increasing role during the course of the 1990s: the growing importance of the Mexican market in the United States and the increased global flow of remittances to Mexico (figure 3). According to the 2002 Current Population Survey (a joint project of the Bureau of Labor Statistics and the Census Bureau), 9.8 million residents of the United States were born in Mexico; of these, 5.3 million are undocumented. This number is more than twice the 1990 census figure of 4.3 million Mexican immigrants.³⁴ The amount of remittances received in Mexico has also grown considerably. In 2001, Mexico was the largest recipient of remittances in the entire world. In 2003, Mexico received \$13.27 billion in remittances, an increase of 30 percent from the previous

FIGURE 3. Remittances to Mexico: Total and Transfer Methods, 1995–2003

Source: Bank of Mexico, www.banxico.org.mx.

year. This marked the first time in Mexico's history that remittances exceeded FDI flows. To put this in perspective, remittances to Mexico are greater than the country's total tourism revenues, more than two-thirds of the value of its petroleum exports, about 180 percent of the country's agricultural exports; they are the country's second most important source of income.³⁵

According to a report by the Organization for Economic Cooperation and Development (OECD), the fees for transferring money from the United States to Mexico decreased significantly from 1999 to 2003.³⁶ The OECD report finds that, in 1999, a \$300 transfer could cost up to \$60, or 20 percent of the total amount. By 2003, this figure decreased to a range of \$10–\$18. An Inter-American Development Bank–Pew Hispanic Center survey found that the share of Mexicans using banks to collect remittances was twice that of other Latin American countries (43 percent in Mexico, 20 percent in Central America, and 19 percent in Ecuador).³⁷ Mexicans today face lower transfer costs than the average Latin American because of greater competition within the remittance market. Mexicans depend far less on the more costly wire-transfer method and are increasingly using cheaper transfer services through commercial bank branches and automated teller machines.

It is likely that banks understood that as more migrants set up bank accounts in the United States many of their family members across the border would also set up accounts in the same bank, facilitating the transfer of funds at a lower cost. For example, Bank of America has found that one-third of its U.S.-Mexican remittance customers have opened up accounts.³⁸ Although this is a long-term strategy for many commercial banks, their ability to increase their customer base in the United States, as well as in Mexico, allows them to cross-sell many more lucrative products, such as mortgages and consumer loans, in the future. In 2004, the IDB said that remittances from the United States to Latin America comprise more than 100 million separate transactions every year, most of which are outside the formal financial system.³⁹ This provides a significant opportunity for foreign banks to capture a steady flow of revenues from an expanding market, while continuing to lower costs for the benefit of senders and receivers of remittances.

Many of the early foreign entrants into the Mexican market, as a result of strong profits, increased their equity stakes. This signaled to potential entrants the attractiveness of participating in the banking sector. Furthermore, by 1998, the economic environment had improved considerably and most of the bank restructuring had been completed. Therefore, once the government removed all restrictions on foreign ownership of Mexican banks in December 1998, banks began to make the large acquisitions that have reshaped Mexico's banking sector.

MERGERS AND ACQUISITIONS: SETTING THE STAGE

The transformation of Mexico's banking system during the past decade holds valuable lessons for countries considering opening up their banking sector, as well as for banks looking for opportunities to move into new markets. Mexico's short history of banking FDI and sector consolidation provides a snapshot of the drastic change that can happen in a short period of time. This section will highlight three trends by looking at the transactions of five foreign banks—Citigroup, BBVA, Santander, Scotiabank, and HSBC—that are among the six largest banks in Mexico. It will also briefly examine Banorte, the only Mexican-owned commercial bank.

Three trends have emerged in Mexico since foreign bank participation was allowed in 1994. These trends have accelerated since Mexico removed all restrictions on banking FDI in December 1998. First, all early foreign entrants have increased their equity stakes in Mexico, illustrating the success of their early decisions and their desire to expand their presence in Mexico. Second, the number of foreign banks participating in Mexico that have made acquisitions since 1994 has continued to increase, demonstrating low entry barriers and a high market potential.⁴⁰ Third, acquisitions have become increasingly larger in size for each foreign bank in Mexico. Table 1 presents the main transactions by foreign banks.

TABLE 1. Main Transactions by Foreign Banks in Mexico since 1994

FOREIGN BANK	DATE OF TRANSACTION	ACQUIRED OR MERGED MEXICAN BANK	TRANSACTION COST
Grupo Financiero Bancomer (BBVA)	June 1995	Probursa	\$136 million
	1997	Cremita and Oriente	N/A
	August 2000	Bancomer (60%)	\$1.4 billion
	February 2004	Bancomer (remaining 40%)	\$4.1 billion
Scotiabank Inverlat	February 1996	Grupo Financiero Inverlat (10%)	\$31.2 million
	November 2000	Grupo Financiero Inverlat (increased equity stake to 55%)	N/A
Santander	November 1996	Banco Mexicano (majority stake)	\$379 million
	May 2000	Serfin	\$1.54 billion
HSBC	March 1997	Serfin (20%)	\$290 million
	November 2002	Bitel	\$1.14 billion
Citibank	October 1998	Banca Confia	\$195 million
	July 2001	Banamex	\$12.5 billion

Steadily increasing numbers of foreign banks participating in Mexico have made acquisitions since 1994, with no foreign banks deciding to exit the market (table 2). Not only has the number of banks increased over time, but so have the amount of money and equity they have invested in Mexico.

TABLE 2. Entry of Foreign Banks into Mexico after 1994

YEAR	NUMBER OF FOREIGN BANKS	FIRST-TIME ACQUISITIONS IN MEXICO (BANK ACQUIRED)
1995	1	BBVA (Probursa)
1996	3	Scotiabank (Inverlat), Santander (Mexicano)
1997	4	HSBC (Serfin)
1998 ^a	5	Citibank (Confia)
2002	6	Bank of America (Santander-Serfin)

^a This table does not include Citibank's presence until 1998 even though Citibank did exist in Mexico before other foreign banks were allowed to participate. Before 1998, Citibank's presence was extremely small, close to 1 percent of total assets.

From a business perspective, the banks have been extremely profitable in trading, credit cards, checking accounts (service commissions), and managing obligatory pension funds known as Afores. From 1997 to 2002, McKinsey & Company reports that the return on equity for the Mexican banking system increased from 5.1 to 13.1 percent, a compounded annual growth rate (CAGR) of 20.8 percent.⁴¹ In addition, foreign banks are earning profits in Mexico while they are diversifying risks and increasing revenues for the parent companies. For example, in 2003, Banamex contributed \$1.45 billion, or about 8 percent, to the profits of Citigroup, the world's largest financial services company. HSBC, Europe's largest lender, also cited its acquisition of Grupo Financiero Bital as one of the main reasons its net profit rose 41 percent in 2003.⁴²

The price of bank acquisitions has also risen. The largest rise in purchase price came from Citibank, whose \$12.5 billion acquisition of Banamex in 2001 dwarfed its \$195 million purchase of Confia in 1998. Other bank deals have also increased (see table 1). Bank of America, in its first deal in Mexico, paid \$1.6 billion in cash to acquire a 24.9 percent stake in Santander-Serfin; this was in line with many of the recent billion-dollar-plus acquisitions.

All of this activity has left Banorte as the only Mexican-owned commercial bank. Banorte has not attempted to grow much through acquisitions, with the exception of a 1996 purchase of Banco del Centro.

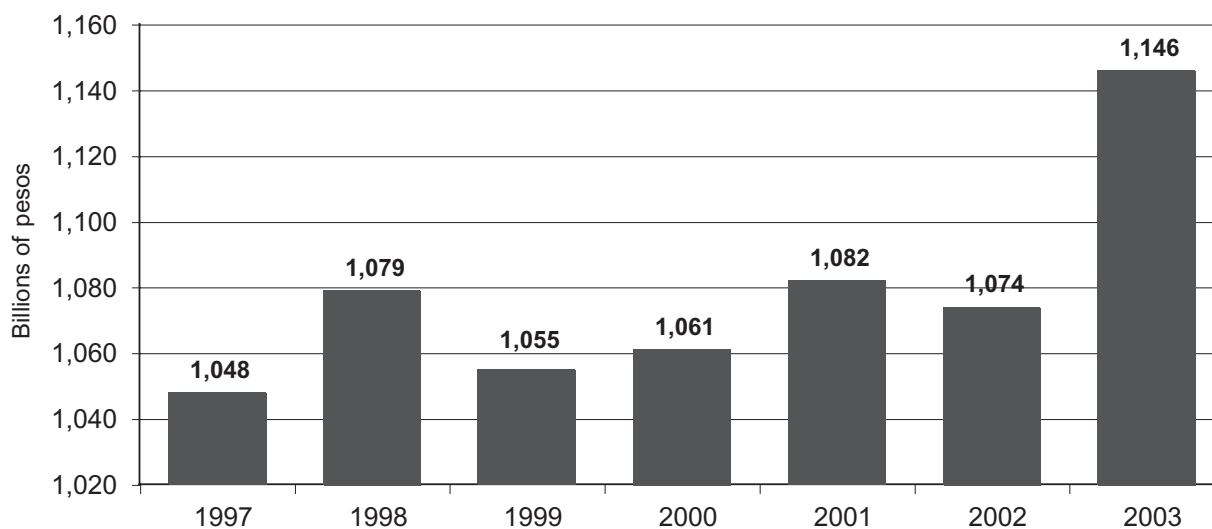
THE IMPACT OF FDI ON BANKING SECTOR INDUSTRY DYNAMICS

Mexico's banking sector hit a low in late 1994 and early 1995, but the sector recovered fairly quickly as a result of a combination of factors: a comprehensive bank bailout and restructuring program, improved government regulation and oversight, and the expansion of FDI in the banking sector. As a result of the inflow of FDI in the banking sector, the amount of government funds that would have otherwise been needed to recapitalize the sector was reduced. Nevertheless, the bailout came at

a large cost to Mexican taxpayers as well as to the United States, IMF, and World Bank. FDI allowed the government to succeed in its first goal of restoring financial solvency and stability to the banking sector. The government's second goal, to restore the role of banks as financial intermediaries and improve the availability of credit, has not been as successful.

