Globalization: The Role of Institution Building in the Financial Sector
The Case of Mexico

I. Introduction

Institutions, understood as the rules, enforcement mechanisms, and organizations that shape the functioning of markets (North, 1990, 1991), have long been recognized as a fundamental element for economies to function properly. Institutional development in the financial sector is particularly important not only because of the role of efficient and sound financial systems in promoting economic development, but also in view of the fact that with globalization the quality of the institutional financial framework is crucial for countries to reap the benefits of international capital flows and to minimize the costs of volatility and contagion.

The process of institution building in the financial sector in Mexico has evolved hand in hand with the efforts of financial liberalization and of inserting the economy more fully into world markets. In fact, the Mexican experience provides a useful illustration of the positive influence of liberalization and globalization on institution building, of the dangers linked to efforts of financial liberalization not accompanied by sufficiently strong institutions, and of the merits of basing reform efforts on institutional elements to avoid backward movements during periods of temporary difficulties.

In this paper, institution building in the financial sector in Mexico is split into several phases. The first one spans from the early seventies to 1988. Although this is a period characterized by financial repression, a number of important institutional developments and some efforts of financial liberalization took place. However, the nationalization of banks and the imposition of exchange controls in the early eighties represented a backward step in the movement towards a market oriented financial sector. The second phase, when ambitious measures of institution building and liberalization were undertaken, goes from 1988 to 1994. The third phase covers the period from 1995 to 2000. Efforts during this stage focused, on the one hand, on the adoption of policies aimed at overcoming the 1994-1995 banking crisis and, on the other, on setting the conditions needed for a healthy development of an even more open financial system. The fourth phase of reforms spans from 2001 to the present. During this period, the new administration that took office in December 2000 has given priority to reform and institution building in the financial sector as a means to increase the size and productivity of the financial system.

II. The Institution Building Process

1) The Era of Protected Financial Markets (First Phase: 1970-1988)

Some of the foundations of the financial liberalization that took place after late 1988 were laid by institutional reforms undertaken since the mid seventies. The most significant reforms enacted were the transition from specialized to universal banking, the modernization of the securities market, and the creation of a domestic public debt market.

In the early seventies, interest rates were comprehensively regulated, and the financial system was integrated by specialized institutions subject to a variety of compulsory credit allocation requirements, each with a maximum rate of interest. This complex system became unmanageable by 1974, when deposit rates had to be increased sharply in response to adverse international conditions and domestic inflation. Pressures on a far too rigid arrangement increased, and it became necessary to remove regulations on lending rates gradually. In response, in that year a weighted average deposit rate (CPP) was introduced to provide a more flexible basis for determining loan rates. Deposit rates, however, remained regulated, and banks continued to be required to allocate credit to certain sectors.

The Law on Credit Institutions was amended in 1974 to allow for multiple-service or universal banks. Until then, the law provided only for banks specializing in different types of services. The new multiple-service banks were then able to attract deposits through various instruments, to channel them into different economic activities more flexibly than in the past, and to benefit from economies of scale and risk diversification.

The trend in international financial markets away from bank credit and into securities also influenced the development of the financial system. In 1975 a Securities Market Act established the legal framework for the expansion of securities operations, and substantially strengthened the regulatory role of the National Securities Commission (CNV).

To alleviate the problems resulting from an extremely complex reserve requirement system, a single reserve requirement ratio for the liabilities in domestic currency of institutions operating as multiple service banks was adopted in 1977. The introduction of Treasury Certificates (CETES) in 1978 complemented the measures adopted on legal reserve requirements and interest rates. In fact, this was to prove a watershed in Mexico's financial development, as it led to the growth of an active money market where interest rates would be increasingly determined by market forces.[1] Other new financial instruments were also created during the second half of the seventies. Particularly important was the issuance of non-bank

1 In the last two an a half decades, the Mexican authorities have strived to develop domestic debt markets. The initial steps date back to this first issue of government peso-denominated fixed rate security (CETES). Initially, both the number of market transactions and the amounts involved were small; securities had short-term maturities, no secondary market existed, and the government determined interest rates. However, over the years, both the government and the central bank increasingly relied on the debt market, the former to cover its financial needs and the latter as an instrument of monetary policy. These issues are discussed in Appendix 1.

paper with short-term maturities and high liquidity. In 1980, the first issues of commercial paper took place, and the first "convertible securities" were placed.

These liberalization efforts were abruptly interrupted when commercial banks were nationalized and exchange controls were introduced in September 1982 at the height of Mexico's debt crisis.

Financial repression during this stage had a major impact on resource allocation. Three indicators are worth noting in this regard:

- **Stagnation of financial savings**. In the 19 year period from 1970 to 1988, financial savings (proxied by the ratio of the broadest monetary aggregate in Mexico (M4) to GDP) declined from 34 percent to 30.9 percent.
- **Distortion of price signals**. The working of fundamental price signals was also distorted by financial repression. Real interest rates in Mexico were negative during the seventies and showed wide fluctuations during the eighties, from highly negative to highly positive figures.
- **Very low financing to the private sector.** As a result of the growing fiscal deficit, the public sector crowded out private borrowing. Commercial bank financing to the private sector fell from 18 percent of GDP in 1970 to less than 13 percent in 1987. Simultaneously, bank credit to the public sector as a proportion of GDP increased from less than 1 percent to 15.9 percent in the same period, mainly through higher reserve requirements and widespread credit controls on private banks.

Financial repression affected resource allocation through a number of additional channels. High reserve requirements and credit controls increased substantially the costs of intermediation, eroded banks´ competitiveness, and channeled an important amount of resources to non-profitable activities. In addition, restricted bank financing to the private sector, coupled with low real interest rates for bank deposits, caused considerable expansion of an already large informal credit market. Since operations in this market were often conducted without proper records, its expansion threatened to introduce an element of instability into the country's economy. Furthermore, with reserve requirements unable to affect operations in the informal credit market, the effectiveness of monetary policy was severely impaired.

2) Fortifying Financial Institutions (Second Phase: 1988-1994)

In the second half of the eighties, Mexico began a comprehensive process of structural change that radically transformed the economy, from a situation characterized by high trade tariffs, foreign trade restrictions, and unhealthy levels of regulation, to one in which a substantial degree of deregulation and opening to international trade and foreign investment were the main features.

