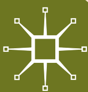

Mexican Banks and Foreign Finance

From Internationalization to Financial Crisis, 1973–1982

SEBASTIAN ALVAREZ

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Sebastian Alvarez
St Hilda's College
University of Oxford
Oxford, UK

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To the memory of my father

Foreword

When did modern financial globalization really take off? This question is today part of a great debate among economists and social scientists. But it is also a historical issue which needs to be grounded in detailed studies which bridge national with international trends as well as changes in the functioning of the world economy. The new study by Sebastian Alvarez on Mexican banks and foreign finance during the 1970s and in the subsequent debt crisis of 1982 provides an original and innovative perspective on the birth of modern globalization from the standpoint of developing nations, which then found themselves at the crossroads of a powerful process of expansion of capital flows that have transformed fundamental aspects of the economies of practically all countries.

In many regards, financial globalization began to take off in 1974, when the last controls over capital movements in the USA were lifted, at a time when the majority of the European governments and Japan had already abandoned the regime of fixed exchange rates and their exchange rates were floating. It is clear that the flexibilization of the exchange rates threatened all economies, but also reinforced what were already considerable capital flows on a global scale, which came initially as a result of the expansion of Eurodollar markets. A great number of multinational companies and international banks (which accompanied them in their worldwide expansion) benefited enormously from this opening.

But simultaneously another financial transformation had its origins at this time as a result of the accumulation of enormous surpluses in the oil-exporting countries that led to the recycling of billions of

petrodollars. The majority of their governments deposited their reserves in short-term accounts with global banks in the USA or Europe after 1973. The banks, in turn, needed to invest these funds with profitable interest, something which they found difficult to achieve in the majority of industrial countries because of the economic recession and the stagnation of the stock exchanges in the 1970s. As an alternative, the banks found use for this capital in shape of the provision of hundreds of large loans for developing countries, particularly in Latin America. Paradoxically, some oil exporters—such as Mexico—as well as the oil-importing countries soon became among the new and great debtors of world finance.

Today there continues to be intense discussions among economists and historians about whether the Latin American debt phenomenon was largely stimulated by the extraordinary *supply* of loans by the transnational banks or whether it was due to the *demand* of funds by the governments of most of the Latin American countries.[1] It can undoubtedly be argued that the governments wanted to maintain the high economic growth rates with cheap loans, which was possible as long as the interest rates reached almost negative levels in the mid-1970s.[2] But the fact that nearly so many developing countries fell into debt simultaneously also suggests that there were other factors that induced very diverse nations to adopt a similar behavior. The international banks played a fundamental role in selling loans but, as Alvarez demonstrates, in the case of Mexico—which along with Brazil became one of the two largest debtors in the world—a forgotten story is that domestic banks (public and private) of developing countries also became major actors in the financial frenzy.

One of the great paradoxes in the increasing provision of loans by the international banks to Latin America was that the credits were mainly destined to finance state enterprises and large-scale public works. In other words, the banks stimulated an era of *state-led capitalism* in the 1970s at a time when dictatorships and authoritative regimes dominated politics in the region. Such regimes were expected to guarantee

[1]A classic work emphasizing the supply is Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton: Princeton University Press, 1989).

[2]Real interest rates are defined as the valid interest rates in the market less the inflation rate. At that time, the interest rates for loans of 6–8% were equal to or lower than the inflation rate, which means that the real interest rates could become zero or even negative.

the servicing of the increasingly high external debt, and this helps explain why global banks fostered the loans, but other questions still need to be answered. For example: Why did the governments of the developing countries and especially those in Latin America raise so many loans? The motives varied. One much-cited reason was that they wished to maintain their high public spending to preserve high economic growth rates. Secondly, many analysts claim that, given the tight Latin American financial markets, it seemed very attractive to obtain abundant international funds at relatively low interest rates.

At this point, it is important to underline the key contributions of the present study by Sebastian Alvarez to these debates and to the already considerable research on the loan booms and debt crises of developing countries. One of the most important contributions is the focus on the international expansion of Mexican banks during the great loan boom of the 1970s and in the midst of the sovereign debt crisis of 1982. A little known fact is that from the early 1970s, leading Mexican commercial banks stepped into international capital markets through the creation of London-based consortium banks in partnership with banks from developed and developing countries. Subsequently they began to open branches and agencies in London and in the USA, the leading international financial centers, where the bulk of sovereign debt was contracted. As a result, both private and public Mexican banks took on an important role in international lending and became involved in the increasingly complex labyrinth of the international debts of both the public and private sectors in Mexico. The empirical information provided in the text is abundant and conclusive, demonstrating that domestic banking in the developing countries is a subject which has been too long ignored in most of the literature on the globalization of finance.

This book also addresses the immediate causes and the devastating consequences of the sovereign debt crises of the developing countries, which began in 1982 when the Mexican government announced the virtual suspension of its payments. The multiple external debt deferments adopted by the majority of the Latin American countries did not allow them to escape the profound and prolonged recessions, which are referred to in the region as the *lost decade*. Furthermore, for several years, an important part of the international banking system was threatened by the suspension of payments. Only prolonged international renegotiations of the debt by governments, multilateral financial agencies and consortia of hundreds of banks avoided the crash of several major,

international banks. On the other hand, as Alvarez demonstrates, the Mexican banks were so critically affected by the debt crisis that nationalization became the option adopted by the government. The prolonged crisis was so profound that it may be considered one of the cornerstones of the modern economic and financial history of Mexico but also of major, international significance.

In recent years, much research has been directed at understanding the economic recessions of the industrial nations in the 1970s in an age of stagflation and declining stock market values of most industrial or multinational companies. At the same time, and paradoxically, this was an age when international banks flowered, largely as a result of the great external loan boom directed to the developing countries. It was in the midst of this process that financial globalization germinated and enormous changes began to take place in the world economy that gained strength in subsequent decades. The study of Mexican banks and the early stages of this financial revolution is therefore a fundamental chapter for analysis and reflection. And it can be most relevant for comparative studies on the evolution of local and international banking throughout the developing world since then. For it is the hypothesis of Sebastian Alvarez that the complex interaction between the domestic and the international lies at the heart of globalization.

Mexico City, Mexico

Carlos Marichal
El Colegio de México

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The personal side story of this book is the early history of my family. When we arrived in Geneva, our first child Santiago had been recently born and by the time I was finishing my dissertation six years later Lisandro and Aquilina have already joined us. My doctorate was the period of the construction of my family, and for that reason, it will always be a very special moment of both my academic and personal life. I enjoyed a lot from my family and our children during this period, but neither my Ph.D. nor this book would have been possible without the encouraging support and care of Romina.

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Abbreviations

BCBS	Basel Committee on Banking Supervision
BESC	Basel Eurocurrency Standing Committee
BIS	Bank for International Settlements
CNBS	Comisión Nacional Bancaria y de Seguros
FDIC	Federal Deposits Insurance Corporation
Fed	Federal Reserve Board
FFIEC	Federal Financial Institution Examination Council
FRBNY	Federal Reserve Bank of New York
G10	Group of Ten
IADB	Inter-American Development Bank
IBA	International Banking Act
IMF	International Monetary Fund
LDC	Less Developed Countries
LIBOR	London InterBank Offered Rate
MyRA	Multi-year Rescheduling Agreement
OPEC	Organization of Petroleum Exporting Countries
PRI	Partido Revolucionario Institucional
SHCP	Secretaría de Hacienda y Crédito Público

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Introduction

The global financial crisis of 2007–2009 provides one of the most eloquent illustrations of the perils of bank globalization and deeper international financial integration. The decade that preceded the outbreak of the crisis was characterized by a significant rise of international finance and a dramatic surge of foreign banking businesses and lending across national boundaries in both developed and developing countries.[3] International banks and their cross-border operations had a preponderant role in the creation of the crisis, and they came to act as main channels for its propagation across countries. What started as a domestic problem in the US housing market and banking institutions engaged in mortgage lending ended up reaching systemic levels and became a full-fledged financial crisis in the USA that also affected the international activities of foreign financial institutions and was transmitted to the old continent through the exposure of large European banks. Moreover, in most cases the problems of the banks went beyond the banking industry, and in some countries, notably in Ireland and Iceland, they severely affected public finances and resulted also in sovereign debt crises.

The pitfalls of international banking unveiled during the recent crisis are not new, and they may be inherent to the process of financial

[3]World Bank, *Bankers Without Border* (Washington, DC, 2018); Manuel Merk Martel, Adrian Van Rixtel, and Emiliano Gonzalez Mota, "Business Models of International Banks in the Wake of the 2007–2009 Global Financial Crisis," *Banco de España Revista de Estabilidad Financiera* 22 (2012), 99–121.

globalization. This book is concerned about the risks and vulnerabilities of foreign banking activities in the early years of modern global finance, the decade of the great foreign lending boom that preceded the international debt crisis of 1982. The period that followed the end of Bretton Woods and the lift of capital controls in the early 1970s also featured growing participation of foreign banks around the world and a remarkable expansion of the international banking activity within and between countries.[4] After the oil shock of 1973, as large amount of liquidity streamed into the Euromarkets, commercial banks became increasingly involved in international lending. A mechanism, known as the petrodollar recycling process, was set into motion, where the dollar revenues from oil-exporting countries deposited with the banks in London were recycled and flowed back to the rest of the world, particularly to Mexico and other Latin American countries, leading to a lending and borrowing boom that ended up with the crash of 1982.