The rise in FDI in the banking sector has somewhat improved the system's financial health. The financial system attracted \$25.3 billion in foreign investment from 2000 to 2003.

**FIGURE 4. Total Assets in Mexico's Banking Sector, 1997–2003
(billions of 1997 pesos)**

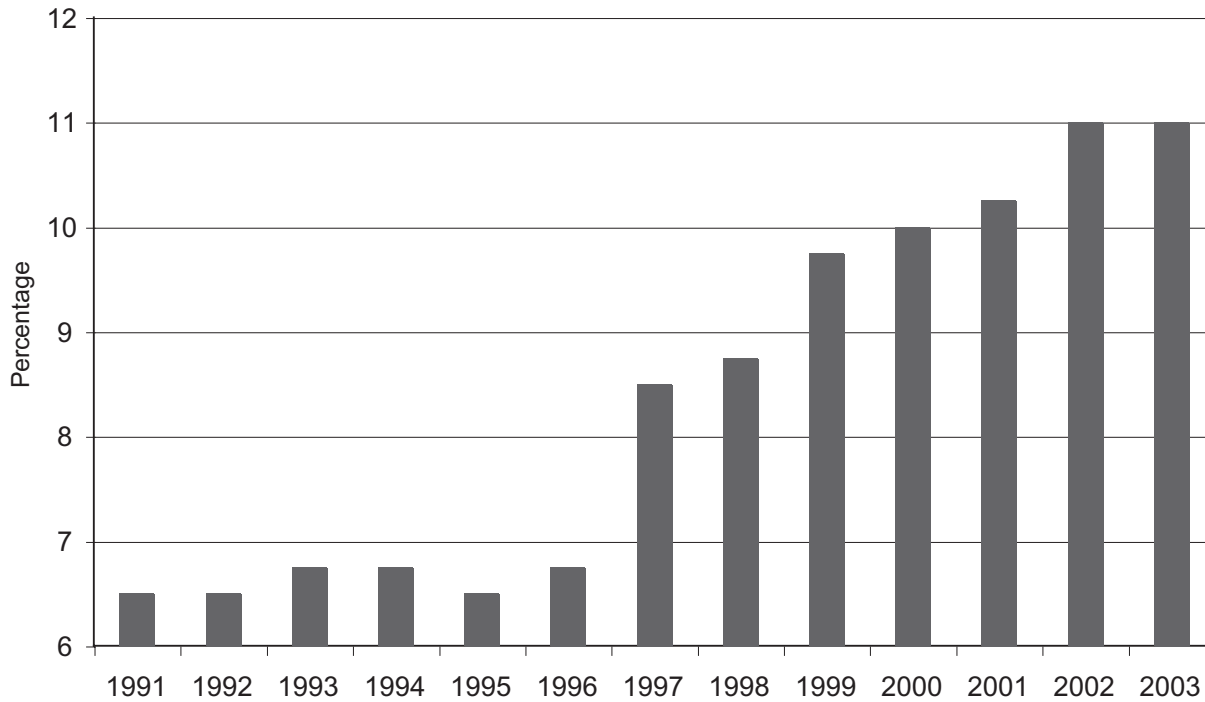


Source: National Banking and Securities Commission (CNBV), www.cnbv.gob.mx.

Foreign banks have increased sector capitalization by at least \$7.4 billion, equivalent to 45 percent of banking sector capitalization in 2002.⁴³ Total banking sector assets have also stabilized and have begun to recover, although asset levels in 2003 still did not reach the high levels of 1994 before the crisis.⁴⁴ Although expansion has not been as pronounced as hoped, total banking sector assets have increased from 1,048 billion pesos in 1997 to 1,146 billion pesos in 2003 (figure 4).⁴⁵ The average annual capitalization, illustrated by the sector's capital-to-assets ratio, rose from 6.5 percent in 1995 to 11 percent in 2003 (figure 5).

Past-due loans as a share of total loans fell from approximately 11.3 percent in December 1997 to 3.2 percent at the end of 2003, an average annual drop of 19.2 percent (figure 6). Efficiency in the sector has improved as the number of commercial bank employees has been reduced and productivity has increased. Although Mexican banks still lag behind best practices in the industry, they have significantly improved their cost efficiency. The merger activity allowed the banks to reduce costs considerably through overhead reductions, lower administrative costs, operational improvements, and synergistic economies of scale. This led to a reduction in the percentage of income allocated to costs, from 70.5 percent in 1997 to 67.1 percent in 2002.⁴⁶ Greater transparency, improved regulations, and stronger accounting standards have also contributed to the banking sector's improving resilience.

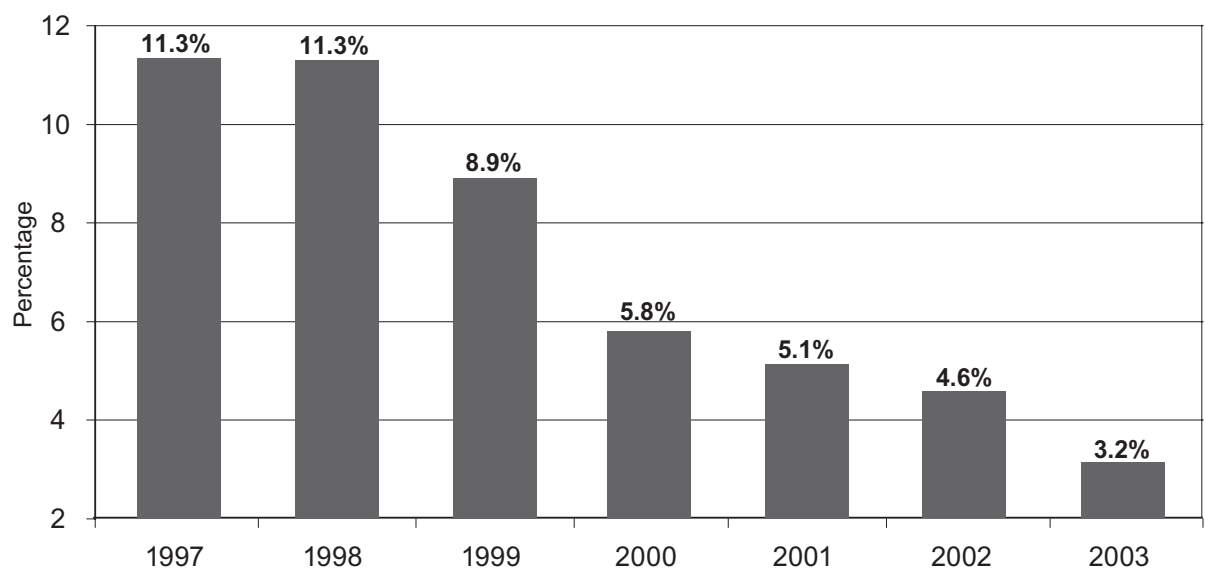
FIGURE 5. Capitalization (capital-to-assets ratio), Annual Average, 1991–2003



Source: Haber and Kantor, "Getting Privatization Wrong."

Note: Annual average calculated.