In November 1988, as part of a stabilization and structural reform program and in view of the high costs resulting from financial repression, a major move towards financial liberalization was launched. Deregulation, internationalization, and bank privatization were the three main aspects of this process. These measures sought to promote the development of the Mexican financial system into a modern, highly competitive, and efficient system. Additionally, Central Bank autonomy was an important achievement in the institution building process in Mexico during this period.

a) Deregulation of the Financial Sector

The main measures adopted in late 1988 were the following: 1) multiple service banking institutions were permitted to place bankers' acceptances without any limit (the instruments´ yields and maturities were determined according to market conditions); 2) banks were allowed to invest freely from these sources, subject to the restriction of maintaining a liquidity ratio of 30 per cent in the form of certain government debt instruments and interest-bearing deposits at the Bank of Mexico; and 3) banks were authorized to participate in CETES auctions, bidding either on their own account or on behalf of third parties.

In April 1989, selective credit controls were abolished, reserve requirements on bank deposits were substituted by a new 30 per cent liquidity coefficient similar to that applicable to bankers' acceptances, and mandatory lending at below-market interest rates to the public sector by commercial banks was discontinued.

In September 1991, the authorities eliminated the 30 per cent liquidity coefficient imposed on banks. During the same year, foreign exchange controls in force since 1982 were removed.

b) Internationalization of the Financial Sector

Institutional reforms in the financial system in the late eighties were also fostered by modifications to the legal framework. The reforms approved by Congress in December of 1989 were aimed at allowing the creation of financial groups, and at placing a larger number of Mexican security issues on international markets, attracting foreign capital, and preparing intermediaries to meet foreign competition.

The 1989 legal reforms also permitted foreign investors to hold a minority share in the capital of financial intermediaries for the first time in 50 years. In addition, the government allowed foreigners to undertake portfolio investment in Mexican equities through special 30 year trust funds. At the end of 1990, the restrictions on the purchase by non-residents of fixed income securities, specially on government securities, were abolished. With the last two measures, the capital account of the balance of payments was fully opened to portfolio foreign investment. This played a significant role in the surge in capital inflows that was registered from 1990 to 1993.

c) The Privatization of Commercial Banks

On May 2, 1990, the President of Mexico submitted a bill to Congress to amend the Constitution, eliminating the government's exclusive right to provide banking and credit services. After Congressional approval, the private sector regained the right to majority participation in the capital of banks. As part of the bank privatization process, long-standing restrictions on foreign investment in the financial sector were liberalized. As a result, foreign investment of up to 30 percent of common stock was permitted in Mexican commercial banks and financial holding companies. The same limit was established for foreign investment in securities intermediaries.

Several forces at work prompted the decision to privatize commercial banks. On the internal front, the government considered that in order to promote sustainable growth, the economy needed healthy means to finance the development process, particularly through internal resources. This required a stronger and more efficient banking system. On the external front, the government recognized that Mexico had to adapt to the dramatic transformations that were taking place in the world economy. The opening of the economy meant that Mexican firms would be competing in increasingly globalized international markets.

In a context of financial liberalization and deregulation such as the one described above, prudential supervision became more important. Thus, banks were required to classify their loan portfolios into risk groups, and began to create global preventive reserves from zero to 100 per cent on the basis of this appraisal. Later on, measures were adopted to strengthen banks´ capital in accordance with the Basel Concordat.

d) Autonomy of the Central Bank

Central bank autonomy is a fundamental achievement in the institution building process in Mexico.[2] The main driving force that led to central bank autonomy was the desire to signal to markets the commitment of the government with price stability in a medium term context. During the late eighties, lack of credibility in the governments' commitment to the announced inflation objective had led to a higher risk premium in interest rates. A less precise but nonetheless important element behind the granting of autonomy to the central bank was the consensus at the political and social level of the desire to eradicate inflation.

By entrenching in the Constitution the mandate to the central bank to achieve price stability, attaining low and stable inflation became an institutional feature of the monetary policy framework in Mexico. A transformation from policy based on individuals to policy anchored on institutions.

2 In August 1993, Congress approved an amendment to Article 28 of the Constitution granting autonomy to the Central Bank. The primary objective of the autonomous Central Bank under the new Article 28 is to seek the stability of the purchasing power of the national currency. In addition, Congress passed a new law for the Banco de México which went into effect on April 1, 1994.

This institutional change acknowledged that the experience of Mexico with an acute and prolonged inflationary process, was closely linked to the financing of large fiscal deficits by the Central Bank. With autonomy, the government would no longer be able to finance its deficit with credit from the Central Bank. It constituted an implicit guarantee that the decade long efforts to bring public finances under control was of a permanent nature.

The move to Central Bank independence in Mexico, was allowed by the fact that the preconditions needed for the scheme to be credible had been met, namely, achieving single digit inflation and sound public finances. In 1993 inflation was down to a one digit level, the public sector borrowing requirements stood at 2.5 percent of GDP, and public debt as a share of GDP amounted to 21 percent.

e) The Role of NAFTA

The signing of the NAFTA in 1993 represents one of the most important institutional changes in Mexico in recent years. It was motivated by the desire to create an environment conducive to promoting economic activity. It sought to take advantage of integration with its largest trading partners and of the certainty which stems from agreements governed by clear and transparent rules.

NAFTA has had a significant impact on the Mexican economy, by providing greater security of access to the largest world market, by increasing the attractiveness of Mexico to foreign direct investment flows, by promoting national productivity and the use of new technologies, and by boosting the export of Mexican products.

Simultaneously, NAFTA provided an additional major impulse to the opening of the financial sector to foreign investment. On December 23, 1993, to respond to the commitments assumed under NAFTA, the Mexican Congress approved new amendments to financial legislation allowing foreign financial institutions, based in a country with which Mexico has signed an international agreement, to establish fully-owned subsidiaries in Mexican territory.

The opening of the financial sector under NAFTA sought to maintain a balance between the objective of promoting competition in the sector and ensuring not to jeopardize the stability of financial intermediaries and the economic stabilization program. In this context, the NAFTA provisions would be phased in gradually, with interim individual and aggregate limits placed on the market share of U.S. or Canada-based banks, brokerage houses, and insurance companies[3]. As will be seen later on, these limitations were relaxed in the context of the financial liberalization that took place in the 1995-2003 period.