In their quests to explain the boom of foreign debt that led into the crisis, scholars have looked at both size of the loan market. On the one hand, the works with focus on the supply side of credits have explored the motives and lending behavior of industrial countries banks, which accounted for the bulk of international capital flows and Euroloans to developing countries, in a context of high liquidity and stagnating domestic economic activity in their domestic markets.[5] On the other hand, the studies on the demand side have analyzed the forces driving the external indebtedness process in developing countries, with special attention to the factors underpinning the financing needs of governments and public companies since they were the main international borrowers.[6] What these studies have in common, however, is the

[4]See, for instance, Rinaldo M. Pecchioli, *The Internationalisation of Banking: The Policy Issues* (Paris, 1983) and Michael Moffitt, *World's Money: International Banking from Bretton Woods to the Brink of Insolvency* (New York, 1984).

[5]Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton, 1989); Philip A. Wellons, *Passing the Buck: Banks, Governments, and Third World Debt* (Boston, 1987); and Benjamin J. Cohen and Fabio Basagni, *Banks and the Balance of Payments: Private Lending in the International Adjustment Process* (London, 1981).

[6]Jeffrey D. Sachs (Ed.), Developing Country Debt and the World Economy (Chicago, 1989); William R. Cline, *International Debt Reexamined* (Washington, DC, 1995); and Philip A. Wellons, *Borrowing by Developing Countries on the Euro-Currency Market* (Paris, 1977).

conventional interpretation of the financial fallout of 1982 as a sovereign debt crisis in the developing world that put in jeopardy the banking system of industrial countries because of the exposure of their most prominent banking institutions.

This book takes a different approach and proposes a novel interpretation of the dynamic of the crisis by focusing on the role played by the domestic banking sector of debtor countries themselves. Considering the situation of domestic banks is important because as Carmen Reinhart and Kenneth Rogoff among others have observed sovereign debt and banking problems are historically associated in both developed and developing countries, and their simultaneity tends to deepen economic recession and exacerbate the social damages of the crisis.[7] In the case of Latin America in the 1980s, banking crises broke out in Argentina in 1980, Chile and Uruguay in 1981, Colombia and Ecuador in 1982, Peru in 1983 and, sometime later, Bolivia in 1986.[8] Other countries, such as Brazil and Venezuela, although not affected by systemic banking meltdowns, still experienced some banking difficulties. Mexico, unlike most of its neighbors, did not suffer from bankruptcies, but the banking sector was nationalized soon after the outbreak of the crisis. There are good reasons, therefore, to think that a connection may exist between the sovereign debt crisis and the problems observed in the banking industry in Latin American countries and that they may be particularly related to the international activities that the region's major banks undertook in the years preceding the crisis.

Indeed, a closer examination to the players of international finance during this period reveals the presence and active participation of Latin American financial institutions. As Chapter 1 will demonstrate, commercial banks from Latin America, like their counterparts from industrial and other developing countries, went also global during the 1970s and became increasingly involved in the Euromarkets toward the end of the decade. Through their network of foreign agencies and branches in the major world money centers, mainly London and New York, Latin

[7]Carmen Reinhart and Kenneth Rogoff, "From Financial Crash to Debt Crisis," *American Economic Review* 101 (2011), 1676–706; *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, 2009), 73–75.

[8]Luc Laeven and Fabian V. Valencia, "Systemic Banking Crises: A New Database," *IMF Working Paper* 08/224 (2008); Vasudevan Sundararajan and Tomás J. T. Baliño (Eds.), *Banking Crises: Cases and Issues* (Washington, DC, 1991).

American banks were able to access the large Eurocurrency and US wholesale markets and get engaged in international financial intermediation. Although not all banks behaved the same way, the general trend was to raise liquidity in the global interbank markets to finance different kinds of international businesses. These involved the issuance of bank acceptances to finance international trade or some interest rate and foreign exchange arbitrage operations with the head offices, but in most of the cases, the bulk of the money was used to fund direct or syndicated loans to private and public borrowers in their home countries.

The case of Mexico, the country responsible for unleashing the crisis at an international level and one of the largest international borrowers at the time, was not an exception. Leading Mexican commercial banks, some of which were among the largest in Latin America, became increasingly internationalized during this period. Banco Nacional de Mexico (Banamex), Banco de Comercio (Bancomer), Banca Serfin and Multibanco Comermex, the country's four largest private financial institutions, and, to a much lesser extent, Banco Internacional and Banco Mexicano-Somex, which were both majority owned by the Mexican state, they all expanded abroad. These were the six biggest commercial banks of the nation and represented as much as three quarters of the assets and the deposit base of the domestic banking system. The USA, particularly the cities of New York and Los Angeles, was their main destination, but they were also operating in London and other Caribbean offshore centers, such as Nassau and the Grand Cayman Islands. As their network of foreign offices and the volume of their operations grew, so did their participation in the Euromarkets, becoming heavily implicated in international lending and the external indebtedness process of the country.

The involvement of Mexican banks with international finance through their foreign agencies and branches created significant risks and vulnerabilities for the domestic banking system in the wake of the debt crisis of 1982. These offices were not separate institutions with their own capital base but an extension of parent banks, and thereby, their operations were consolidated in the books of the home offices in Mexico along with those of any other domestic branch or agency. Parent banks were, therefore, exposed to the several imbalances and financial problems resulting from the international business of such agencies and branches, and because of the systemic importance of these institutions, so was the entire domestic banking system. When the crisis broke out, these banks

had significant amounts of Mexican external debts in their balance sheets and confronted severe liquidity pressures in the international wholesale interbank markets. Their financial, and indeed solvency, position as well as the broader stability of the Mexican banking system became crucially dependent on foreign capital under the control of the country's international creditors, and this brought Mexico's government into an extremely weak bargaining position when negotiating external debt rescheduling conditions.

This in brief is the argument that I will develop over the rest of the book. Chapter 2 traces the early stages of Mexican foreign finance with special emphasis on the domestic and external driving forces of the international expansion of the leading domestic banks. After decades of stability, growth and increasing penetration in the national economy, the evolution of the assets of Mexican commercial banking sector came to a halt and started to decrease after 1972. On the one side, the combination of rising inflation with the interest rate policy followed by the Mexican central bank affected the domestic funding base of the banks, damaging their lending capacities at a time of strong economic development and high demand for credit in Mexico. On the other hand, the rise of international liquidity and the increasing supply of funds by foreign banks at attractive interest rates represented a new source of competition on the credit market that further contributed to the financial disintermediation problems affecting the domestic banking industry. Under such circumstances, the country's largest banks turned their eyes to the international capital markets and looked at the Euromarkets for providing the potential solution for overcoming their domestic financial difficulties.

The first steps of Mexican banks in the Euromarkets were made through the creation of London-based consortium banks in association with major commercial banks form industrial countries during the first half of the 1970s. As this initial experience proved successful, Mexican banks decided to take a step forward toward international finance and opened their own agencies and branches in main international financial centers. Chapter 3 shows that access to foreign capital, along with the improvement of the domestic funding base that followed the banking reform and financial changes introduced by Mexican monetary authorities in the mid-1970s, allowed domestic banks to reverse the trend of the previous years and regained the ground they had lost in the national economy. For the Mexican government and central bank, who had been assisting this process in direct and indirect ways, the participation of

domestic banks in the international capital markets was desirable because it helped to accommodate the increasing financial and foreign currency needs of their developmentalist strategy and fixed exchange rate regime. The drawback of such involvement with international finance was the accumulation of an increasing amount of foreign liabilities in the balance sheets of the banks.

The revival experienced by the domestic banking industry during the run-up to the debt crisis of 1982, as Chapter 4 analyzes, came along with a progressive deterioration of its health and balance sheet structure. Between 1977 and 1982, the banking sector became significantly more leveraged, and much more reliant on debt than equity to finance the expansion of business and lending activities. There was also a substantial deterioration of the funding base, with a declining participation of sight deposits and a sharp shortening on the maturity structure of medium- and long-term deposits. These problems were considerably more important among the banks involved with international finance: Their leverage levels and liquidity position were twice as weak as that of banks operating only at the national level. The increasing use of foreign capital as source of funding came to compensate the fall of liquid domestic fundraising instruments, but at the expense of higher risks for the individual borrowing banks and the Mexican banking system as a whole. These were short-term interbank money market facilities denominated in foreign currencies and much more volatile than domestic retail deposits.