FIGURE 6. Past-Due Loans as a Share of Total Loans, 1997–2003



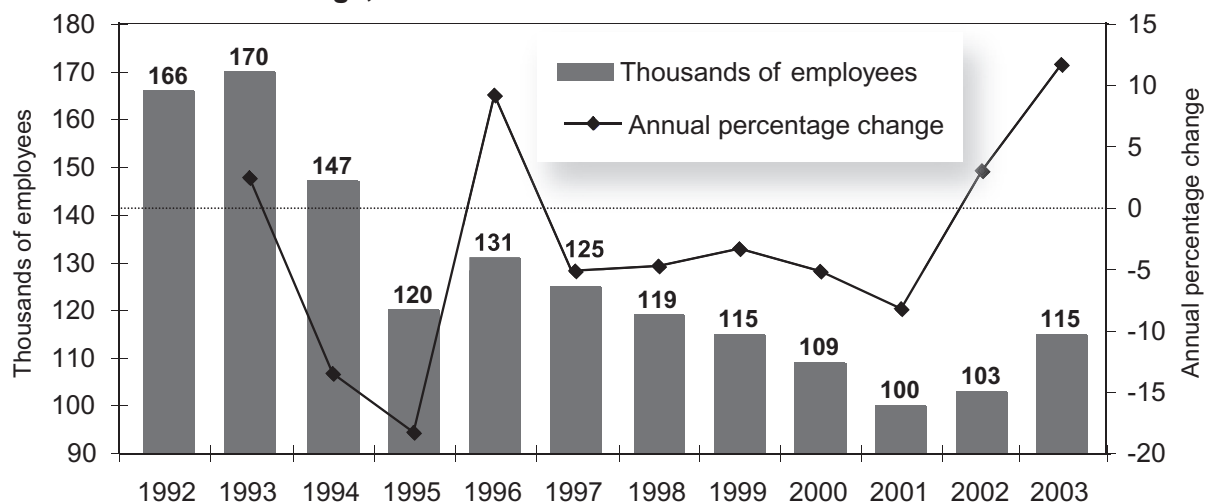
Source: CNBV.

As mentioned in the previous section, the foreign banks that purchased Mexican banking assets have fared extremely well. Their profits increased an average of 20.8 percent annually from 1997 to 2002. This explains why the number of foreign banks has increased since 1995, along with foreign banks' equity stakes in Mexico and the value of their acquisitions. Banks have been able to maintain high prices with only modest improvements in product selection and quality, owing to a continued lack of competition resulting from high consumer switching costs and high entry barriers. Banks were also able to profit considerably as lenders to the Mexican government because of high interest rates and limited competition. Since interest rates have fallen, banks are focusing more on high service fees rather than primarily on loan interest.

Banking industry competitiveness still is not at a level that allows consumers to choose from products and services with a wide range of prices and qualities. As FDI in the banking sector has increased since the late 1990s, asset concentration of the top two banks—BBVA-Bancomer and Citibank-Banamex—has grown from 44.8 percent in 1997 to 48.2 percent in 2003. However, Santander-Serfin is emerging as a potential challenger to the leaders, and Banorte continues to be a strong regional player. The high concentration of assets partially explains the lack of competitiveness in the sector and the banks' high profit margins. Because most of the Mexican assets have already been acquired, banks will need to increase their market share through means other than mergers and acquisitions. As the six main players fight for market share, competition may increase.

The rise in banking FDI has had a significant impact on sector employment and productivity. The number of commercial banking employees shrank from 166,000 in 1992 to 115,000 in 2003, reaching a low of just under 100,000 in 2000 (figure 7). Banking employment had been falling since privatization began in 1991, with most reductions before the entry of foreign players in 1996. The rate of shrinkage has slowed since foreign banks moved into Mexico in 1996. The total number of commercial banking employees fell an average of 16 percent in 1994 and 1995, dropped only 3 percent from December 1995 to December 2001, and rose at a yearly average of 7.2 percent in 2002 and 2003.

FIGURE 7. Commercial Banking Employees in Mexico and Annual Percentage Change, 1992–2003



Source: CNBV.

Increased productivity as a result of staff cutbacks and the reduction in nonperforming loans led to outstanding profits. The McKinsey study found that commercial banking labor productivity rose 19.4 percent annually from 1992 to 1994 during the privatization stage, fell 4.8 percent annually from 1994 to 1996 during the financial crisis, and increased 15.6 percent annually from 1996 to 2000 as the sector consolidated.⁴⁷ The study estimates 31 percent of the productivity growth between 1996 and 2002 was due to cutbacks in employees, while 63.1 percent was a result of the reduction in nonperforming loans.

While labor productivity in the sector improved, financial service wages fell 1.5 percent per year from 1995 to 2001, contributing to the banks' profitability. This is surprising considering overall wages rose 0.4 percent annually over the same period, raising the question of why financial service wages moved opposite to wages in the overall economy (this is discussed in greater detail in the section on banking sector workers). Therefore, lower relative wages for workers in the sector (a decrease of 1.5 percent from 1995 to 2001) and sector productivity increases have contributed to higher profits (20.8 percent per year from 1997 to 2002). Because of surplus labor in Mexico, wages for lower-level banking employees are not likely to increase in the near future.

WAS BANKING SECTOR FOREIGN DIRECT INVESTMENT GOOD FOR DEVELOPMENT?

The previous section discussed the impact of banking sector FDI on the industry and participating banks. This section will address its impact on broader economic development in Mexico, focusing on three main areas: availability of credit, effect on consumers and taxpayers, and impact on banking sector workers.

Credit Crunch

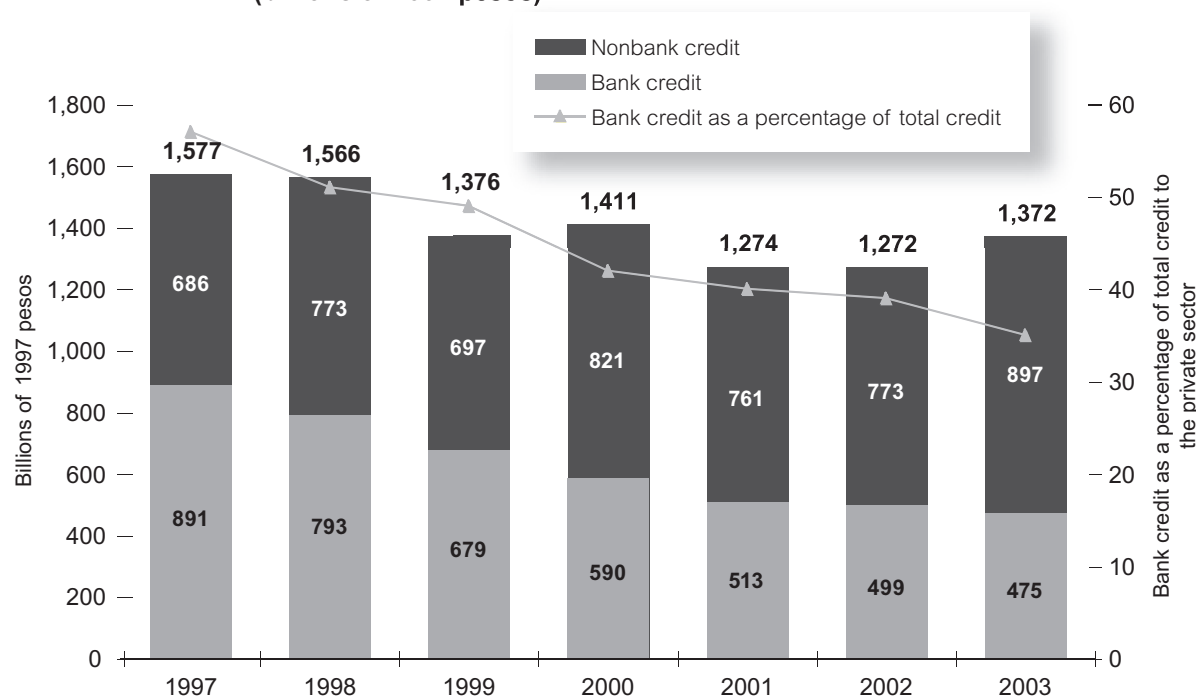
Mexico experienced a credit crunch from 1997 to 2003 despite strong economic growth and an increase in FDI and assets in the banking sector. Total credit to the private sector, total bank credit to the private sector, total bank credit to the nonfinancial private sector, and the ratio of loans to bank assets all declined during this six-year period.

Total credit to the private sector fell from 1,577 billion pesos in 1997 to 1,372 billion pesos in 2003, an average annual decrease of 2.3 percent (figure 8). Not only did the total amount of lending to the private sector drop, but the composition of this lending—banks versus nonbanks—also changed dramatically.⁴⁸ In 1997, banks provided 57 percent of total credit to the private sector. By 2003, this dropped to 35 percent, an average annual decrease of 10 percent in total bank credit to the private sector. This decrease in bank credit to the private sector from 1997 to 2003 is greater than the 8.1 percent average annual reduction from 1994 to 1996 and the 1.8 percent average annual increase from 1992 to 1994.⁴⁹ Meanwhile, nonbank credit to the private sector has increased its share of total credit to the private sector from 43 percent in 1997 to 65 percent in 2003, an average annual increase of 4.6 percent.