3 For instance, in the case of banks, the aggregate net capital market share allowed to subsidiaries of NAFTA-based financial institutions would rise in steps from 8 percent on January 1, 1994 to 15 percent on January 1, 2000. During that period, the size of individual foreign banks would also be limited and may not represent more than 1.5 percent of net capitalization of the Mexican market. In addition, during the four year period beginning January 1, 2000 and ending December 31, 2003, Mexico would have the option to impose a three year freeze if the market share of all foreign subsidiaries exceeded 25 percent. A restriction was maintained on the acquisition of large Mexican banks by foreign banks.

f) Impact on the Economy

The consolidation of public finances, the implementation of market oriented structural reforms, the restructuring of the external public debt, and the privatization of commercial banks and of the telephone company, among other developments, contributed to the emergence of very optimistic prospects on the economy in the early nineties. The results of the liberalization of the financial sector, and especially the opening of the capital account in a context of booming confidence, led to a surge in capital inflows, which reached an average of nearly 8 percent of GDP during the period 1991-93.

The financial liberalization measures adopted since 1988, coupled with capital inflows, prompted a strong increase in financial depth. The ratio of M4 to GDP rose from 31 percent in 1988 to 51 percent in 1994.

Financial liberalization and capital inflows increased the availability of credit. Moreover, as a result of the strengthening of public finances, the borrowing requirements of the public sector fell, thus freeing more financial resources for the private sector. These developments coincided with a strong demand for credit, fostered by favorable economic expectations, the need to modernize the industrial plant in the face of higher competition, a severe housing shortage, the decrease in the cost of credit in real terms, and pent up consumer demand, among other factors. Thus, bank financing to the private sector posted an impressive growth: its share in GDP increased fourfold between 1988 and 1994 (from 10.8 percent to 42.9 percent).

Unfortunately, bank credit increased at a time when supervision by the financial authorities was inadequate, despite the efforts made, and before banks could establish the necessary internal controls to ensure that credit would be granted prudently (see Ortiz, 1998). The nationalized banking system, which for years had directed financing mainly to the public sector, had organizational and information systems that could not adequately assess credit and market risks or monitor loan performance. In addition, as the banks were re-privatized, some new management teams, which were not in all cases experienced, took charge of the banks´ lending function. Furthermore, as a consequence of the unlimited backing of banking liabilities, moral hazard increased. The situation was complicated by the emergence of important macroeconomic disequilibria, namely, a significant appreciation of the peso in real terms, a sharp decline in private savings, and a large current account deficit.

The weaknesses that accompanied the growth in bank credit and the decline in private saving set the stage for a major economic and banking crisis, which was unleashed by the sudden interruption of capital flows at the end of 1994. The crisis was a result of a combination of many factors, external and domestic, economic and political. Although the measures of financial liberalization introduced since the late eighties played an important role, the fundamental problem was not liberalization per se, but rather the fact that the conditions required to ensure its success were not present, in particular: a stable macroeconomic environment, an adequate timing and sequencing of domestic and capital account liberalization, a financially sound banking system at the time of liberalization, and institutional deficiencies in several areas, in particular, inadequate mechanisms of bank supervision, inefficient and unexperienced management at the front of financial institutions, and the presence of deposit guarantees giving rise to serious moral hazard problems (see Mancera, 1996 and 1997, and Gil Díaz, 1998).

3) Revamping the Financial Sector in the Aftermath of the Crisis (Third Phase: 1995-2000)

The third phase covers the period from 1995 to 2000. Despite the severe balance of payments and financial crisis of 1994-95 and its devastating effects on the banking system, the financial liberalization process continued. This result stems, to a significant extent, from recognition of the benefits of liberalization and from the fact that the process of institution building made it extremely difficult to revert the liberalization of the financial sector achieved in the late eighties and early nineties. Efforts during this stage focused, on the one hand, on the adoption of a number of measures aimed at overcoming the banking crisis and, on the other, on setting the conditions needed for a healthy development of an even more open financial system. These efforts were supported by international financial organizations, which began during this period to emphasize the importance of institution building.

a) Macroeconomic Stabilization 1995-1996

Mexico launched a comprehensive stabilization program in 1995. This program included cuts in public expenditure and a tight monetary policy within a newly adopted flexible exchange rate arrangement. In addition, the authorities were confronted with the need to manage the threat of a systemic banking crisis. At this point it was clear that a sound financial system could not be achieved without addressing institutional weaknesses, including deficiencies in management, lack of transparency and information disclosure, a poor market discipline and credit culture, weak prudential regulation and supervision, and ineffective judicial systems and bankruptcy laws. As a result, implementing a far-reaching institutional reform of the financial system became a policy priority.

b) The Macroeconomic Setting: Monetary and Fiscal Policies

Monetary Policy

With the adoption of the floating exchange rate regime following the balance of payments crisis in 1994-95, monetary policy became the nominal anchor of the economy. The challenge for the autonomous central bank was to reduce inflation, which had skyrocketed in 1995 in the aftermath of the devaluation of the peso, and to confront the credibility crisis that it was facing.

Since 1995, the central bank adopted a gradual disinflation process. In the early stages after the crisis the central bank targeted the path of base money, but it gradually shifted to the attainment of monetary conditions consistent with the inflation objective. A formal inflation targeting framework was introduced in 2001.[4]

This framework includes the following features:

- The consolidation of an autonomous monetary authority.
- The reiteration of price stability as the fundamental objective of monetary policy.
- The announcement of short and medium term inflation targets.
- A permanent analysis of all potential sources of inflationary pressures.
- An emphasis on transparency and communication with society.
- An improved framework for central bank accountability.

The implementation of monetary policy in the context of a strong institutional setting and supported by a prudent fiscal policy, have proved very successful in reducing inflation. The annual rate of growth of the consumer price index fell from 52 percent in December 1995 to 4.1 percent in July 2003. Core inflation has followed a similar trend.

Fiscal Policy

The tightening of fiscal polity in the aftermath of the 1994-1995 economic crises represented one of the main pillars of the successful stabilization of the economy in that period. However, efforts in the area of public finances extended beyond this. In particular, given the importance of a prudent and efficient management of fiscal policy, a number of institutional adjustments were made aimed at contributing to achieve these objectives on a long term basis.

The efforts of institutional reform in the area of public finances have included the introduction of a longer-term approach to public spending through three different channels: 1) developing a multiannual perspective consistent with public debt sustainability in the medium term; 2) limiting the financing of current expenditures with public debt and; 3) guaranteeing the financing of new programs or the expansion of existing ones with stable sources.