Chapter 5 describes the business model followed by Mexican banks on their international activities and the financial mismanagement behind the operations of the foreign agencies and branches. In a context of high domestic interest rates and foreign exchange parity between the peso and the dollar, parent banks could use their foreign banking offices to borrow in the international wholesale money markets at lower costs and relend this money back home at rates that allowed them to compete with the credits offered by foreign banks. This is, indeed, what they did, but incurring maturity, interest rates and currency mismatches that dangerously increased the external risk position of the banks. The practice of funding long-term credits with very short-term interbank deposits was a worrisome one, and it was aggravated by the fact that most loans were granted at fixed rates while the underlying funding lines were arranged at variable rates. Lending was done in dollars, but largely to Mexican borrowers that were essentially operating in pesos, and thereby, although the banks were not currency mismatched in their books, their clients were.

The sharp increase in international interest rates during the late 1970s and early 1980s, the devaluation of the peso in February 1982 and the following debt payment problems of the Mexican private and public sector aggravated these imbalances and complicated the financial positions of the foreign agencies and branches.

Within such a context, the moratorium declaration of the Mexican government in August 1982 was a major blow, and represented the final *coup de grâce*, to the international activities of Mexican banks. After the outbreak of the crisis, interbank credit lines to Mexican borrowers became scarce and expensive, increasing funding risk and jeopardizing the solvency position of the foreign banking offices and parent banks. Chapter 6 documents the extent of the exposure of Mexico's leading banks to its home country's external debt, which was much larger than that of their US and other foreign creditor counterparts, along with the role played by the interbank credit lines with their offshore agencies in the subsequent debt renegotiating process. On the one side, the international loans to Mexican borrowers represented several times the capital base of the nation's most prominent banks; on the other side, their external financial position was heavily dependent on foreign financing that international creditors were only willing to supply under tough rescheduling conditions. The chapter argues that the strong determination of the Mexican government to protect its banking system and securing their access to interbank funding provided international creditors with leverage to drive the negotiating conditions in their favor. To obtain the foreign exchange needed to keep its banks afloat, Mexico had little option but to repay its external debt and accept what the group of international creditor banks, developed countries governments and the IMF demanded of it.

The involvement of debtor countries banks with foreign finance has received little scholarly attention on the accounts of the international debt crisis of the 1980s, as it was implicitly assumed that only developed nations' banks participated in the foreign credit boom that preceded the crash. However, scholarship on the Latin American debt crisis of 1982 has demonstrated that in some countries, domestic banks were also responsible for the external indebtedness process that led into defaults. In the case of Chile, for instance, Carlos Diaz-Alejandro has argued that the sovereign debt crisis of 1982–1983 was the result of the bailout of a banking system heavily indebted abroad and engaged in intermediating

foreign capital for their associated domestic companies.[9] Likewise, in his study of the Brazilian experience, Jeffry Frieden stressed that "domestic banks swelled their lending by funding their operations abroad and earning virtually ensured profits for relending dollars to domestic borrowers."[10] In Mexico, early work by José Manuel Quijano has already highlighted the Euromarket activities of leading Mexican banks and their participation in international lending back home.[11]

This book delves into the intricacies of the foreign expansion of domestic banks and the financial fallout of 1982 by examining a transmission mechanism that linked international banking, domestic economies and sovereign finance and has been overlooked so far: Interbank deposits—i.e., the flows of funds among banks that smooth their funding needs. Between 1973 and 1982, as the Euromarkets and international lending grew, the scale and circulation of deposits and credit lines among banks expanded exponentially. During this period, the interbank market passed from encompassing some hundred banks from developed countries to over one thousand financial institutions from many different countries all over the world. By the time of the outbreak of the crisis, the volume of interbank transactions reached over one trillion dollars and it accounted for between two-thirds and three quarters of all international banking activity. This market was a fundamental channel for the transmission of liquidity among banks and to allow many of them to meet lending opportunities that could not be afforded with own retail deposits. The depth and breadth of interbank market transactions, and the fact that they were so central to international lending, raise the question about their role in the creation of the crisis.

The dangers of interbank transactions and financial intermediation based on money market liquidity have been dramatically illustrated by the recent global financial crisis. The heavy use of international wholesale funding by banks, which was one of the defining characteristics of

[9] Carlos F. Diaz-Alejandro, "Good-bye Financial Repression, Hello Financial Crash," *Journal of Development Economics* 19 (1985), 1–24.

[10] Jeffry A. Frieden, "The Brazilian Borrowing Experience: From Miracle to Debacle and Back," *Latin American Research Review* 22 (1987), 95–131, 7–8.

[11] José M. Quijano, *México: Estado y banca privada* (Mexico City, 1987), 241–58; María E. Cardero, José M. Quijano, and José L. Manzo, "Cambios recientes en la organización bancaria y el caso de México," in José M. Quijano (Ed.), *La banca: pasado y presente* (Mexico City, 1983), 161–219.

the crisis, was an important source of vulnerability and a main factor behind the systemic liquidity crunch that followed the failure of Lehman Brothers in late 2008. The scope and extent of cross-border interbank activity created financial linkages through which problems in one country spilled over to other countries' banking systems. Money markets and international spillover effects were at the base of the collapse of Northern Rock bank in the UK after the US subprime mortgage crisis, as well as of the systemic financial meltdown in Ireland.[12] As the Irish central bank stated, "the increasing reliance of Irish banks on wholesale external borrowing at a time when international financial markets were awash with cheap investable funds (…) greatly increased [their] vulnerability to changing market sentiment and ultimately triggered their downfall."[13] Moreover, in this case, as in some other countries whose banks were heavily involved with international wholesale activity such as Iceland, the problems experienced in the banking sector resulted in a full-fledged sovereign debt crisis.[14]

The focus on the involvement of Mexican banks with international wholesale funding and sovereign lending provides interesting insights for understanding the 1982 financial crash and debt crises more generally. On the one hand, in their role of intermediaries between foreign liquidity and local borrowers, domestic banks became an element that exacerbated the dynamic of external debt accumulation and over-lending to Mexico. Together with the Federal government, the public agencies and the non-banking private sector, as borrowers in the interbank money markets, Mexican banks were part of the country's demand for foreign capital. However, because they re-lent these funds back home, they were also on the other side of the market, and thereby simultaneously pushed both the demand for and supply of credit. On the other hand, through their international activities Mexican banks created new vulnerabilities for the domestic banking system related to foreign exchange and world financial fluctuations, but they also exposed the international banking

[12] See Paul Goldsmith-Pinkham and Tanju Yorulmazer, "Liquidity, Bank Runs, and Bailouts: Spillover Effects During the Northern Rock Episode," *Journal of Financial Services Research* 37 (2010), 83–98.

[13] Patrick Honohan, Donal Donovan, Paul Gorecki, and Rafique Mottiar, *The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003–2008* (2010), 8.

[14] See, for instance, Icelandic Parliament, Report of the Special Investigation Commission, Chapter 21, April 2010.

system to their own financial problems. The challenges of international banking and increasingly integrated financial systems came into sharp focus with the liquidity problems confronted by Mexican banks after the outbreak of the crisis.

Understanding the origins and dynamics of banking and sovereign debt crises is important, not only because of the negative consequences they entailed for economic activity, but also because of the implications in terms of who gets to call the shots and who gets to bear the burden of the adjustments. During the recent international financial crisis, the management of the problems of the banking sector in the USA and Eurozone countries required the intervention and assistance of national governments and financial authorities, which in most cases resulted in a substantial increase of public indebtedness. Likewise, in the 1980s many Latin American governments bailed out banking systems in the brink of collapse and provided subsidies or extraordinary facilities for the servicing of private external debt, which in some cases was implicitly socialized or directly nationalized. To the extent that crisis management policies result in higher fiscal needs of governments and that they represent an opportunity costs in terms of the other possible uses that such public spending could have, it is naturally in the interest of any citizen or taxpayer to know who the actors behind the creation of these crises are and who, if anybody, is to be held responsible for the costs they generate.

CHAPTER 1

Euromarkets and Debt Crisis

The international debt crisis of the 1980s was the first global financial meltdown of the postwar era and represented a new wave of sovereign debt crises since the Great Depression of the 1930s. After the declaration of the moratorium on external debt principal payments by the Mexican government in August 1982, an increasing number of heavily indebted countries in the developing world come also under debt payment difficulties following the same path. The scale and extent of the defaults were a major threat for the international financial system because the amount of external debt in troubles represented several times the capital base of the world's largest banks. The outbreak of the crisis brought into an end the foreign bank lending boom to developing countries, particularly to Latin America, that had developed within the Euromarkets after the rise of international liquidity that followed the oil shock of 1973.