Total bank credit to the nonfinancial private sector decreased from 436 billion pesos in 1997 to 338 billion pesos in 2003, an average annual drop of 4 percent (figure 9).⁵⁰ Bank credit to the nonfinancial private sector consists of commercial, mortgage, and consumer lending. As overall

bank credit to the nonfinancial private sector declined, the distribution of these three components changed. Commercial credit decreased from 286 billion pesos in 1997 to 196 billion pesos in 2003, an average annual drop of 6.1 percent. Mortgage lending also fell from 122 billion to 71 billion pesos from 1997 to 2003, an average annual reduction of 8.6 percent. On the other hand, consumer credit from banks increased 16.8 percent a year, from 28 billion pesos in 1997 to 71 billion pesos in 2003, largely owing to the rise in credit card lending. In 2003, total bank credit to the nonfinancial private sector increased 0.9 percent, the second year in a row of positive, albeit small, progress. Consumer credit rose an enormous 42 percent in 2003, as commercial and mortgage lending fell 4.9 and 10.1 percent, respectively.

FIGURE 8. Total Credit to the Private Sector in Mexico, 1997–2003
(billions of 1997 pesos)



Source: Bank of Mexico.

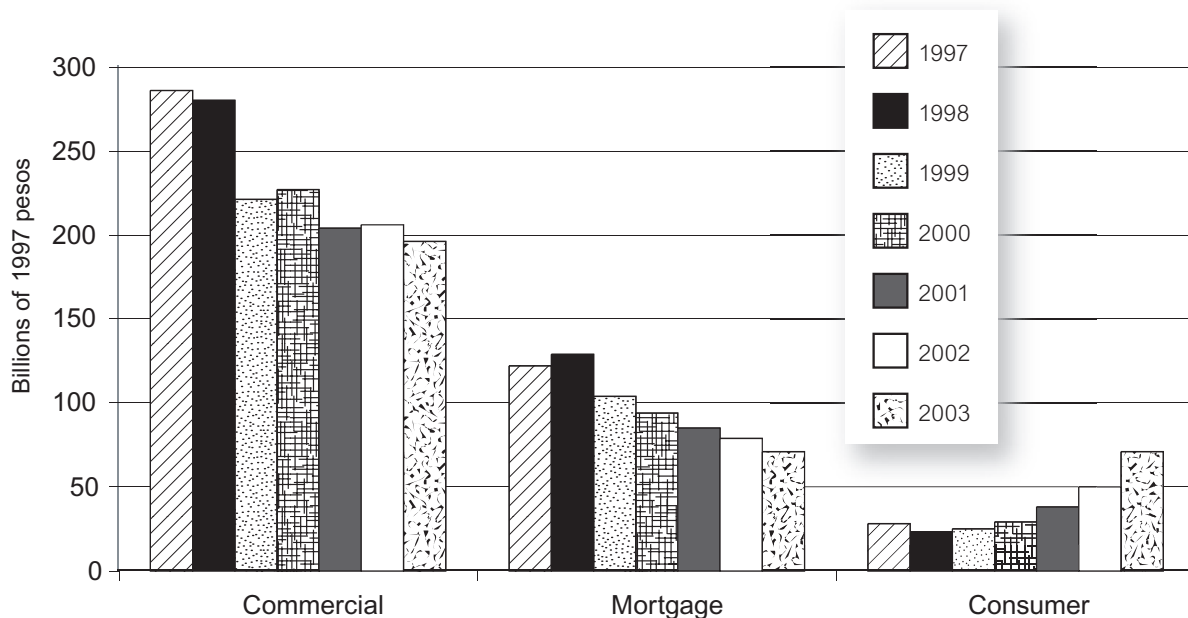
Note: Nonbanks include special purpose lending institutions (SOFOLDES), development funds (fondos de fomento económico), leasing companies, factoring companies, credit unions, savings and loan associations, suppliers, retailers, and capital markets.

These changes have altered the composition of total credit to the nonfinancial banking sector. As a percentage of total bank credit to the nonfinancial private sector, commercial credit decreased from 66 to 58 percent, mortgage credit fell from 28 to 21 percent, and consumer credit rose from 6 to 21 percent from 1997 to 2003. Although mortgage lending fell at a faster rate than commercial lending, its drop in absolute terms, 51 billion pesos, was less than the 90 billion decrease in commercial lending. One of President Vicente Fox's most important initiatives is to expand the availability of mortgage credit and reduce Mexico's severe housing shortage; therefore it is extremely worrying that mortgage lending by banks has dropped at such a sharp rate. The increase in consumer

credit, relative to commercial and mortgage credit, is also disconcerting because consumers may be increasing their debt burden without creating equity ownership through their investments.

Mexican bank lending ranks relatively low compared with other, similar countries in Latin America. Two indicators—domestic credit to the private sector as a share of GDP and domestic credit provided by the banking sector as a share of GDP—illustrate the point (figures 10 and 11).⁵¹ In 2002, domestic credit to the private sector as a percentage of GDP was 12.6 percent in Mexico, 15.3 percent in Argentina, 25.1 percent in Colombia, 35.5 percent in Brazil, and 68.1 percent in Chile. Similarly, domestic credit provided by the banking sector as a percentage of GDP in 2002 was 26.6 percent in Mexico, 62.4 percent in Argentina, 36.5 percent in Colombia, 64.8 percent in Brazil, and 77.6 percent in Chile.⁵² Furthermore, from 1994 to 2003, both of these indicators have decreased considerably in Mexico (figures 12 and 13). Not only is credit in Mexico falling in absolute terms, but it is also declining as a percentage of GDP.

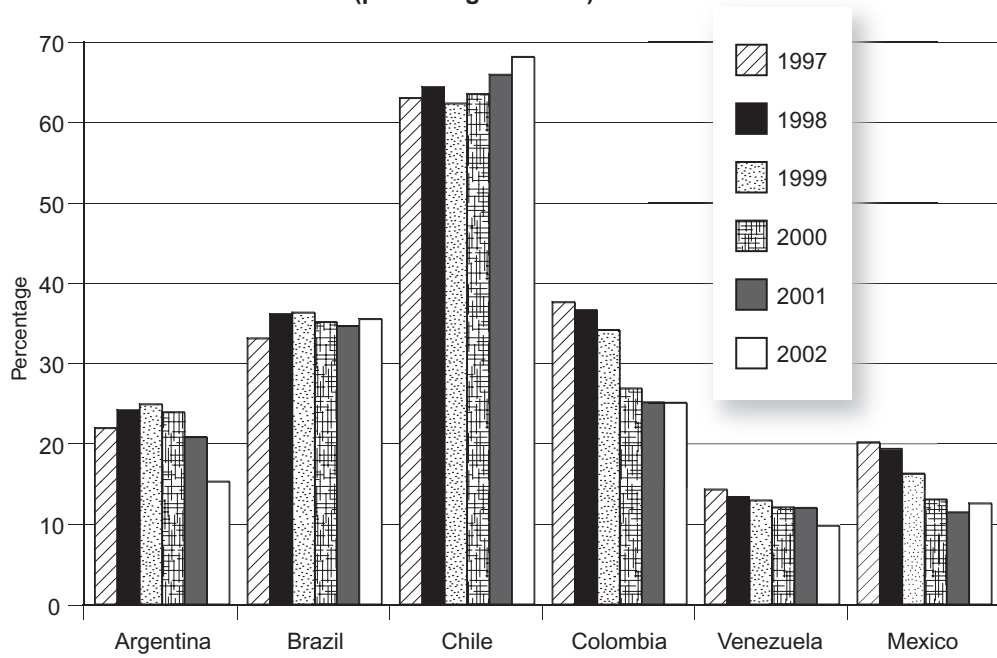
**FIGURE 9. Bank Credit to the Nonfinancial Private Sector, 1997–2003
(billions of 1997 pesos)**



Source: CNBV.