Mexico has also strengthened the institutional framework for public finances by including fiscal responsibility principles in the budget, to help ensure that the

4 Under this framework, the Banco de México established a medium-term inflation objective with well-defined annual targets consistent with this objective. The medium-term objective was set at around 3 percent by end-2003 (end-year headline consumer price inflation), with intermediate targets of under 6.5 percent in 2001 (the observed inflation rate was 4.4 percent) and under 4.5 percent for 2002 (the observed inflation rate was 5.7 percent). In July 2002, the Banco de México formally established the 2003 inflation target at 3 percent and announced that from 2004 onwards it would be maintained at 3 percent with a band of +/- 1 percent around the midpoint.

approved expenditure ceilings and deficit targets are met. For example, in addition to establishing ceilings on global expenditure and net public indebtedness, as well as a primary surplus target for PEMEX (the state oil company), over the last few years the budget has included automatic adjustors, which provide for saving the bulk of excess revenue and which require offsetting expenditure cuts in the case of revenue shortfalls[5]. Although the government retains discretion in applying these adjustors, the authorities have a track record of abiding by the adjustors to ensure compliance with the fiscal targets. Nonetheless, even if the government opted to ignore the adjustors, the debt ceiling included in the annual revenue law would provide a legal limit to the overall nominal deficit and, thus, an indirect obligation to adjust expenditure.

Also, in 1998 a budgetary reform was introduced to enhance the administrative efficiency of government programs and, in general, to improve the allocation of public resources. This reform took place as a system called the Sistema Integral de Administración Financiera Federal (SIAFF). Its goal was to optimize the administration of government financial resources, through the generation and concentration of homogeneous information. In addition, the Federal Government worked on the implementation of a new accounting model to enhace the functioning of all Federal Government Entities' administrative procedures.

c) Strengthening the Financial System

As explained before, despite the negative repercussions of the 1994-95 crisis, the Mexican authorities did not revert the financial liberalization process. On the contrary, the latter was deepened. Efforts in the financial sector after the crisis concentrated in two areas:

(a) Safeguarding the integrity of the financial system. This objective was met satisfactorily, since systemic risk on the financial system was eliminated, and the fiscal cost of the schemes introduced to support debtors and the banking system was limited and was distributed over many years; and

5 Automatic Stabilizers currently operate under the following guidelines:
- In particular, automatic stabilizers are triggered if government revenues are lower than anticipated:
  a) If oil related revenues are lower than anticipated, the shortfall can be offset with up to 50 percent of the resources accumulated in the Oil Stabilization Fund, plus interest earnings and other less important sources.
  b) If other revenues are lower than anticipated then:
     - If revenues decrease by 5.0 percent of tax revenues or less, the government will cut programmable expenditures and inform Congress of the items where these expenditure reductions will be carried out.

     In case the previous adjustments are not enough to compensate for the revenue shortfall, the government will be entitled to adjust other expenditure items.
     - If the reduction in revenues is larger than 5.0 percent of tax revenues, programmable expenditures will be reduced. In this case, Congress will have to approve the specific items where the expenditure adjustments will take place.
  - Extra revenues would be directed as follows:
    a) 25 percent to the Oil Stabilization Fund.
    b) 25 percent to strengthen the Public Sector Balance.
    c) 50 percent to promote infrastructure projects in federal entities.

(b) Setting in motion the policies needed to ensure the adequate functioning of the financial system in an increasingly liberalized environment.

A number of measures were introduced since the late nineties to accomplish the second of these objectives. In December 1998, Congress approved an ambitious package of financial reform. Three items stand out from this package. First, the gradual and orderly lifting of the blanket coverage of bank deposits, an important source of moral hazard in the financial system, was begun. Under the new system, by December 31, 2005 deposit coverage will be limited to an amount equivalent to 400,000 UDI´s[6] per person and per financial institution. Second, a new institute was created, the Institute for Bank Deposit Insurance (IPAB). The IPAB became operational in June 1999 having three main responsibilities: a) to manage the new deposit insurance scheme, b) to manage restructuring programs for banks that have received its support, and c) to administrate and sale assets acquired through several banking-support programs. Third, barriers to foreign ownership in the financial system were eased further, so that foreign investment of up to 100% of common stock was permitted in Mexican commercial banks and financial holding companies.

Furthermore, the supervisory and regulatory frameworks were strengthened. Thus, accounting standards and rules were adjusted to conform to best international practices, and stricter capital adequacy requirements were introduced.

It is worth to highlight two additional measures undertaken in this period:

1. In April 2000, Congress approved bankruptcy and secured lending legislation. These reforms were considered fundamental, since the deficient legal framework in these areas had represented an important obstacle for the resumption of lending to the private sector. With the new laws, both creditor rights and the efficiency of loan collection were significantly enhanced.

2. On July 1997, a pension system began operating based on an individual capitalization scheme. The contributions made by employees, employers, and the government are deposited and registered in a personal account owned by the employee. These accounts are administrated by financial entities named Administration for Retirement Funds (AFORES).[7] The social security reform entailed a significant institutional and regulatory overhaul as part of broader efforts to tackle the financial viability of the previous pension system. By shifting from a pay-as-you-go system to a fully funded individual capitalization scheme, the reform strengthened the link between contributions and benefits, enhancing overall financial soundness. Although the impact of the scheme on domestic saving is

6 The UDI is a unit of account with constant real value; its daily value reflects movements in the Consumer Price Index, with a short lag. Since the 1st of April, 1995, UDI´s values are estimated every 15 days by the central bank.

7 Besides this individual account, the scheme has two additional sub-accounts for the employees. One is the voluntary contribution, which allows the employee or employer to deposit additional contributions besides the ones by law, benefiting from an increase in the amount accumulated for retirement in addition to those required by law. And the second is the housing scheme, in which the employer's contributions are registered in the AFORES and are destined to a housing institution named INFONAVIT, in conjunction with the interest rates this Institute pays.

difficult to quantify because of its relatively short life and the influence of other factors, it is useful to note that at the end of 2002 resources outstanding under the system amounted to 9.9 percent of GDP and 19.7% of financial savings (M2).

d) Impact on the Financial Sector

The reforms that took place from 1995 to 2000 strengthened the financial sector in Mexico and in general improved the working of financial markets. In this respect, it is worth to highlight the following:

- **The strategy implemented allowed to strengthen banks' financial conditions.** The capitalization index stood in 2000 at 13.8 percent, almost double its annual average level in 1992-95 (the index rose to nearly 16% in 2002). Total loan loss provisions as a share of past due loans, which showed a figure of 63 percent in 1997, rose to 115.4 percent in 2000 and to almost 140 percent in 2002.