In the literature on the foreign debt boom leading to the crash of 1982, commercial banks from developed countries have attracted the lion's share of scholarly attention.[1] There are good reasons for their prominence since major US and European banks were the main depository institutions of the large surpluses of oil-exporting countries, and they were the largest international lenders to the developing world.

[1]For two classic accounts of the crisis, see William R. Cline, *International Debt Reexamined* (Washington, DC, 1995); Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton, 1989).

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S. Alvarez, *Mexican Banks and Foreign Finance*,
https://doi.org/10.1007/978-3-030-15440-0_1

Also because, working together with them, a great number of other industrial countries' banks operating in London or connected to the world capital markets from their home countries were contributing to sovereign lending and taking part of syndicated credit deals through the Euromarkets. The banking industry of developed countries accounted indeed for the large majority of the international financial operations and capital flows, and they were in possession of the bulk of developing countries' external debt by the time of the outbreak of the crisis.

However, international finance and Euromarket activity were not limited to financial institutions from the industrial world. A closer look at the members of some syndicated lending operations reveals the presence of financial institutions from developing countries as well. In the case of Latin America, as this chapter shows, the most important banks of the region, notably from Brazil, Mexico and Argentina, were also involved with foreign finance and Euromarket operations. With a physical presence in the main world financial centers of the time, as shareholders of consortium banks or through their own agencies and branches, these banks gained access to the Eurocurrency interbank market and raise funds that they then used to finance the expansion of their international businesses. Like their counterparts from developed countries, Latin American banks were also participating in the so-called petrodollar recycling process and sovereign lending operations to their home countries.

There is little doubt that the volume of international lending of Latin American institutions was meager when compared to that of US, European or Japanese banks and that the amount of capital that they controlled represented only a minority of the Euromarkets and world capital flows. Neither were Latin American banks the main suppliers of funds to their home government or other public or private companies borrowing abroad. Nevertheless, by intermediating foreign capital with domestic borrowers these banks were intrinsically intertwined with the external indebtedness process of their countries, which means not only that they were involved in the creation of the crisis but also exposed to it. Moreover, because these banks were usually large domestic financial actors and the volume of international operations represented a significant part of the banking system, their potential problems represented a systemic threat for the domestic economies.

Mexico and the Global Crisis

On Friday August 20, 1982, in a meeting held with foreign bankers at the FRBNY, Mexican officials announced to the international financial community that they could no longer service its external debt. During previous weeks, Mexico's economic and financial authorities had already been in contact with their US counterparts regarding the insufficient reserves of the country to meet its external bank obligations. The repayment difficulties of Mexico were a source of considerable concern in the USA because a default could threaten the capital positions of the most prominent banks of the country.[2] To cope with the crisis, the US Treasury and Federal Reserve provided emergency financial assistance at the same time that they organized a collective response together with the International Monetary Fund (IMF), creditor governments and international banks as the situation went beyond their control and managing capacities and had the potential to hurt the financial stability of other industrial countries as well.

The moratorium declared by the Mexican government sent shock waves through the international financial system and unleashed crises at an international level. "Although Mexico," as IMF historian James Boughton has remarked, "was not the first indebted economy to erupt, nor the largest, nor the one with the most serious economic or financial problems, the 1982 Mexican crisis was the one that alerted the IMF and the world to the possibility of a systemic collapse."[3] Soon after the crisis erupted, Brazil and Argentina, the other two major international debtor countries back then, also approached their international creditors asking for refinancing. One by one, developing countries entered into multilateral debt renegotiations and, by the beginning of 1983, virtually all Latin American countries, with the exception of Colombia, were in discussions with the IMF, developed countries' governments, and private creditor banks to negotiate adjustment and rescheduling programs. As of November 1983, the IMF reported that 20 cases of debt restructuring by developing countries had been completed and 7 were still under negotiation, and Latin America accounted for 12 and 4 of these, respectively.[4]

[2] United States General Accounting Office, *Financial Crisis Management: Four Financial Crises in the 1980s*, May 1997, Chapter 2, 19–34.

[3] James Boughton, *Silent Revolution: The International Monetary Fund, 1979–1989* (Washington, DC, 2001), 281.

[4] IMF SM/83/227, Table 9, 38 and Table 1 in the Appendix.

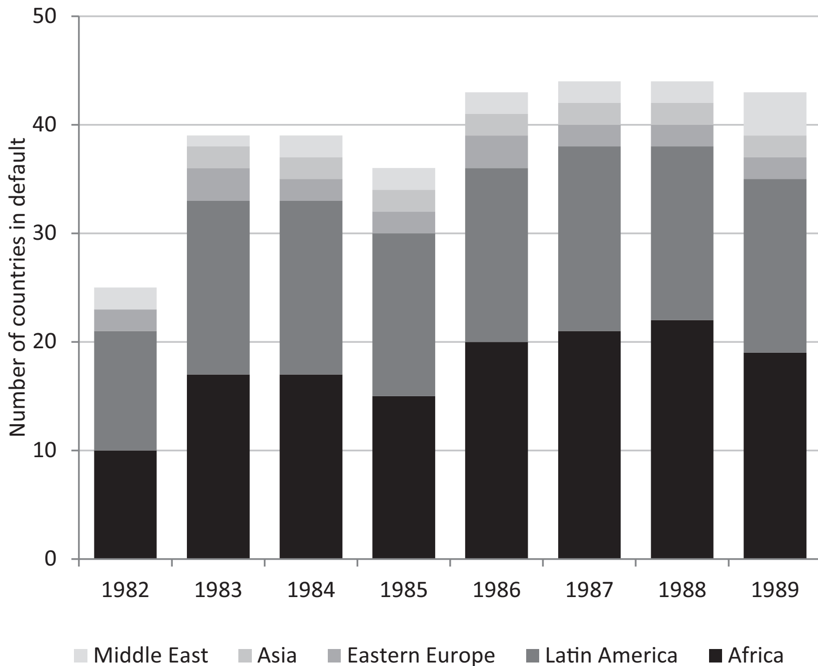

Fig. 1.1 Defaults in the developing world, 1982–1989 (*Source* Standard and Poor's [see text])

The international debt crisis of the 1980s was global, but its epicenter was in Latin America and Mexico was the country at the heart of the storm. Figure 1.1 illustrates the extent of external debt payment problems in the developing world based on the country default database of Standard and Poor's.[5] The number of countries in default on foreign currency bonds or bank debt went from 25 in 1982 to 39 in 1983 and over 43 in 1986. Latin America and Africa were the most affected regions, accounting for about 85% of such defaults, with developing economies in the Middle East, Asia and Eastern Europe making up the remaining 15%. The great number of debtor governments that approached the Fund is also an indicator of the magnitude of

[5] Standard and Poor's, *Rating Performance 2002: Default, Transition, Recovery and Spreads*, February 2003.

the problem, with almost all defaulting countries subscribing to an IMF agreement and adjustment program at some point during the crisis. In Latin America, the major economies like Mexico, Brazil and Argentina were in default for most of the decade and subscribed to several IMF or debt rescheduling agreements during this period.[6]

The importance and relevance of Latin America not only lay on the scope and intensity of its crises, but, most importantly, in the fact that the bulk of international debt was concentrated there. Table 1.1 shows the level of total outstanding external debt for the largest borrowing countries of the developing world as registered by the World Bank and the Bank for International Settlements (BIS). As of 1982, Brazil, Mexico, Argentina and Venezuela were the top four debtors in the developing world, with foreign indebtedness levels considerably higher than the ones observed for other indebted countries in Eastern Europe, Africa, Asia and the Middle East. In the case of Brazil, for instance, its external debt was about 3.5 times higher than Egypt's, which was the biggest non-Latin American defaulter. In comparison with African countries, which was the other region most impacted by debt crises, Brazilian debt represented 7.6 times that of Morocco, the largest defaulting economy of the region.

Along with the highest levels of total foreign debt, Latin America was also the region holding the bulk of commercial bank claims. In June 1982, before the outbreak of crisis, commercial banks from the G10 and Switzerland reported total outstanding claims on Latin American countries to be US$191.5 billion, an amount representing as much as 58.7% of their assets with developing countries. Mexico, in particular, was the country where banks' exposure was the largest and along with Brazil, Venezuela and Argentina, accounted for almost 85% of their Latin American assets. The figures of Table 1.1 make evident the extent to which Africa was much less of a problem than Latin America for creditor banks since, although largely affected by defaults, it represented only 8.7% of the assets of developed countries' banks. After Latin America, the regions where banks' exposure was the highest were Eastern Europe and Asia, but the volumes of assets were considerably lower, and defaults and debt crises were much less frequent there.

[6] Devlin, *Debt and Crisis in Latin America*, 183–90; Robert Devlin and Ricardo Ffrench-Davis, 'The Great Latin America Debt Crisis: A Decade of Asymmetric Adjustment', *Revista de Economía Política* 15 (1995), 117–42.