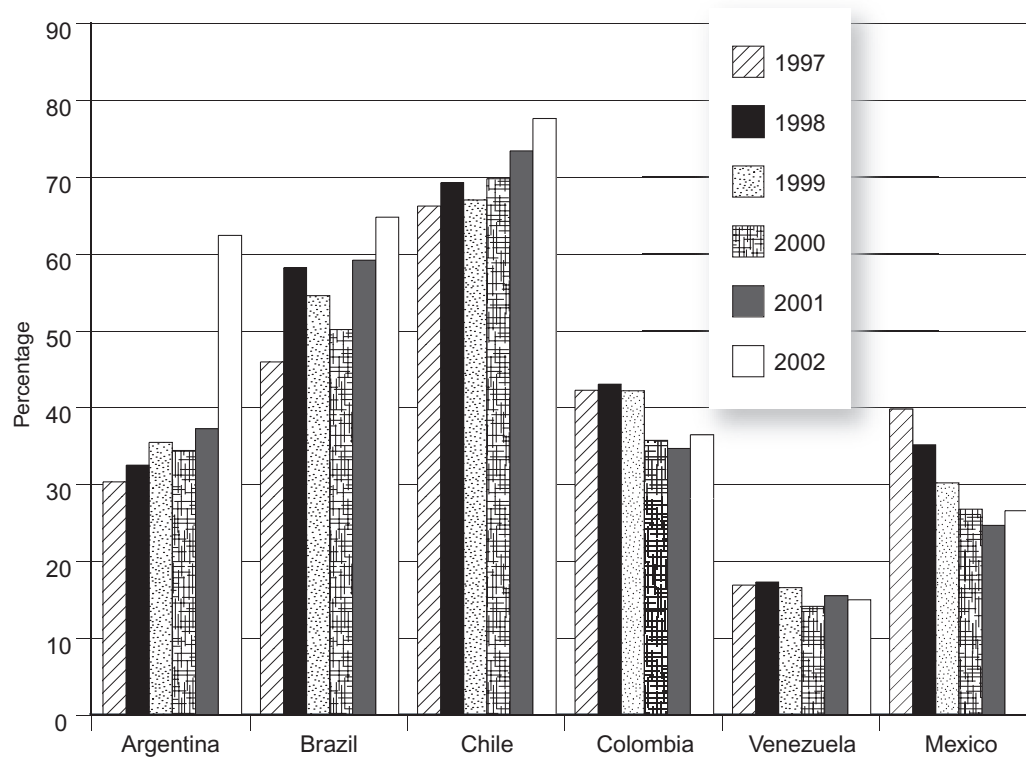
SMEs—significant job creators—have been negatively affected by the reduction in bank lending to the private sector. Unlike large, export-oriented firms that have access to international capital markets, many SMEs do not have access to international finance. For many informal and unregistered businesses—a disproportionately large number of Mexican enterprises—it is nearly impossible to obtain the documents necessary to access bank credit. Furthermore, many Mexicans do not own rights to their land, possess bank accounts, or have enough personal property of value for loan collateral. Banks argue that the difficulty of obtaining extensive financial documents and repossessing borrowers’ assets has limited their ability to lend to SMEs and individual borrowers.

FIGURE 10. Domestic Credit Provided to the Private Sector in Various Countries 1997–2002 (percentage of GDP)



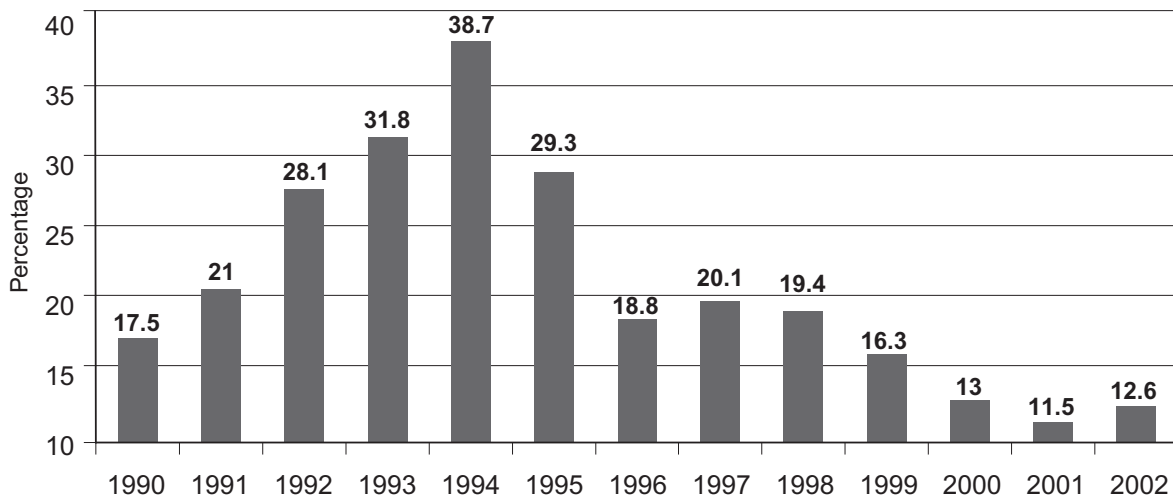
Source: World Development Indicators 2004.

FIGURE 11. Domestic Credit Provided by the Banking Sector in Various Countries, 1997–2002 (percentage of GDP)



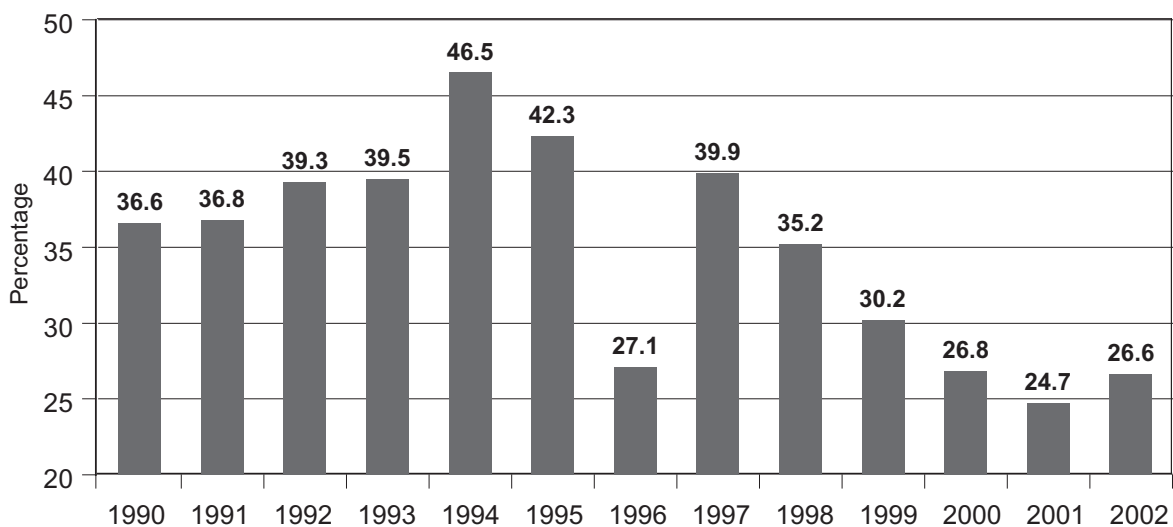
Source: World Development Indicators 2004.

FIGURE 12. Domestic Credit Provided to the Private Sector in Mexico, 1990–2002 (percentage of GDP)



Source: World Development Indicators 2004.

FIGURE 13. Domestic Credit Provided by the Banking Sector in Mexico, 1990–2002 (percentage of GDP)



Source: World Development Indicators 2004.

Whatever the causes, the credit crunch has had a profound impact on the ability of SMEs to create jobs, innovate, and expand production. Mexico's entrepreneurial spirit has been sapped, and many now claim that banks have betrayed the public trust. Recognizing the problem at the sixty-seventh annual Mexican Banking Association convention in 2004, President Vicente Fox said, "Mexico needs banks to retake their role as motors of sustained economic growth. We ought to expand the offering of credit. Without credit there is no growth, without growth there is no development."⁵³

In terms of private credit from banks, small farmers face an uphill battle for many of the same reasons plaguing SMEs. After Salinas' reforms began in 1989, Banrural—Mexico's national bank for rural credit—cut its staff, branches, and outstanding loans in half. Despite these measures, 40 percent of its portfolio underperformed in 2002. As a result of this poor performance, the government replaced Banrural in 2003, creating a new, nonbanking, decentralized institution known as *Financiero*, which aims to promote the development of rural financial markets. In 2003, the World Bank provided Mexico with a \$505 million loan—a rural finance development structural adjustment loan—to support this initiative. Isabel Guerrero, the World Bank director for Mexico, stated that "reducing the fiscal costs of inefficient operating structures will help save resources that can then be used to support social programs for the poor."⁵⁴

The inability of farmers to access credit easily can be traced to several causes. The two most prominent were the pervasive inefficiency that plagued Banrural, as well as Salinas' rural financial reforms. Large, export-oriented farms are receiving an increasing amount of the government's farm subsidies, as well as most of the commercial banks' agricultural lending.⁵⁵ If Mexico's goal is to improve the ability of small farmers to access credit, it appears that the role of government in rural financing might have to be restored. Public or quasi-public development banks could cover markets such as low- and middle-income rural farmers that are not adequately served by commercial banks.

Many factors contribute to the decrease in lending to the private sector and the changing composition of these credits. The slow recovery in total commercial banking assets, the reduction in bank retail deposits, the expansion of the Mexican debt and equity markets, and the existence of "perverse incentives" are some of the possible reasons why bank intermediation remains too low. It is counterintuitive, but true, that bank credit to the private sector fell at a greater pace during the economic growth years of the mid- to late 1990s than it did during one of the country's most severe financial crises.

Total commercial banking assets increased 1.5 percent annually from 1997 to 2003, illustrating sector stabilization after banking FDI began flowing into Mexico (figure 4). Despite the recent increase, commercial banking assets are still below their 1994 level as a result of the financial crisis. Furthermore, commercial banking assets as a percentage of GDP dropped from 59 percent in 1994 to 28 percent in 2002.⁵⁶ Despite the increase in commercial banking assets from 1997 to 2003, total credit to the private sector, total bank credit to the private sector, and total bank credit to the nonfinancial private sector all decreased.