- **A higher efficiency in the banking system was achieved, as reflected in the narrower spread between lending and deposit rates.** Expressed in real terms, such spread recorded a figure of 5.2 percentage points in the period 1996-2000 (3.4 percentage points in 2002), which compares with 7.2 percentage points in the period 1979-1988.

- **Foreign participation in the domestic banking system rose substantially** after the liberalization measures introduced in 1999, from 20 percent of bank assets in that year to 52 percent in 2000 and to over 80 percent in 2002. This promoted competition and was a fundamental element for the capitalization of the banking system.

Notwithstanding these important achievements major problems remained in several areas. Two of these are particularly worth noting:

1. Despite the improved financial situation of banks, the enhanced efficiency of the banking system, and the measures implemented to strengthen the legal framework within which banks operate, bank credit failed to recover. Total bank credit to the private sector fell from 42.9 percent of GDP in 1994 to an annual average of 24.4 percent in the period 1997-2000 (15.6 percent in 2002). The most important factors explaining such behavior include the following: uncertainty resulting from the weakness of the economy; an adverse external environment; and institutional constraints, such as incomplete changes to the legal framework for the recovery of guarantees, that contributed to banks´ reluctance to grant credit.

2. The long standing efforts of financial reform were unable to foster financial intermediation in Mexico. The latter remained stagnant since 1994. The ratio of M4 to GDP, which reached a peak of 50.9 percent in 1994, fell to 44.6 percent in 2000 (51.2 percent in 2002). This is unfortunate, given the role of intermediation

through the financial system in both the financing of investment and an efficient allocation of savings, and the small size of the financial system in Mexico for international standards.

4) Recent Institutional Reforms (The Fourth Phase 2001-2003)

The fourth phase of reforms spans from 2001 to the present. In December 2000 there was a change of administration that meant a profound transformation in Mexico's political scenario. For the first time in 70 years the elected President did not belong to the PRI. No political party held a majority in Congress. This political arrangement brought a new equilibrium for decision and policy makers. The new political equilibrium translated into a new institutional arrangement that required more thorough negotiation in Congress before approving any reforms.

Within this new institutional setting, the administration that took office in December 2000 has introduced a substantial number of reforms to strengthen the institutional framework for the financial sector. A major concern is that due to the relatively small size of the financial system in Mexico, and to the strong demand of financial resources by the public sector, an insufficient fraction of the financing of investment is carried out through the financial system. In this context, a prominent role was assigned to financial reform in the 2002-2006 National Program for the Financing of Development (PRONAFIDE). In general, the objectives of financial reform are:

- To promote domestic savings, with emphasis on popular and long term savings.
- To accelerate the modernization of the financial system and facilitate the reactivation of bank credit.
- To deepen domestic stock and debt markets.
- To modernize development banks
- To modernize and consolidate the pension system.

To meet these objectives, Congress has approved or amended a number of laws since 2001 in the following areas:

a. Commercial Banking

Although as explained above progress in enhancing the strength and efficiency of commercial banks in the period 1995-2000 was substantial, a number of important problems remain. Due to the decline in bank credit to the private sector, commercial banks have not supported economic activity adequately. This has been due to an important extent to the absence of a framework providing legal certainty to creditors through appropriate guarantees and loan recovery mechanisms. Furthermore, the reforms to the regulatory and supervisory framework for the banking system carried out during the period 1996-2000, though important, were insufficient to substantially reduce the possibility of a new banking crisis. In addition, the Mexican financial system lacked a basic institutional component to allow banks to provide financing on a healthy basis, namely, credit information societies. Against this background, the following laws and amendments were approved by Congress:

- **The Credit Institutions Law and the Financial Groups Law**, which aim to channel a greater portion of national savings through the financial system, fostering long-term savings and strengthening banking regulation and supervision, while promoting transparency, competitiveness, and the development of new financial products and services. Likewise, these Laws strengthen the credit institutions' corporate governance and broaden the range of services offered. In this regard, mechanisms for timely risk identification were introduced, based on the level of banking institutions' capitalization, existing regulation on related credits was complemented, an independent advisor was introduced, and an auditing committee was created.
- **Amendments to the Rules of Capitalization Requirements for Multiple Banking Institutions.** This reform aims to advance the process of convergence between banking regulation and international standards, particularly banking capitalization recommendations proposed by the Bank for International Settlements (BIS). This resolution contemplates simplifying some procedures and/or homologating established criteria with the Mexican National Securities and Banking Commission (CNBV), as well as the elimination of certain discretional faculties of financial authorities.
- **Amendments to the Miscellany on Credit Collateral.** This reform is aimed at promoting bank lending by reducing transaction costs and interest rates, as well as by widening the options to secure credit transactions and promote competition among trustees. This will be achieved through faster repossession of collateral, conservation of assets, new kinds of collateral and trustees competition, as well as other financial transactions. The Amendments will grant greater judicial certainty to creditors and borrowers and thus will promote an orderly and sustainable recovery of bank lending. Similarly, the legal modifications will reduce the risks associated with credit operations and will translate into lower interest rates.

- **The Credit Information Institutions Law.** This Law regulates the establishment and operation of credit information societies and sets transparent rules for creating and repealing this kind of societies, by establishing a legal framework for them to function adequately in the provision of credit information, while ensuring that financial secrets are respected. Likewise, this Law defines basic concepts related to the subject, object, competent authorities, and the type of information that can be managed.

b. Development Banks

The sharp increase in development bank lending during the period 1990-94 was not accompanied by appropriate evaluation processes or credit infrastructures, thus resulting in important losses. As a result, net financing from development banks during the period 1995-2000 was basically nil. With the objective of widening access of the population to financial services and to promote the creation of small and medium size firms, the PRONAFIDE proposed a deep transformation of development banks. This has included improvements in the corporate governance of these institutions, greater autonomy, and an improved accountability process, among others. In addition, Congress approved the following laws:

- **The Organic Law of the Federal Mortgage Association**, which increases the housing supply for wage earners and other workers, promotes the construction and acquisition of housing, preferably low-income, fostering assets securitization and increasing credit supply for housing construction and acquisition.