Table 1.1 External borrowing of the largest developing debtor countries by region

	Total External debt			*Years in Default 1982–89*	*Total Ext. Bank Debt*[b]	
	1972	*1982*	*Annual growth (%)*		*June 1982*	
	US$ Mil.	*US$ Mil.*			*US$ Mil.*	*Share (%)*
Latin America					**191,490**	**58.7**
Brazil	11,864	94,429	23.1	1983–89	50,460	15.5
Mexico	8352	86,275	26.3	1982–89	62,405	19.1
Argentina	6894	43,787	20.3	1982–89	23,627	7.2
Venezuela	2614	32,182	28.5	1983–88	22,805	7.0
Chile	2963	13,959	16.8	1983–89	10,888	3.3
Peru	3585	10,871	11.7	1983–89	5134	1.6
Colombia	2965	10,520	13.5		5002	1.5
Ecuador	538	7808	30.7	1982–89	4343	1.3
Uruguay	440	1907	15.8	1983–85, 1987	1045	0.3
Eastern Europe					**43,311**	**13.3**
Yugoslavia	3438	16,077	16.7	1983–89	9243	2.8
Hungary[a]	n.a.	6739			6777	2.1
Greece[a]	1339	6719	17.5		8795	2.7
Poland	n.a.	n.a.		1982–89	13,643	4.2
Romania	n.a.	n.a.		1982–83, 1986	4375	1.3
Asia					**40,522**	**12.4**
India	10,029	27,810	10.7		1341	0.4
Indonesia	5863	25,133	15.7		4963	1.5
Philippines	2671	24,413	24.8	1983–89	8125	2.5
Korea	3088	21,499	21.4		16,591	5.1
Malaysia	940	13,354	30.4		3777	1.2
Thailand	1229	12,235	25.8		2826	0.9
Pakistan	4055	11,527	11.0		759	0.2
Africa					**28,527**	**8.7**
Algeria	1550	17,639	27.5		6465	2.0
Morocco	1186	12,401	26.5	1983, 1986–89	3352	1.0
Nigeria	1082	11,992	27.2	1982–89	5732	1.8
Ivory Coast	580	8961	31.5	1983–89	2929	0.9
Sudan	452	7169	31.8	1982–89	959	0.3
Tanzania	1396	6130	15.9	1984–89	257	0.1
Zaire[a]	573	4049	21.6	1982–89	984	0.3
Tunisia	753	3777	17.5	1982	933	0.3
Middle East					**22,245**	**6.8**
Egypt	1952	27,323	30.2	1984	4726	1.4

(continued)

Table 1.1 (continued)

	Total External debt			*Years in Default 1982–89*	*Total Ext. Bank Debt*[b]	
	1972	*1982*	*Annual growth (%)*		*June 1982*	
	US$ Mil.	*US$ Mil.*			*US$ Mil.*	*Share (%)*
Turkey	3555	19,716	18.7	1982	2912	0.9
Israel[a]	3585	14,900	15.3	1989	5832	1.8
Syria[a]	337	2616	22.8		595	0.2
Jordan[a]	171	1685	25.7	1989	516	0.2

Note 'n.a.' indicates not available, '*Mil.*' indicates million
Source Total external debt: World Bank's World Development Indicators; Total external bank debt: BIS, International Banking Statistics, 1977–1991, April 1993; Years in default: Standard and Poor's (see Fig. 1.1)
[a]Total External debt includes only Public/Public guaranted external debt
[b]Total banks claims of BIS reporting countries

The large indebtedness level of developing countries was the result of a vigorous borrowing–lending process that took place during the decade preceding the crisis. Between 1972 and 1982, as exhibited in Table 1.1, heavily indebted defaulting countries increased their external debt at average annual rates ranging from 11.7 to 31.8%. The provision of foreign financing was essentially done through syndicated or direct international loans granted by private commercial banks operating in the Euromarkets. After the oil shock of 1973, the Euromarkets became the dominant institutional mechanism for recycling the oil-exporting countries' large revenues, which were deposited in the international banking system, to the private and public sectors of borrowing countries.[7] As a result of this petrodollar recycling process, commercial banks evolved into the most important source of international financing and the main creditors of developing countries, surpassing the prior predominant positions of international organizations and governments from the industrial world.

Mexico, because of its large oil wealth, became a preferred destination for international lenders, and, along with other countries in the region, it attracted the lion's share of Eurolending. By 1981, Latin America

[7] Philip A. Wellons, *Borrowing by Developing Countries on the Euro-Currency Market* (Paris, 1977).

had absorbed almost two-thirds of the loans extended to the developing world, and US banks were prominent suppliers of portfolio flows to the region.[8] For Mexico, Eurocredits proved to be a better source of funds than Eurobonds and other financial instruments available in the international capital markets. As Mexican scholar Sergio Negrete Cárdenas notes, as early as 1974 and "in just six months, with two syndicated loans, Mexico had borrowed virtually the same nominal amount accumulated through bond offerings in the 1963–72 decade."[9] As of 1982, bank lending represented about 90% of Mexico's total outstanding liabilities to non-official creditors, while the balance consisted of publicly issued bonds and other credit facilities from private non-banking institutions.

Bank International Lending

The expansive phase of the 1982 debt cycle was funded upon the enthusiastic wave of foreign bank loans to developing countries that took place during the years preceding the crisis. After several decades of operations largely concentrated on retail banking inside national boundaries, US and European banks started to develop businesses abroad and to continuously expand their international financial activities during the late 1960s and early 1970s.[10] The internationalization of the banking industry and the re-opening of the international capital markets that followed the end of Bretton Woods were accompanied by an increasing penetration in the developing world and a boom of cross-border bank lending. Between 1973 and 1979, total outstanding bank claims on developing countries grew at an estimated average annual rate of 35.8%, slowing down to 24% in the 1979–1980 period, 18% in 1981 and 7% in 1982, the year in which the crisis started.[11]

The Euromarkets were the institutional platform from where private commercial banks built up their international businesses and lending

[8] Barbara Stallings, *Banker to the Third World: U.S. Portfolio Investment in Latin America, 1900–1986* (Berkeley, 1987), 94–104.

[9] Sergio Negrete Cárdenas, 'Mexican Debt Crises: A New Approach to Their Genesis and Resolution', Unpublished PhD diss., University of Essex, 1999, 154.

[10] Carlo E. Altamura, *European Banks and the Rise of International Finance: The Post-Bretton Woods Era* (London, 2017).

[11] Jeffrey D. Sachs, 'Introduction', in Jeffrey D. Sachs (Ed.), *Developing Country Debt and the World Economy* (Chicago, 1989), 1–34.

activities. Initially originated as a pool of dollars held outside the US banking system in the postwar period—the so-called Eurodollars, it was then expanded by European countries during the 1960s and 1970s, primarily in London, becoming a much larger and active market of dollar-denominated foreign currency deposits and Eurocurrency operations. While in the early times these operations consisted essentially of placing or borrowing funds in the Eurocurrency interbank markets, the banks progressively enlarged their business through the creation of new instruments, notably the Eurobonds and Euroloans, intended to finance non-bank customers. Particularly important was the syndicated Euroloan market, whose access was largely restricted to all but the most creditworthy clients prior to the oil shock in 1973, but went on to become the main lending instrument for public and private sector borrowers from developing countries.[12]

The historical rise in oil prices was a decisive factor in the evolution of foreign lending to developing countries in the lead-up to the 1982 debt crisis. Eurocurrency deposits, which had grown almost threefold over the 1970–1973 period, became the largest single depository for the substantial trade surplus of oil-exporting countries from 1974 on.[13] As large amounts of US dollar liquidity streamed into international private banks in London, they became available to the rest of the banking system through the Eurocurrency wholesale interbank markets, providing the banks with considerable new loanable funds. A mechanism, known as the petrodollar recycling process, was set into motion, where dollars flowing to Organization of Petroleum Exporting Countries (OPEC) as result of the increase in oil exports were recycled and flowed back to the rest of the world. Within the international banking and financial system, the petrodollar surpluses boosted the syndicated Eurocredit market, which eventually overcame the Eurobonds and other traditional types of private finance as source of financing in the international capital markets.

The counterpart to the rush of international bank lending was a large-scale demand for external finance. At the aggregate level, the increasing

[12] Miguel S. Wionczek, 'The LDC External Debt and the Euromarkets: The Impressive Record and the Uncertain Future', *World Development* 7 (1979), 175–87.