The decrease in bank retail deposits, relative to retail deposits in nonbanks, may have contributed to the decrease in total bank credit to the private sector.⁵⁷ Total retail deposits increased from 1997 to 2002 in real terms, but the banks' share of these deposits fell from 91 percent in 1997 to 82 percent in 2002. On the other hand, the nonbanks' share of retail deposits increased from 9 percent in 1997 to 18 percent in 2002.⁵⁸ Just as nonbanks are capturing an increasing amount of retail deposits, these nonbank financial institutions, other nonbank sources, and public institutions are expanding their lending capabilities.⁵⁹

Another factor contributing to decreased bank lending may be that it is now much easier for the government and large companies—historically significant borrowers from commercial banks—to raise money through capital markets. Companies, especially larger multinational corporations, find it much cheaper to access credit through sources other than private banks. Mexican companies increasingly raise money through debt capital markets (by issuing corporate bonds) rather than from traditional sources, such as commercial banks. An example of the increased ability of the government to raise money outside of borrowing from commercial banks is the recent issuance of fixed-rate treasury bills (*cetes*) at a maturity of twenty years. This latest offer, although small, created demand that was three times greater than the issuance. The rate the government paid, 8.39 percent, was well below market estimates, indicating a growing level of trust in Mexico’s ability to repay its debt. Until 2000, Mexico did not issue fixed-rate treasury bills at maturities longer than one year.⁶⁰

In the past, government borrowing—which previously depended heavily on private banks for capital—crowded out lending to the private sector, thereby reducing the supply of available credit. One would expect that, as banks lend less to the government, they would increase lending to the private sector. It is disappointing that this has not been the case.

One study found that “perverse incentives” have reduced or eliminated the incentive for banks to lend to the nonfinancial private sector.⁶¹ As a result of the government’s restructuring plan, banks have been holding IPAB bonds in their portfolios.⁶² The study determined that banks would prefer to hold IPAB bonds that pay a competitive interest rate with zero default risk and no holding costs rather than increase lending, which would in turn increase the banks’ risk and the supply of credit, causing a drop in the interest rate banks could charge. The study concludes that “banks have no incentive to lend when they can profit from simply holding IPAB bonds.” Another study notes that Mexican banks, especially those acquired by foreign institutions, have reduced their loan-to-asset ratio significantly, from 72 percent in early 1998 to 56 percent in early 2003. As the banks reduced their loan-to-asset ratio, they increased their holdings of securities, which, unlike loans, are not subject to default risk.⁶³

Costs and Benefits for Mexican Consumers and Taxpayers

Increased banking sector FDI has had a mixed impact on consumers. Consumers benefited from the preservation of a functioning banking system, lower real prices for financial service and banking products, and the expansion of capital markets. Many of these benefits also came at a cost to consumers, however, especially with respect to their role as taxpayers.

The Mexican government improved oversight, regulation, and transparency in its financial system to help restore economic growth after the financial crisis and to attract foreign banks and capital. Consumers now have more information and a wider choice of investment options. Workers can now invest their savings in a wider range of liquid financial products, in both bank and nonbank investments such as stocks and long-term government bonds. In the past, most savers put their money into the unstable banking system or kept it in cash.

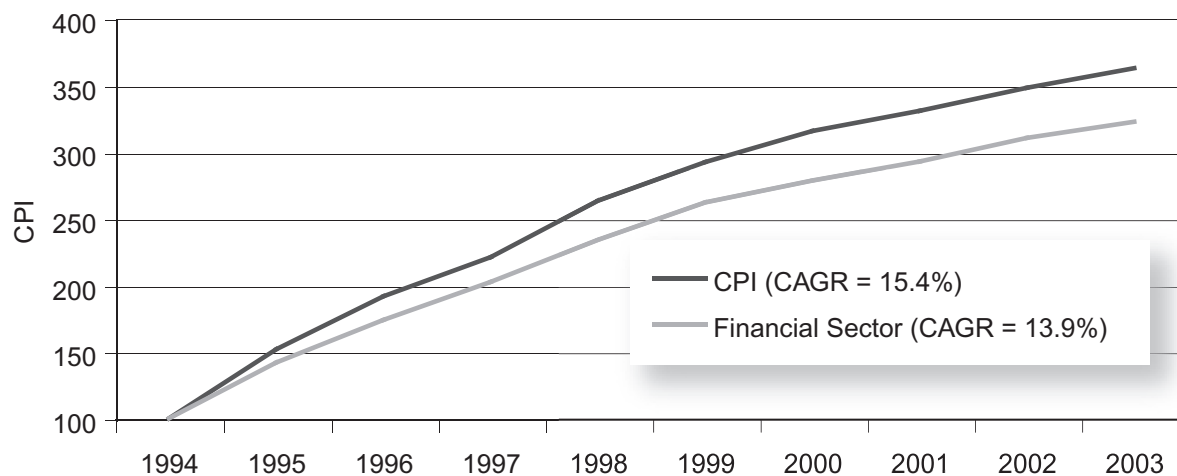
Prices for financial services and banking products were lower in real terms in 2003 than they were in 1994 as sector prices increased at a compounded annual growth rate of 13.9 percent, slightly below the 15.4 percent inflation in the overall economy (figure 14).⁶⁴ In addition to this positive trend in prices, banks have increased consumer lending (primarily credit card lending) as well as their range of services, such as insurance and pension funds. Consumer credit card lending grew 33

percent in real terms in 2003, marking the fourth year of strong double-digit growth.⁶⁵ Credit card rates declined as new products were introduced and competition intensified.

Nevertheless, banks have hurt consumers in other areas by increasing fees for other products, such as checking accounts, to compensate for the negative effect narrowing interest rate spreads have had on profits. The banks' role as financial intermediaries, at least in regard to providing credit to the private sector, has diminished from 1997 to 2003, which hurts consumers, businesses, and workers. Because banks have been reluctant to expand lending to the private sector, many consumers and local companies who paid for the bailout through taxes have not directly benefited from the strengthened financial system.

A functioning banking system is critical to financial intermediation, deposit taking, lending, and payment transactions. FDI in the banking sector played a role in restoring the system as a whole, but to date FDI has not increased the banks' role as financial intermediaries. This result has come at a cost to those consumers who pay taxes. One report states that "the intervention of the banks transferred revenue from Mexico's taxpayers to bank depositors."⁶⁶ An article in the *Wall Street Journal* reports, "Mexican taxpayers assumed \$20 billion of bad bank loans when the banks still were in Mexican hands."⁶⁷

FIGURE 14. Inflation in Mexico: Overall and Financial Sector CPI, 1994–2003

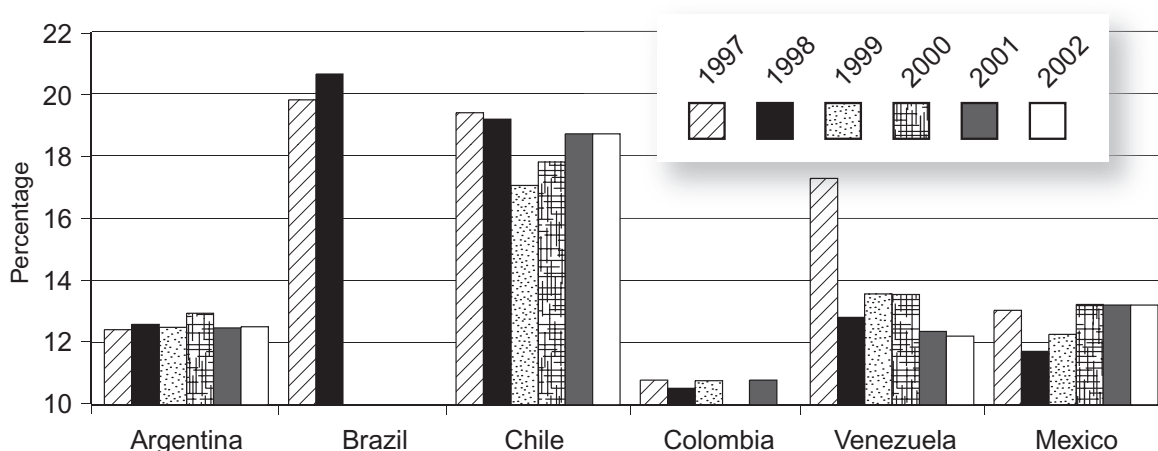


Source: INEGI.

Note: Index: 1994 = 100.

The percentage of taxes collected in Mexico is extremely low. This is a result of tax evasion, government-granted tax breaks to attract investment, and other factors (figure 15). The tax system's incentives allow many businesses capable of paying taxes to avoid taxation. This explains why Mexico's tax revenue as a percentage of GDP is low compared with other countries. Because the bailout came at an extremely high cost to taxpayers, those households, individuals, and businesses that pay taxes bore the burden of the financial bailout. By allowing FDI in the banking sector, the Mexican government reduced some of its financial burden.

FIGURE 15. Tax Revenue in Various Countries, 1997–2002 (percentage of GDP)



Source: World Development Indicators 2004.