- **The Popular Savings and Credit Law and The Organic Law of the Bank of National Savings and Financial Services.** This legislation strengthens the institutional and regulatory framework of popular savings and credit activities, increasing access of low-income sectors and small enterprises to the formal financial sector. It also establishes the conditions to foster the development of a popular savings and credit system. Through these Laws the Bank of National Savings and Financial Services was created, offering training and consulting services to popular savings and credit entities, and regulating their activities and operations.

- **The Organic Law of the Financiera Rural,** which aims at supporting the development of agriculture, forestry, fishing, and other rural activities. A new Financiera Rural has replaced the former Rural Credit Bank (BANRURAL). The Financiera does not take deposits from and does not issue debt to the public. The funding comes directly from the government through the budget process. All appropriations and allocations, financing, and guarantees alike will be properly and explicitly accounted for in the budget and approved by Congress. This is an important institutional reform in the development banking sector, since there is increased transparency as to the fiscal resources that are required to support financial institutions that foster development in targeted sectors of the Mexican economy.

c. The Stock and Debt Markets

The Mexican Stock Exchange has been affected by important structural problems, including a low number of firms controlled by a few owners, and a small investor base, both at the institutional and the retail level. On the other hand, the domestic debt market is dominated by public sector instruments, with private issues accounting for only a small share of the total (9.5 percent in 2002). To overcome these difficulties, Congress approved reforms to the **Securities Market Law and to the Mutual Funds Law**. These changes aim at promoting the development of the securities market by making it more transparent, efficient, and liquid. They provide a higher degree of protection to investors and create a transparent corporate mechanism through several channels, such as an enhanced provision of information, better corporate governance practices, and the establishment of explicit rights for minority stockholders. An important additional action is that these laws introduced a new instrument, “Certificados Bursátiles”, that can be issued by the private and public sectors, and whose versatility makes it very attractive. In fact, with the creation of Certificados Bursátiles a major boost has been given to the issue of debt by the private sector in the domestic market (see annex 1). Also, these Laws promote growth and development of mutual funds, provide adequate transparency to their operation, disseminate information to the public in general, avoid conflicts of interest in the management of resources that the public entrusts to mutual funds, and expand small investors’ participation to a broader range of savings instruments. To this end, these Laws establish new rules of corporate governance for these funds.

d. The Insurance Sector

While the structure of the insurance sector in Mexico in recent years has been strengthened through the creation, merger, acquisition, and alliance of firms, its size remains very small for international standards. As a matter of fact, the current administration considers that the main challenge in this area is to take advantage of the growth potential of the insurance sector. For this reason, the **General Law of Mutual Insurance Institutions and Associations** seeks to strengthen the institutional and regulatory framework in which the activities of insurance institutions develop. This Law seeks to increase the efficiency of insurance institutions’ operations, to homologate the insurance sector’s legal framework with that in place for the financial sector, and to develop best corporate governance practices among intermediaries. The Law stipulates the establishment of a legal base for the adequate dispersion of risk through the use of reinsurance institutions, allows a single investor to keep two or more institutions for the same operation, establishes the specialization of life- and non life- insurance institutions to protect the interests of clients, and introduces the possibility that insurance institutions leverage their capital through debt issues.

e. The Pension System.

The reform of the pension system in 1997 represents one of the most important structural measures of the last years in Mexico. In addition to ensuring the financial viability of pensions, it has stimulated the expansion of long term financial savings, as well as a higher participation of workers in the formal labor market. To reinforce the System in its strategic areas, **The Amendments and**

Additions to the Retirement Savings System Law open the possibility for more workers to access the benefits of the New Pension System, including workers not registered in a social security regime, workers affiliated to the social security system for public sector employees (ISSSTE), state and municipal governments, public universities, and private pension funds. With this amendment, complementary contributions for retirement can be made which can be collected when the worker turns 60 years old. Furthermore, the amendments eliminate the restriction to invest in foreign securities, allowing retirement savings fund managers to invest up to 20% of their total assets in these instruments.

f. The Payments System.

Being the payments system an essential part of the financial infrastructure of a market economy, the Banco de México began in 1994 a gradual reform to achieve a balance between the objectives of reducing risks in the system and maintaining an adequate operational efficiency in financial markets. Since 2001, reform efforts have focused on revamping the legal framework in order to ensure payment finality, and to improve the execution of collateral and the oversight powers of the central bank. The Banco de México presented in 2002 a legislative proposal to clarify the Bank's legal mandate to supervise the payments system and to increase certainty of payments by eliminating the current practice by which payments could be reversed by court-order up to 270 days after they have taken place. The Banco de México has implemented a plan to eliminate remaining credit risks in the payments systems, in line with its objective of complying with the BIS Core Principles for Systemically Important Payment Systems. In this regard, in 2001 the Banco de México announced to financial institutions a sequence of measures that would be implemented within the following three years. The first of these measures, which was introduced in February 2002, requires that any overdraft in the large value electronic payments system be settled in the same day by using bilateral credit lines provided by other banks. In the last quarter of 2002, additional measures were adopted to improve the quality of collateral associated with the Banco de México's credit, and to consolidate the intra-day credit into one payments system from the prevailing three.

III. The Role of International Financial Institutions in Fostering Institution Building

During the second half of the nineties, international financial institutions (IFIs) began to emphasize the importance of institution building in the financial sector as a result of the severe effects of the crises observed in several emerging economies. The G-22, the predecessor of the G-20, established a working group on strengthening financial systems which presented a comprehensive report on this issue in October 1998. Along these lines, the IMF/World Bank developed initiatives such as the Financial Sector Assessment Program (FSAP) to identify the strengths and weaknesses of countries´ financial systems, and the Reports of the

Observance of Standards and Codes (ROSC) to evaluate the performance of a country in areas such as fiscal and monetary policies, financial supervision, etc.

The process of institution building in the financial sector in Mexico has benefited from these initiatives. In 2001, a joint IMF-World Bank mission carried out a FSAP, which had as important inputs reports on the observance of standards and codes and good practices of transparency in the following areas: monetary and financial policies, payments systems, banking supervision, IOSCO objectives and principles of securities regulation, and IAIS supervisory principles.

The FSAP proved to be a useful exercise for Mexico for several reasons. It represented an input for the financial reform measures that were introduced in 2001. Discussion with the FSAP team allowed the authorities an exchange of views and the opportunity to confirm that the path chosen was the correct one. Also, self assessments performed by each institution as background for the FSAP compelled them to review the strengths and weaknesses of the financial system and its institutions on the basis of an international point of reference.