[13] Daniel R. Kane, *The Eurodollar Market and the Years of Crisis* (London, 1983), 110–11; Richard Roberts, *Take Your Partners: Orion, the Consortium Banks and the Transformation of the Euromarkets* (London, 2001), 94.

surpluses accumulated by oil-exporting countries were, after all, a mirror image of the deteriorating current account of oil importers. This included both industrial countries, which consumed the largest share of global energy production, and developing economies, which had structurally negative trade balances and were dependent on imported oil for growth. Within this context, the international banking sector had the resources and was particularly well situated to intermediate financial surpluses and deficits between countries on a worldwide scale. To the extent that the private banking institutions allocated international liquidity to countries where foreign capital was needed, as Benjamin Cohen and Fabio Basagni have argued, they helped to accommodate the shift of global external imbalances provoked by the rise in energy costs.[14]

The reconfiguration of world trade flows and balances was accompanied by a change in the balance of payment financing patterns in the developing world. In contrast to industrial countries, which mainly attempted to adjust oil-related deficits through an expansion of exports, developing countries increasingly relied on external borrowing based on recycled petrodollars, primarily bank lending, to bridge the wider financial gap. There were, however, important differences in the development of foreign indebtedness across regional groupings of developing countries, with middle-income economies borrowing relatively more from private financial markets than their low-income counterparts. In Africa, for instance, where external debt expanded more rapidly than in any other region, foreign borrowing relied almost exclusively on official sources of funds. While official creditors accounted for as much as 85% of external financing of low-income oil-importing countries between 1973 and 1982, the correspondent share for higher income countries was only 25%.[15]

The escalation of commercial bank indebtedness in the developing world was, therefore, a predominantly middle-income economy phenomenon. Among the largest borrowers in this group, as classified by the World Bank, were oil exporters, such as Mexico, Venezuela and Algeria, and upper-middle-income countries like Brazil, Spain, Argentina, Yugoslavia and South Korea.[16] By the beginning of the 1980s, these

[14] Benjamin J. Cohen and Fabio Basagni, *Banks and the Balance of Payments: Private Lending in the International Adjustment Process* (London, 1981).

[15] Jeffrey D. Sachs, 'LDC Debt in the 1980s: Risk and Reforms', NBER Working Paper Series No. 861 (1982), 13.

[16] World Bank, *World Development Report*, August 1981, 49–63.

eight countries accounted for about two-thirds of total outstanding bank debt. Although with different backgrounds, a common feature among them was that they had all participated in the postwar economic boom and were perceived to be relatively prosperous emerging economies at the time of the oil shock, qualifying for bank loans according to the usual country risk criteria.[17] In contrast, access to the Euroloan market by lower-income economies was much more limited, and they could only borrow meager amounts from international private commercial banks.

The increased participation of middle-income countries in bank lending came along with a growing concentration on Latin American borrowers. The period from the end of World War II to 1980 "was marked by the highest economic growth rates [that had been] attained by Latin America in its entire history."[18] Economic performance during the years between 1966 and 1973 was particularly outstanding also when compared to other developing countries in expansion such as East Asia, whose weighted average annual growth rate was lower than the levels attained in Latin America.[19] In addition to strong economic growth, Latin American economies had displayed an improvement in the purchasing power of their exports, along with greater diversification in the commodities exported and destination markets for their products. Thus, by the time of the first oil shock, Latin American countries had positioned themselves as a preferred place where to invest banks' increasing loan funds: They were creditworthy and considered good borrowers in the private international capital markets.

Lending to Latin America was attractive to the banks, but also appealing to industrial countries policymakers seeking to ease the impact of oil shocks. Faced with the big balance-of-trade deficits of the mid-1970s, as Philip Wellons has alleged, the governments of major industrial countries sought to expand exports to developing countries, and Latin America was a good market.[20] As these economies underwent industrialization processes, they became more reliant on capital goods and equipment

[17] Irving S. Friedman, *The World Debt Dilemma: Managing Country Risk* (Washington, DC, 1983).

[18] Luis Bértola and José Antonio Ocampo, *The Economic Development of Latin America Since Independence* (London, 2012), 139.

[19] See Barry J. Eichengreen and Albert Fishlow, 'Contending with Capital Flows: What Is Different About the 1990s?', in Miles Kahler (Ed.), *Capital Flows and Financial Crises* (New York, 1996), 23–55.

[20] Philip A. Wellons, *Passing the Buck: Banks, Governments, and Third World Debt* (Boston, 1987).

from industrial countries. Imports of goods and services were also increasing as a consequence of Latin American countries' high rates of economic growth, their population explosion and the rapid urbanization process they underwent. In such a context, the multiplying effects of trade and investment projects financing on industrial countries' exports to the region revealed significant.[21]

Latin American Banking Presence

An outstanding, though largely neglected, feature of the lending boom to Latin America during the decade leading up to the 1982 crisis was the participation of domestic commercial banks in the external indebtedness process of the region. In the case of Mexico, for instance, José Manuel Quijano has pointed out that Mexican banks took part in approximately a third of the total credit raised by the country's public and private sector borrowers in the syndicated Euroloan markets between 1974 and 1978.[22] Likewise, Brazilian banks led eight syndicated loans to Brazil and participated in another 29 between October 1978 and December 1979, of which 20 went to home country borrowers while the remainder were mainly granted to other Latin American countries. Although to a much lesser extent, Argentine banks were also involved in the Euromarkets and participated in international lending, as did banks from Venezuela and other smaller Latin American countries as Colombia, Chile and Peru.

The first steps of Latin American banks in international lending and the world capital markets were done through their participation as shareholders of London-based consortium banks in the early 1970s. Consortium banks—also called Eurobanks—as the Bank of England portrayed them, were banks "owned by other banks but in which no one bank has more than 50% ownership and in which at least one shareholder is an overseas bank."[23] These institutions were, therefore, independent

[21] In this regard, some scholars have argued that the boom in international lending and borrowing by developing countries was actually encouraged by industrial country governments. See, for instance, Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, 1994); Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, 1996).

[22] José M. Quijano, *México: Estado y Banca Privada* (Mexico City, 1987), 241–58.

[23] 'Consortium Banks on Course', *The Banker*, February 1976, 167.

banks collectively owned by several different banks, mainly established in London and conceived for conducting Eurocurrency operations in any of its forms. The first of its type was the Midland and International Banks (MAIBL), established in 1964, but many others were created in the upcoming years as part of a process that went hand in hand with the development of the Euromarkets. As the size of the Euromarkets grew exponentially in the wake of the oil crisis of 1973, the number and the scale of operations of consortium banks in London also surged.[24]

During the heydays of the 1970s and 1980s, when the Eurocurrency markets experienced its most dynamic expansion, virtually every major international bank participated in at least one consortium bank. But their ownership was not limited to the world's largest international banks, and it often included small banks from many countries or regions that sought to combine their resources and get involved in international finance. This group of London-based international consortium banks included a large variety of institutions which focused on a diversity of businesses ranging from short-term trade finance to longer-term bonds and credits to multinationals and foreign governments all around the world or from specific geographical areas or industries. As they expanded, consortium banks became active players in the development of international banking, with especial participation in syndicated deals and direct sovereign lending to developing countries.

Table 1.2 provides information on the ownership composition of the consortium banks with Latin American partnership operating in London during this period. Between 1972 and 1974, four of such banks were created with the participation of Latin American shareholders. The involvement of Latin American banks in consortium banking was part of a trend among a handful of developing country financial institutions that got involved in the international financial community and the Euromarkets at that time. As reported in the financial magazine *The Banker*, client nations of the international money and capital markets had been increasingly promoting, through government-controlled domestic banks or private sector banks, the creation in London of consortium banks, in partnership with European and North American banks, specialized in international banking to local customers.[25] Thus, in addition to

[24] Roberts, *Take Your Partners.*

[25] 'Consortium Banks at the Crossroads', *The Banker*, November 1977, 115–19.

Table 1.2 London-based Latin American consortium banks

	Founded	*Founder Banks*	
		Latin America	*Other*
European Brazilian Bank	1972	Banco do Brasil (31.9%)	Deutche Bank (13.7%), UBS (13.7%), Dai-Ichi Kangyo Bank (8.8%)
Libra Bank	1972	Banco Itau (8%), Bancomer (8%)	Chase (23.6%), Mitsubishi Bank (10.6%), Royal Bank of Canada (10.6%), Westdeutsche Landesbank (10.6%), Credito Italiano (7.1%), National Westminster (5%), Swiss Bank Corporation (10.6%) Espirito Santo (5.9%)
International Mexican Bank	1974	Banamex (38%)	Inlat (13%), Bank of America (20%), Paribas, Cai-Ichi Kangyo, Deutsche Bank and UBS (7.25% each)
Euro-Latinamerican Bank	1974	Banca Serfin, Banco de Colombia, Banco de la Nacion, Banco de la Nacion Argentina, Banco de la Republica Oriental del Uruguay, Banco del Estado de Chile, Banco do Brasil, Banco Industrial de Venezuela, Banco de Pichincha, Banco Mercantil de Sao Paulo (each less than 6%)	Algemene Bank, Banca Naziolale del Lavoro, Banque Bruxelles Lambert, Banque Nationale de Paris, Barclays Bank International, Bayerische Hypotheken, Dresner Bank, Osterreichische Landerbank, Banco Central, UBS, Deutsche Sudamerikanische Bank (each less than 5%)

Source Richard Roberts, *Take Your Partners: Orion, the Consortium Banks and the Transformation of the Euromarkets* (London, 2001)

those owned by large international banks, there were a significant number of other consortium banks that had participation of banks from borrowing countries themselves.