Banking Sector Workers

Even though the financial crisis played the largest role in shrinking commercial bank employment levels and wages, FDI has also contributed to their drop since 1996. From 1996 to 2003, the number of commercial bank employees decreased 0.5 percent annually as foreign banks consolidated and eliminated merger-related duplications. Despite continuing to drop in absolute terms, the rate of commercial bank job loss has slowed since the arrival of banking FDI in 1996. The total number of commercial banking employees fell 5.9 percent per year from 1992 to 1994 during privatization and 16 percent per year during the financial crisis in 1994 and 1995. This is significantly greater than the 0.5 percent annual reduction from 1996 to 2003. Wages in the financial services sector also grew at a faster rate after 1996 than they did before. Nevertheless, wages in the financial services sector still grew more slowly than overall wages.

KEY FINDINGS

Foreign participation in Mexico’s banking sector has benefited foreign banks tremendously. The low level of industry competitiveness and the increasing market share and concentration of foreign banks have allowed banks to charge high fees and maintain wide spreads between lending and deposit rates. The banks’ holding of risk-free IPAB bonds and their capture of some of the growing remittance market have contributed to revenue growth, thus producing high profits. The foreign banks’ positive performance in Mexico not only increased company profits, but also created greater market potential and risk diversification for their parent institutions.

Expanded FDI in the banking sector has improved the overall health of the financial system. As a result of the government’s bailout program and an increase in financial sector FDI, the Mexican banking system has progressed considerably since the 1994–1995 crisis. Regulation and supervision, capitalization, and efficiency have all improved.

Mexico exemplifies that a sound banking system is necessary, but not sufficient, for economic development. Despite FDI's benefits for the stability of the financial system and profitability of participating foreign banks, problems persist in the banking sector, constraining economic growth and development (table 3). Efficient financial intermediation in the banking sector is key to economic growth, especially in developing countries where there is less access to international financial markets. Although FDI benefited the overall stability of the Mexican financial system, banks have decreased their role as financial intermediaries since 1997, retreating from private sector lending. The fall in bank lending to the private sector has been especially pronounced in commercial loans and mortgages. As a result, nonbanks have had to fill the void. Many argue that the lack of credit is constraining growth of Mexico's economy. For example, Federico Sada, chief executive of Mexican glassmaker Vitro SA, said, "the lack of available credit is a key obstacle to economic growth," while he explained how the scarcity of credit prevents small companies from borrowing.⁶⁸

Countries participating in the WTO's Doha Development Round and General Agreement on Trade in Services should pay particular attention to Mexico's experience when they evaluate their development goals in the context of financial liberalization. A stable financial system, including adequate financial intermediation, is an important contributor to achieving development goals. Many developing countries face problems similar to Mexico's, including inadequate bank credit to the private sector (especially for SMEs and rural farmers).

TABLE 3. Development Balance Sheet of FDI Impact in Mexico

POSITIVE
<ul style="list-style-type: none"> ● Preservation of banking system ● Recapitalization of sector ● Gradual recovery of banking sector assets (1997 to present) ● More efficient and profitable banking system <ul style="list-style-type: none"> ❑ Reduction in employees ❑ Reduction in past-due loans ❑ Increase in productivity ❑ Consolidation ● Lower fees on remittances ● Increase in consumer credit from banks
NEGATIVE
<ul style="list-style-type: none"> ● Decrease in domestic credit provided by the banking sector ● Decrease in total credit to the private sector <ul style="list-style-type: none"> ❑ Decrease in total bank credit to the private sector <ul style="list-style-type: none"> ○ Decrease in total bank credit to the non-financial private sector ○ Decrease in commercial credit from banks ○ Decrease in mortgage credit from banks ● High fees for services ● Reduction in asset levels (compared with 1994) ● Higher concentration (oligopoly) ● More difficult for SMEs and the rural sector to access private credit ● Drop in sector employment ● Financial service wages grew more slowly than overall wages

NOTES

- ¹ This figure is calculated by taking total commercial banking assets in 2003, 1,855 billion pesos, and dividing by the year-end exchange rate (11.237 pesos/U.S. dollar).
- ² United Nations Economic Commission for Latin America and the Caribbean (ECLAC), *Foreign Investment in Latin America and the Caribbean, 2002* (Santiago, Chile: United Nations, April 2003). However, a *Wall Street Journal* article in 2004 estimated the share of foreign ownership at 85 percent; see John Lyons, "Mexico's Foreign Banks Grow Uneasy: Outsiders' Control of Market Brings Rising Resentment, Criticism for Failing to Lend," *Wall Street Journal*, March 17, 2004, p. A15 (hereafter referred to as Lyons, "Mexico's Foreign Banks Grow Uneasy").
- ³ The country currently has eleven free trade agreements with forty-three trade partners, including the United States, Canada, the European Union (EU), the five countries of the Central American Common Market, and Israel. When Mexico entered NAFTA in 1994, it became the first developing country to complete a comprehensive trade agreement with two developed neighbors. Mexico also signed fifteen bilateral investment treaties and sixteen double taxation treaties from 1995 to 2002. See United Nations Conference on Trade and Development (UNCTAD), "Country Fact Sheet: Mexico," *World Investment Report 2003*, available at www.unctad.org/sections/dite_dir/docs/wir03_fs.mx.en.pdf (accessed on May 24, 2004).
- ⁴ The only two banks not to be nationalized were the union-owned Banco Obrero and a branch of U.S.-based Citibank, which was established before restrictive legislation was signed in 1966.
- ⁵ William C. Gruben and Robert McComb, "Liberalization, Privatization, and Crash: Mexico's Banking System in the 1990s," *Economic Review* (Federal Reserve Bank of Dallas) (First Quarter 1997) 22, available at www.dallasfed.org/research/er/1997/er9701c.pdf (accessed July 1, 2004) (hereafter referred to as Gruben and McComb, "Liberalization, Privatization, and Crash").
- ⁶ These banking components included brokerage houses, insurance companies, and other bank operations that did not take deposits and make loans. Assets controlled by nonbank financial institutions as a percentage of total financial system assets expanded from 9.1 percent in 1982 to 32.1 percent in 1988. Gruben and McComb, "Liberalization, Privatization, and Crash," 22.
- ⁷ Elizabeth McQuerry, "The Banking Sector Rescue in Mexico," *Economic Review* (Federal Reserve Bank of Atlanta) (Third Quarter 1999) 15, available at www.frbatlanta.org/filelegacydocs/mcquerry.pdf (accessed July 1, 2004) (hereafter referred to as McQuerry, "The Banking Sector Rescue in Mexico").
- ⁸ The twenty commercial banks were made up of eighteen privatized banks plus the two that were never nationalized.
- ⁹ Gruben and McComb, "Liberalization, Privatization, and Crash," 23.
- ¹⁰ Gruben and McComb, "Liberalization, Privatization, and Crash," 23; McQuerry, "The Banking Sector Rescue in Mexico," 15. Haber and Kantor calculated the unweighted and weighted book ratio average as 3.53 and 3.04 respectively; see Steven Haber and Shawn Kantor, "Getting Privatization Wrong: The Mexican Banking System, 1991–2003," World Bank working paper, November 10, 2003, available at www.worldbank.org/research/projects/bank_privatization_conference/haber_kantor.pdf (accessed on May 24, 2004) (hereafter referred to as Haber and Kantor, "Getting Privatization Wrong").
- ¹¹ Gruben and McComb, "Liberalization, Privatization, and Crash," 23.
- ¹² Nancy Birdsall, Michael Gavin, and Ricardo Hausmann, "Getting the Lessons Right: A View from the Inter-American Development Bank," in *Anatomy of an Emerging Market Crash*, ed. Sebastian Edwards and Moisés Naím (Washington, D.C.: Carnegie Endowment for International Peace, 1997), 277.
- ¹³ Francisco Gil-Díaz, "The Origin of Mexico's 1994 Financial Crisis," *Cato Journal* 17, no. 3 (September 11, 1998), available at www.cato.org/pubs/journal/cj17n3-14.html (accessed May 27, 2004).
- ¹⁴ Gruben and McComb, "Liberalization, Privatization, and Crash," 25.
- ¹⁵ Gruben and McComb, "Liberalization, Privatization, and Crash," 26.
- ¹⁶ These numbers are considered to be lower than the real amount because of the government's former methodology of reporting past-due loans. McQuerry, "The Banking Sector Rescue in Mexico," 17.
- ¹⁷ McQuerry, "The Banking Sector Rescue in Mexico," 18; Michael W. Mackey, *Comprehensive Evaluation of the Operations and Functions of the Fund for the Protection of Bank Savings "FOBAPROA" and Quality of Supervision of the FOBAPROA Program 1995–1998*, Report submitted to the Congress of Mexico, July 1999, 96.
- ¹⁸ Gruben and McComb, "Liberalization, Privatization, and Crash," 24.