Although as shown by the Mexican experience IFI's can be an important force behind countries' efforts to reinforce institution building in their financial sectors through initiatives such as FSAP's and standards and codes assessments, this process is not free of problems: 1) Many countries have expressed concerns about the appropriateness of the existing standards and codes for their stage of development. Thus, the importance of country involvement in the design of standards and codes has been emphasized. An example may be useful. Mexico participated actively in the design of the core principles of transparency for payments systems. This gave rise to at least two benefits. On the one hand, the views of Mexico (and other emerging markets) were taken into account in developing the principles and this helped greatly to balance the final outcome. On the other hand, this process allowed the authorities to make an adequate diagnosis of the problems faced by the domestic payments system before the FSAP exercise was carried out. 2) To be useful in the medium and long term, exercises such as the FSAP need to be updated frequently. However, capacity constraints make this unlikely to happen. 3) It is not clear whether markets are taking sufficiently into account the evaluations made by the IMF and the World Bank under FSAP's. We only have partial evidence, and neither of these institutions provides such information.

IV. Lessons from the Mexican Experience

The institutional measures carried out in the Mexican financial system during the period 1970-88 set the basis for the far reaching liberalization of the sector that was begun at the end of this period. Since then, liberalization and more generally globalization have been important catalytic forces behind institution building efforts. Simultaneously, the Mexican case has served to illustrate the risks that may accompany globalization if it is not accompanied by a sufficiently strong institutional setting.

Since the late eighties, as the process of globalization was gaining momentum, Mexico transformed radically its economic structure. It opened its economy to world trade, redefined the role of the state in economic activity, and embarked on wide ranging structural changes, including in the financial sector. During the period 1988-94, major institutional developments took place, including the opening of the capital account of the balance of payments, the privatization of commercial banks, the authorization of foreign investment in the banking system, the approval by Congress of autonomy for the Central Bank, and the signing of NAFTA.

The combination of these and other factors gave rise to a surge in capital inflows and an explosion of credit, that set the stage for an economic and banking crisis of major proportions that began in late 1994. Although the factors that gave rise to the crisis are complex and varied, the lack of a sufficiently strong institutional environment in the financial sector was clearly one of them. Indeed, financial liberalization was accompanied by important institutional weaknesses: an inadequate supervision of banks, unexperienced management at the helm of financial institutions, and the presence of major moral hazard problems in the banking system, among others.

In the aftermath of the 1994-95 crisis, the institutional measures introduced during the previous years contributed to the decision of the authorities of not reverting the financial liberalization process. In fact, the decision was to deepen globalization of the financial sector. In addition, in what represented one of the major institutional changes of this period, the pension system was transformed from a pay-as-you-go to a defined contribution fully funded scheme. Moreover, the crisis raised public awareness of the importance of maintaining prudent economic and financial policies, and of developing and supporting institutions that limit the discretionary powers of the authorities in these areas. In this context, monetary policy was reinforced and fiscal rules that contribute to maintain a low fiscal deficit on a long term basis were adopted

Although the above measures resulted in a stronger and more efficient financial system, a number of problems remained. Among them, a relatively small financial sector and a banking system which has not supported adequately economic activity through the provision of credit. In view of the above and of other problems, the pace of reform of the financial system has accelerated over the last three years, with efforts concentrated on establishing the institutional framework needed for promoting financial savings, modernizing the financial system, fostering the resumption of bank credit, deepening domestic debt and stock markets, modernizing development banks, and consolidating the pension system.

With the progress made in institution building, the Mexican financial system is poised to reach international standards as for its effectiveness, security, and potential contribution to the development of the country. But this is an ongoing process and there is still plenty of room for improvement of the institutional setting. Particularly, additional efforts are required to enhance the efficiency of the framework for regulation and supervision, to create a new legal basis for bank resolution, to review the banking system´s normative scheme, and to implement the measures needed, if any, to ensure the resumption of bank credit.

Appendix 1[8]

The Evolution of Domestic Debt Markets in Mexico

The Mexican authorities have made considerable efforts in the last two and a half decades to develop domestic debt markets. The initial step was taken back in 1978, when the first government peso-denominated fixed rate security (CETES) was issued. At the beginning, both the number of market transactions and the amounts involved were small; securities had short-term maturities, there was no secondary market, and the government determined interest rates. Despite these limitations, over the years both the government and the central bank relied increasingly on the debt market, the former to cover its financial needs and the latter as an instrument of monetary policy.

Secondary markets started to develop slowly after 1982, when the government allowed banks and brokerage houses to submit bids at public auctions for CETES. During that period, Banco de México decided to begin gradually conducting its monetary policy through the use of marketable government securities. To support the development of markets for government securities, Banco de México refrained from issuing its own securities until 2000.

In the early stages of debt market development, when private issuance is small, financial authorities usually pay particular attention to improving the market for government securities as these provide a benchmark for pricing other fixed income securities, help financial intermediaries to manage their interest rate risks, and can also be used as vehicles for funding. The characteristics of government debt and its issuance process have a profound influence on the development of markets.

The composition and average maturity of peso-denominated government securities have been changing over the years in response to several episodes of financial instability. For many years, the government's domestic funding came from placing short-term zero coupon bonds, floating rate notes, inflation- and oil-price-indexed bonds, and, until 1994, short-term dollar-linked bonds. The first issuance in the market of one-year zero coupon bonds took place in 1990. Other sources of funding were obtained from the issuance of long-term bonds sold to banks over-the-counter to facilitate their compliance with mandatory reserve requirements.

As macroeconomic conditions have become more stable, market participants are showing greater willingness to hold longer maturities and fixed coupon securities, to take advantage of the expected decline in interest rates. The government has therefore been able to issue successfully three-, five-and 10-year fixed coupon bonds and to decrease the share of floating rate issues in the

8 This section is based on Sidaoiu (2002).

outstanding stock of government debt. Nowadays, the government issues short-term zero coupon bills with maturities up to one year, and floating rate bonds, fixed coupon bonds, and inflation-indexed bonds with maturities up to 10 years. Floating rate bonds constitute half of the government´s debt. Ten-year inflation-indexed bonds were issued for the first time in October 1999, five-year fixed coupon bonds were issued in May 2000, and 10-year fixed coupon bonds in July 2001.