Among Latin American consortium banks, the Euro-Latin American Bank, also known as the Eulabank, was the largest with assets of

£1518.2 million in 1982. It was 50% European and the other 50% belonged to 10 Latin American banks from nine different countries, to which Banco del Estado de Bolivia would be added in 1979. It was founded to strengthen the economic ties between Latin America and Europe, and its main focus was on medium- and long-term Eurocurrency loans, project finance and Latin American trade finance. The other three Latin American consortium banks were the European Brazilian Bank (Eurobraz), created under the initiative of and majority owned by Banco do Brasil with 31.9% of the shares, the Libra Bank, of which Brazil Banco Itaú and Mexico Bancomer owned 8% each, and the International Mexican Bank (Intermex), which was majority owned by Banamex with 38% of the shares. The function of these banks, as Philip Wellons explained, was "to act as a go-between for domestic borrowers, including their home office, and to raise money (…) in world markets for their home countries."[26]

Along with these institutions, Latin American banks started also to open their own international banking offices. Between 1973 and 1982, as exhibited in Table 1.3, the number of Latin American branches and agencies in London increased from six to 18, with the majority of them created after 1977. In terms of nationality, while in 1973 only four Latin American countries—Argentina, Brazil, Mexico and Chile—had banking representation in London, by 1982 the number had increased to nine. Similarly, during this period, Latin American banks also opened branches and agencies in the USA, where their expansion was even more dramatic. While in 1973 there were only seven banking offices of Latin American banks in the USA—5 of those being Brazilian, the number jumped to 48 by the end of 1982. Like in London, the opening of US agencies and branches by Latin American banks was largely concentrated in the 1977 to 1982 period, and New York was the main destination.

As in London, the USA also experienced outstanding growth in its foreign banking community in the 1970s.[27] The abolition of the Interest Equalization Tax, along with the expiration of exchange controls in January 1974, made the US capital market once again relevant for

[26]Wellons, *Borrowing by Developing Countries*, 77.

[27]See United States General Accounting Office, *Considerable Increase in Foreign Banking in the USA Since 1972*, August 1979; Henry S. Terrell and Sydney J. Key, 'The Growth of Foreign Banking in the United States: An Analytical Survey', *Federal Reserve Bank of Boston* 18 (1977), 54–90.

Table 1.3 Number of foreign agencies and branches of Latin American banks

	London			*United States*		
	1973	*1977*	*1982*	*1973*	*1977*	*1982*
Latin America	**6**	**9**	**18**	**7**	**16**	**57**
Argentina	2	2	2	1	1	8
Brazil	2	4	6	5	9	27
Chile	1	1	1	0	0	1
Colombia	0	0	2	0	1	3
Mexico	1	1	4	1	3	10
Peru	0	0	1	0	0	0
Uruguay	0	0	1	0	0	1
Venezuela	0	1	1	0	2	5
Panama	0	0	0	0	0	1
Paraguay	0	0	0	0	0	1

Source London: *The Banker* magazine (several issues); USA: FFIEC 002 Call Reports

foreign borrowers and international banks. Apart from New York, the London's rival international financial center, California and Chicago also welcomed an increasing number of foreign banks, though on a much smaller scale. In 1980, foreign banking assets in New York accounted for approximately 70% of US total foreign banking assets, compared with the 23% of California and 3% of Chicago.[28] As for Latin American banks, the total assets of their agencies and branches in the USA reached nearly US$10 billion in 1982, of which those located in New York accounted for 63.1%, Los Angeles and San Francisco 17.7 and 12.7%, respectively, and Miami, Chicago and Washington the remainder. The main reason that Latin American banks established locations in the USA, and in particular in New York, was to access its money market and open a dollar-based funding channel.

The presence of Latin American financial institutions abroad shows that debtor countries, like their creditor counterparts, also underwent a process of internationalization in the banking sectors. This process of foreign expansion was the result of a combination of domestic and external factors that push the banks to look beyond the national market and get involved in a more dynamic and attractive international atmosphere. In Latin America, banking institutions were operating within a system

[28] *The Banker*, February 1980, 87.

heavy regulated by monetary authorities, or domestic *financial repression* as defined by Ronald McKinnon and Edward Shaw,[29] and in the case of Mexico, the banks were suffering from an erosion of their funding and lending capacities linked to inflation and the interest rate policy of the central bank. International finance and the Euromarkets, on the other hand, offered the banks with a new, unregulated, more flexible space to develop their businesses and overcome local financial constraints.

Wholesale Interbank Money

A central feature of the expansion of international bank lending during the 1970s was its large interbank element. Although the interbank market had always been at the core of the international banking system, it took on an increased role after the first oil shock, becoming, in Michael Moffitt's words, "the mainstay of the Euromarkets."[30] "Interbank transactions [were]," as reported by the Bank of England—the institution under whose jurisdiction most of these activities took place, "the most frequent form of trading in the Euromarket."[31] Figure 1.2 shows the evolution of the Euromarkets, namely external and local positions in foreign currency of BIS reporting banks, along with its interbank component. Interbank activity increased from less than US$200 billion in 1973 to over US$1 trillion by 1982, accounting for between two-thirds and three quarters of the Euromarkets during the entire period. The large size of the Eurocurrency interbank market makes the Euromarket look essentially like an international wholesale money market, where banks could access dollars, sterling, marks, francs and any other currencies around to conduct their local and offshore businesses.

International interbank transactions consisted of fast, informal transfers of short-term funds between banks. They not only enabled individual banks to lend without being tightly constrained by deposits attracted from the non-banking sector, but, like other money market transactions, they also provided a way to adjust the volume and nature

[29] Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington, DC, 1973); Edward Shaw, *Financial Deepening in Economic Development* (New York, 1973).

[30] Michael Moffitt, *World's Money: International Banking from Bretton Woods to the Brink of Insolvency* (New York, 1984), 69.

[31] 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin*, September 1981, 352.

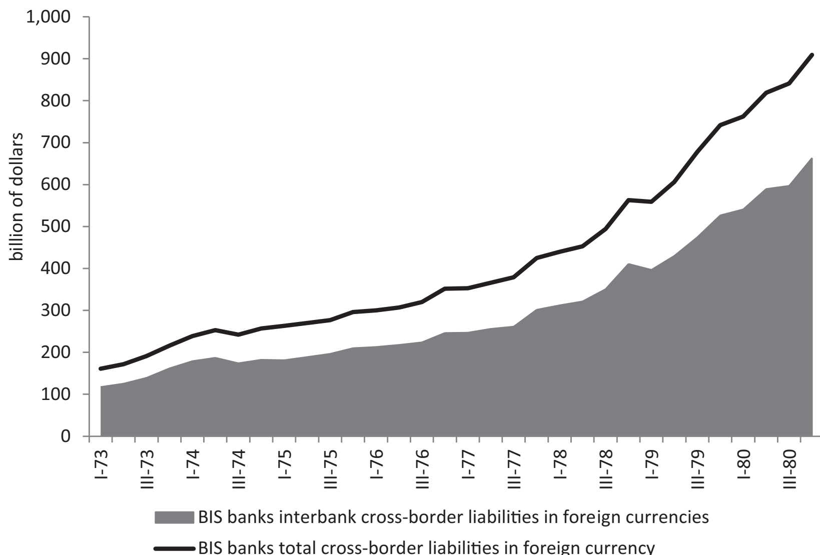

Fig. 1.2 Euromarkets and the international interbank market in the 1970s (*Source* John G. Ellis, 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin*, September 1981, 351–64)

of their assets and liabilities. At an international level, the interbank market acted as a channel from banks with a domestic dollar base or an excess of deposits to direct lending toward banks where lending opportunities exceeded deposits. Indeed, as the Eurocurrency deposits expanded, the interbank market provided a flexible device that made large amounts of loanable funds quickly ready for use. To the extent that liquidity was available at a price—London InterBank Offered Rate (LIBOR) plus a premium, banks could borrow in the Eurocurrency market to fund domestic and international credits to corporations, governments and other customers. This both allowed the banks to meet new lending opportunities and encouraged the recycling of petrodollars, while letting them hedge the interest and exchange rate risks that arose from their foreign business.

Consortium banks, which were major players in the Euromarkets and recycling process, relied heavily on the international interbank market to develop their business. Unlike commercial banks, they had no branch network or territorial presence and were thereby unable to cultivate

a strong retail deposit base. They were instead largely dependent on the purchase of deposits in the wholesale money markets, with a liability structure heavily concentrated on obligations to the banking sector. Their main funding source was short-term borrowing from other banking institutions, but they also drew on negotiable London dollar certificate of deposits, floating-rate loan notes, Eurobonds, loans from other branches and domestic funds from parent banks.[32] Conversely, the asset side of the balance sheet was mainly made up of medium- and long-term Euroloans, and to a much lesser extent, liquid assets and reserve balances in the form of informal credit facilities with other banks. As a result of their intermediating activities, a significant degree of maturity transformation built up along the interbank chain and in the balance sheets of consortium banks.