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- ¹⁹ These concepts are explained in Gruben and McComb, “Liberalization, Privatization, and Crash,” 24–26.
- ²⁰ Sandra Polaski, “Jobs, Wages, and Household Income,” in *NAFTA’s Promise and Reality: Lessons from Mexico for the Hemisphere* (Washington, D.C.: Carnegie Endowment for International Peace, 2004) 19, available at www.ceip.org/files/pdf/NAFTA_Report_ChapterOne.pdf.
- ²¹ McQuerry, “The Banking Sector Rescue in Mexico,” 16.
- ²² Gruben and McComb, “Liberalization, Privatization, and Crash,” 26–27.
- ²³ FOBAPROA differed from the Federal Deposit Insurance Corporation in the United States because it insured 100 percent of all deposits.
- ²⁴ The program is widely known as FOBAPROA, after the deposit insurance agency that administered it. These bonds pay 2 percent above the *cete* rate.
- ²⁵ Gruben and McComb, “Liberalization, Privatization, and Crash,” 27; McQuerry, “The Banking Sector Rescue in Mexico,” 19–20.
- ²⁶ McQuerry, “The Banking Sector Rescue in Mexico,” 18–20.
- ²⁷ Citibank was the only foreign bank chartered to operate as a deposit-taking and lending institution in Mexico as a result of its existence predating the 1966 legislation. The bank’s presence, however, was extremely small.
- ²⁸ See Skip Edmonds, “Mexican Banks Open to Foreign Investors,” *Financial Industry Issues* (Federal Reserve Bank of Dallas) (First Quarter 1995) 1, available at www.dallasfed.org/banking/fii/fi9501.pdf (accessed July 1, 2004); Gruben and McComb, “Liberalization, Privatization, and Crash,” 27.
- ²⁹ McQuerry, “The Banking Sector Rescue in Mexico,” 17–18.
- ³⁰ Haber and Kantor, “Getting Privatization Wrong”; “Mexico’s Banking Sector Is Bouncing Back,” *Knowledge@Wharton* (March 2004), available at <http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&ID=942> (accessed May 27, 2004) (hereafter referred to as “Mexico’s Banking Sector Is Bouncing Back”).
- ³¹ Gruben and McComb, “Liberalization, Privatization, and Crash,” 24.
- ³² Financial penetration measured by M4/GDP, where M4 includes currency, checking accounts and other short-term deposits, banker’s acceptances, long-term bank deposits, and government bonds held by the state; explained in Gruben and McComb, “Liberalization, Privatization, and Crash,” 24.
- ³³ Greenfield FDI is different from cross-border merger-and-acquisition FDI because it involves a foreign investment in new production facilities rather than the purchase of a preexisting domestic asset.
- ³⁴ Jeffrey Passel, “Mexican Immigration to the US: The Latest Estimates,” *Migration Information Source* (March 2004), available at www.migrationinformation.org/Feature/display.cfm?ID=208 (accessed on May 24, 2004).
- ³⁵ Inter-American Development Bank (IDB), *Sending Money Home: Remittance to Latin America and the Caribbean* (Washington, D.C.: IDB, 2004) available at www.iadb.org/mif/V2/files/StudyPE2004eng.pdf (accessed on May 25, 2004) (hereafter referred to as IDB, *Sending Money Home*).
- ³⁶ Organization for Economic Cooperation and Development, *OECD Economic Survey: Mexico* (Paris: OECD, 2004), 146–157.
- ³⁷ IDB, *Sending Money Home*.
- ³⁸ Devesh Kapur and John McHale, “Migration’s New Payoff,” *Foreign Policy* (November/December 2003).
- ³⁹ Inter-American Development Bank and Bendixen Associates, *State by State Survey of Remittance Senders: U.S. to Latin America* (Washington, D.C.: IDB, 2004), available at www.iadb.org/mif/V2/files/Bendixen_May17_2004.pdf (accessed July 1, 2004).
- ⁴⁰ This analysis does not include Citibank’s presence until 1998 even though Citibank did exist in Mexico before other foreign banks were allowed to participate. Before 1998, Citibank’s presence was extremely small, close to 1 percent of total assets.
- ⁴¹ Figures are from December 1997 and September 2002. McKinsey Global Institute, *New Horizons: Multinational Company Investment in Developing Economies* (McKinsey & Company, 2003), 50, available at www.mckinsey.com/knowledge/mgi/newhorizons/ (accessed on May 24, 2004) (hereafter referred to as McKinsey, *New Horizons*).
- ⁴² Lyons, “Mexico’s Foreign Banks Grow Uneasy”; also see companies’ annual reports.

- ⁴³ McKinsey, *New Horizons*, 39.
- ⁴⁴ Unless otherwise noted, annual figures come from the Comisión Nacional Bancaria y de Valores (CNBV) December *Boletín Estadística*. In other words, data for 1997 are year-end annual figures published in December.
- ⁴⁵ Assets are in billions of 1997 pesos calculated with the financial services consumer price index (CPI). Unless otherwise noted, the average annual increase (decrease) is the compounded annual growth rate (CAGR).
- ⁴⁶ McKinsey, *New Horizons*, 56.
- ⁴⁷ McKinsey, *New Horizons*, 50.
- ⁴⁸ Nonbanks include Sofoles (nonbank special purpose lending institutions), leasing companies, factoring companies, credit unions, savings and loan associations, suppliers, retailers, and capital markets.
- ⁴⁹ For periods 1992–1996 see McKinsey, *New Horizons*, p. 49.
- ⁵⁰ National Banking and Securities Commission (CNBV), available at www.cnbv.gob.mx.
- ⁵¹ Domestic credit provided by the banking sector is not a subset of domestic credit to the private sector. “Domestic credit to the private sector” refers to financial resources provided to the private sector, such as through loans, purchases of nonequity securities, trade credits, and other accounts receivable, that establish a claim for repayment. For some countries these claims include credit to public enterprises. “Domestic credit provided by the banking sector” includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks, as well as other banking institutions where data are available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations.
- ⁵² *World Development Indicators 2004* (Washington, D.C.: World Bank, 2004).
- ⁵³ “Fox Asks Bankers to Pick Up Lending,” *Business News Americas* (March 19, 2004).
- ⁵⁴ “World Bank Approves \$505 Million to Reform Banking Sector in Mexico,” World Bank News Release no. 2003/419/LAC, June 12, 2003, available at www.worldbank.org.
- ⁵⁵ See Scott Vaughan, “The Greenest Trade Agreement Ever?” in *NAFTA’s Promise and Reality*, chapter 3, available at www.ceip.org/files/pdf/NAFTA_Report_ChapterThree.pdf.
- ⁵⁶ Findings from the period 1994–2002 can be found in McKinsey, *New Horizons*, 40. This study calculates the real value of commercial banking assets using 1993 pesos in billions. My findings, from 1997 to 2003, are calculated in real terms using 1997 pesos. The difference in period as well as the base year used explain why commercial banking assets decreased 3.5 percent annually from 1994 to 2002 but increased 1.5 percent a year from 1997 to 2003. With my data from 1997 to 2002, commercial banking assets increased 0.5 percent annually. This is close to the findings of the McKinsey report, which shows an increase of 0.8 percent annually from 1997 to 2002. The extremely small difference is due to the difference in base year used (1993 versus 1997) and the fact that the McKinsey data do not include October, November, and December 2003.
- ⁵⁷ In this case, nonbanks include savings and loan associations, credit unions, and retail mutual funds. See McKinsey, *New Horizons*, 42.
- ⁵⁸ McKinsey, *New Horizons*, 42.
- ⁵⁹ Suppliers represent the largest source of financing for the commercial sector. Sofoles and public institutions like Infonavit and Fovisste are the main sources of mortgage credit. Retailers play a key role in providing nonbank credit to consumers.
- ⁶⁰ See David Luhnow, “Mexico’s New Lender: Mexico,” *Wall Street Journal*, November 13, 2003, p. A16.
- ⁶¹ See José Antonio Gonzalez-Anaya, “Why Have Banks Stopped Lending in Mexico since the Peso Crisis in 1995,” Working Paper no. 118, Center for Research on Economic Development and Policy Reform, Stanford University, April 2003, available at <http://credpr.stanford.edu/pdf/credpr118.pdf> (accessed on July 1, 2004).
- ⁶² IPAB bonds are bonds that the government issued to banks in exchange for bad bank loans; this was part of the government’s bailout program after the financial crisis of 1994–1995. See discussion on Mexican government motivations, p.9.
- ⁶³ Haber and Kantor, “Getting Privatization Wrong,” 26.
- ⁶⁴ Data used for year-end 1994 and 2003 are January 1995 and January 2004 data because figures for December 1994 are not available.

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- ⁶⁵ “Mexico’s Banking Sector Is Bouncing Back.”
- ⁶⁶ Haber and Kantor, “Getting Privatization Wrong.”
- ⁶⁷ Lyons, “Mexico’s Foreign Banks Grow Uneasy.”
- ⁶⁸ Lyons, “Mexico’s Foreign Banks Grow Uneasy.”

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