The central bank started issuing its own securities in 2000 to sterilize the continuous increase in its foreign reserves. These securities, called “BREMS”, consist of one- and three-year floating rate bonds with coupons linked to overnight rates. Banco de México considered this a more appropriate course than continuing to sell long-term government debt, as the latter has a larger impact on the shape of the yield curve. At the same time, the deposit insurance agency (IPAB) has been issuing floating rate debt with government guarantees to finance its operations and the costs incurred during the banking crisis of 1994-95. These measures have augmented the variety of low credit risk securities available to investors.

Banco de México, acting as the government’s financial agent, carries out auctions of government securities every week. In this task, the authorities must strike a difficult balance between issuing different maturities to provide the market with a benchmark yield curve, and issuing amounts of single maturities large enough to attract investors concerned with liquidity. Despite the efforts to extend the yield curve by issuing securities with maturities of up to 10 years, the average duration of the debt is relatively short and has increased proportionally less than the increase in average maturity, because a large proportion of longer-term bonds are floating rate notes.

Securities in Mexico are dematerialized and registered at a private depository institution (INDEVAL). Most of the secondary market transactions with government securities are carried out through repo operations. Overnight repos represent the most liquid segment of the market and there are hardly any operations maturing beyond seven days. Banks and brokerage houses use repos as the main source of funding for their positions in government securities. They are the most important players and holders of government securities in the fixed income market.

Secondary trading of government securities is almost exclusively conducted in over-the-counter markets. Liquidity in the secondary market increased substantially when foreign investors were allowed to purchase peso-denominated government securities at the end of the 1980s. Liquidity in secondary markets also improved with the participation of voice and electronic inter-dealer brokers in 1994-95, which facilitated price discovery. Finally, the opening of the financial system to foreign banks at the end of 1993 and their increasing participation in the secondary debt market further improved liquidity.

With a view to increasing liquidity, the government introduced in 2000 the figure of “primary dealer or market-maker”. The objective of “market-makers” is to enhance the liquidity of fixed rate securities in secondary markets by making continuous bid-ask offers in exchange for certain privileges, such as bidding for additional securities at the auction's average price results once they are known. Liquidity in short-term zero coupon bills (CETES) and fixed-coupon bonds (Bonos) consequently increased substantially after 2000.

Financial markets in Mexico, as in the majority of Latin American countries, are still dominated by banks, despite their decline in importance over the last few years. However, to ensure high liquidity and a stable demand for fixed income securities, it is crucial to have a diversified investor base in terms of time horizons, risk preferences, and trading motives. In the last few years, Mexican institutional investors such as pension and mutual funds, as well as insurance companies, have increased their participation in debt markets, helping to create a more stable demand for fixed income securities. However, the institutional investor base in Mexico remains underdeveloped.

Over recent years, Mexican domestic government debt markets have experienced remarkable growth, as macroeconomic stability has been consolidated. In particular, the decline of inflation has enabled the government to increase the duration of its debt, creating a yield curve in fixed rate instruments that goes up to 10 years. In addition, the creation of "market-makers" has provided liquidity to the market, making it more efficient. The Mexican securities market now has prices for the complete yield curve. On the other hand, the local corporate bond market has developed rapidly since 2001, with the legal changes introduced and the growing appetite for corporate paper by institutional investors. An important force behind this development has been the success of a new instrument called "Certificados Bursátiles", which is very flexible in its design (tenor, fixed or flexible rates, etc.) and is issued by blue chip companies, state and municipal governments and public sector enterprises (PEMEX, CFE).

There is still work to be done and the authorities are concentrating on the following issues:

- Operating the repo market under international standards.
- Facilitating short selling in the market.
- Increasing the liquidity of government securities.
- Further developing the corporate debt market.
- Fostering asset securitization.
- Consolidating a more sophisticated and liquid derivatives market.

Appendix 2

Financial Laws and Amendments approved, 2001-2003

Laws approved in 2001:

- Credit Institutions Law (Ley de Instituciones de Crédito)
- Financial Groups Law (Ley para Regular las Agrupaciones Financieras)
- National Banking and Securities Commission Law (Ley de la Comisión Nacional Bancaria y de Valores (CNBV))
- General Law of Auxiliary Credit Organizations and Activities (Ley General de Organizaciones y Actividades Auxiliares de Crédito)
- National Possessions General Law (Ley General de Bienes Nacionales)
- General Law of Mutual Insurance Institutions and Associations (Ley General de Instituciones y Sociedades Mutualistas de Seguros)
- Investment Societies Law (Ley de Sociedades de Inversión)
- Organic Law of the Federal Mortgage Association (Ley Orgánica de Nacional Hipotecaria)
- Credit Information Institutions Law (Ley para Regular las Sociedades de Información Crediticia)
- Popular Savings and Credit Law (Ley de Ahorro y Crédito Popular)
- Securities Market Law (Ley del Mercado de Valores)

Laws and Amendments approved in 2002:

- Amendments to the Credit Institutions Law
- Amendments to the Rules of Capitalization Requirements for Multiple Banking Institutions (Reglas para los Requerimientos de Capitalización de las Instituciones de Banca Múltiple)
- Amendments to the General Law of Securities and Credit Operations (Ley General de Títulos y Operaciones de Crédito)
- Organic Laws of:
    - Nacional Financiera
    - National Bank of Foreign Trade (Banco Nacional de Comercio Exterior)
    - National Bank of Public Services and Infrastructure (Banco Nacional de Obras y Servicios Públicos)
    - National Bank for the Army, Air Force, and Navy (*Banco Nacional del Ejército, Fuerza Aérea y Armada)*

  - Bank of National Savings and Financial Services (Banco del Ahorro Nacional y Servicios Financieros)
  - Financiera Rural
  - Federal Mortgage Association (Sociedad Hipotecaria Federal)
- Amendments and Additions to the Retirement Savings System Law (Ley de los Sistemas de Ahorro para el Retiro)
- Deposit Institutions Federal Law (Ley Federal de Instituciones de Fianzas)

Laws and Amendments approved in 2003:

- Amendments to the Miscellany on Credit Collateral (Miscelánea de Garantías de Crédito)

Laws and Amendments to be presented to Congress in 2003:

- Money Laundering Reform
- Reform to Credit Organizations
- Banking Crisis Resolution Reform
- Amendments to the Securities Market Law

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