While initially limited to the world's major international banks, the interbank market became increasingly used by a larger number and wider variety of actors as it expanded. The market grew from a few hundred participants in the mid-1970s to well over 1000 banks from more than 50 countries by the early 1980s.[33] This expansion entailed both greater volumes of operations between banks in the same financial center, as well as more cross-border business, including inter-office positions and genuine interbank activities among banks throughout the world. Many smaller institutions, ranging from regional banks in advanced industrial countries to commercial banks in less developed countries, became active participants in the Eurocurrency interbank market. As in the case of consortium banks, this interbank market provided them with an attractive wholesale source of funding to develop their domestic and international activities. In the case of large Latin American banks, the network of foreign agencies and branches in main international financial centers served as the platform from where the head offices could become involved in the Euromarkets.

Table 1.4 presents the 1982 balance sheet of the London agencies and branches of commercial banks from the three larger Latin American debtor countries. The consolidated assets and liabilities were US$8.5

[32] Gunter Dufey and Ian H. Giddy, *The International Money Market* (Englewood Cliffs, 1994), 216–32; Steven I. Davis, *The Euro-Bank: Its Origins, Management and Outlook* (New York, 1980).

[33] Ian H. Giddy, 'Risk and Return in the Eurocurrency Interbank Market', *Greek Economic Review* (August 1981), 158–86.

Table 1.4 Branches and agencies of Latin American banks in London (End-June 1982, millions of dollars)

	Brazil			*Mexico*			*Argentina*		
	Assets	*Liab.*	*Net P.*	*Assets*	*Liab.*	*Net P.*	*Assets*	*Liab.*	*Net P.*
Banks	3921	4520	−599	1068	1824	−756	1308	750	558
In the UK	404	1435	−1031	260	1147	−887	350	194	156
Outside the UK	570	1938	−1368	331	429	−98	176	498	−322
Own offices overseas	2947	1147	1800	477	248	229	782	58	724
Non-Banks	1083	369	714	984	52	932			
In the UK	90	40	50	0	0	0			
Outside the UK	993	329	664	984	52	932			
Other	178	292	−114	70	246	−176	20	578	−558
Negotiable papers	4	199	−195	3	243	−240	0	555	−555
Other	174	93	81	67	3	64	20	23	−3
Total	5182	5181	0	2122	2122	0	1328	1328	0

Note The net position is computed as the difference between assets and liabilities, '*Liab.*' indicates Liabilities, '*Net P.*' indicates Net position
Source Bank of England archive, Task Force, 13A195/1

billion, of which 61.1% corresponded to Brazilian banks, while their Mexican and Argentine counterparts accounted for the remaining 23.2 and 15.7%, respectively.[34] The large part of liabilities to banking institutions, which accounted for as much as 85% of the total obligations of the Brazilian and Mexican agencies, makes the interbank nature of these agencies' funding strategies clear. The fact that the net position, computed as the difference between assets and liabilities, vis-à-vis other banks was negative implies that they were net borrowers in the interbank market. On the asset side, the net position with the head office and other non-banking institutions was positive, indicating that the foreign liquidity these offices raised in the international wholesale markets was channeled to parent banks or to other borrowers outside the UK.

Access to international wholesale liquidity was not limited to the London Eurocurrency interbank market since Latin American banks were also present in the USA. As Table 1.5 shows, the balance sheet of the US agencies and branches of Brazilian, Mexican and Argentine commercial banks had a similar structure to their London counterparts. As of June 1982, they had consolidated assets and liabilities of about US$9.5 billion, of which US$8 billion or 85% was owed to banking institutions. Of this amount, 67.2% were liabilities to banks in the USA, while the remaining 14.1 and 18.7% were liabilities to banks abroad and head offices, respectively. In fact, although levels varied among the countries, banks in the USA were agencies' main creditors, accounting for between 40 and 60% of their total liabilities. The large part of these obligations consisted of deposits and trade balances that the banks held with the agencies, but there were also substantial amounts of federal funds, borrowed money and interbank credit lines. Like in the case of London, the net position of the agencies was negative, meaning they were funding themselves in the US money market. Obligations with the non-bank sector, both in the USA and abroad, and other liabilities represented an average of 15% of the balance sheet liabilities.

In contrast, the net position of the agencies compared to the non-banking sector was largely positive. The private and public non-bank sector was indeed their main debtor, accounting for about 40%

[34] The four Brazilian banks were Banco do Estado de Sao Paulo, Banco do Brasil, Banco Real and Banco Mercantil do Sao Paulo; the four Mexicans were Banamex, Bancomer, Banca Serfin and Multibanco Comermex; and the two Argentine were Banco de la Nación Argentina and Banco Galicia y de Buenos Aires.

Table 1.5 Branches and agencies of Latin American banks in the USA (End-June 1982, millions of dollars)

	Brazil			*Mexico*			*Argentina*		
	Assets	*Liab.*	*Net P.*	*Assets*	*Liab.*	*Net P.*	*Assets*	*Liab.*	*Net P.*
Banks	2942	3507	−565	924	2551	−1627	631	1899	−1268
In the US	727	2707	−1979	300	1854	−1554	114	784	−670
Outside the US	496	277	219	264	488	−224	430	358	72
Own offices overseas	1719	523	1196	360	210	150	87	757	−670
Non-Banks	1326	827	500	1904	10	1894	1354	156	1198
In the US	217	734	−517	8	1	7	6	110	−104
Outside the US	1109	93	1016	1896	10	1886	1348	46	1302
Other	224	159	66	81	347	−266	143	73	70
Negotiable papers	1	81	−80	2	293	−291	27	28	−1
Other	223	77	146	79	54	24	116	45	71
Total	4492	4492	0	2909	2909	0	2127	2127	0

Note The net position is computed as the difference between assets and liabilities, '*Liab.*' indicates Liabilities, '*Net P.*' indicates Net position
Source FFIEC 002 Call Reports

of consolidated total assets. These claims primarily consisted of lending facilities to final borrowers outside the USA. Loans and advances granted by Argentine and Mexican agencies to non-US residents reached US$1.3 billion and US$1.6 billion, respectively, amounts that represented as much as 99% of their loan portfolio. As for Brazilian banking offices, the corresponding figures were US$1 billion and 84%. These were either direct loans granted from the US agency to a foreign borrower or syndicated credits that their parent banks participated in, along with other international banks, through them. This balance sheet structure suggests that the function of these agencies and branches consisted in raising interbank money to finance international loans.

In the case of Mexico, the use of the international wholesale markets by leading domestic banks to fund cross-border lending created new risks and vulnerabilities. Heightened reliance on foreign interbank borrowing meant a higher weight of foreign currency external debt in the liabilities, while dollar-denominated claims were largely concentrated in Mexican borrowers, who mainly operated in the domestic currency. In addition, the use of interbank money as the basis for funding loans resulted in the accumulation of significant maturity and interest risks mismatches, which compromised the financial and solvency position of the agencies and branches as the crisis approached. After Mexico's moratorium declaration, the size of the international interbank market shrank, and this became a serious problem for banking institutions heavily dependent on foreign wholesale interbank liquidity, largely exposed in their home countries, and with only very limited alternative source of funding.[35]

The Impact of the Crisis

The outbreak of the crisis in Mexico represented a shock to the international interbank market, and it disturbed the normal funding transactions and rollovers of existing money market lines with the agencies and branches of Mexican banks and from other Latin America countries. Bankers' acceptances, pre-export financings, straight Eurodollar

[35] Jack M. Guttentag and Richard J. Herring, 'Funding Risk in the International Interbank Market', in Wilfred J. Ethier and Richard C. Marston (Eds.), *International Financial Markets and Capital Movements: A Symposium in Honor of Arthur I. Bloomfield* (Princeton, 1985), 19–32.

and prime-based advances all became increasingly difficult in a nervous and uncertain market atmosphere. As the crisis spread throughout the region, the increased risk perception on operations with banks from troubled countries prompted creditor banks to reduce their businesses and involvement with them, stopping the renewals of interbank claims, with some of them demanding to be paid off at maturity.

Figure 1.3 shows the evolution of the liabilities to banking institutions of the US and London agencies and branches of Brazilian, Mexican and Argentine banks in 1982. It provides a clear perspective on the erosion of interbank funding that these agencies suffered around the outbreak of the international debt crisis. In the last third of 1982, Brazilian agencies lost US$1.7 billion dollars in the interbank market, an amount representing a drop of 25% of their outstanding obligations in only three months. In the case of Mexico, the agencies lost about US$886 million or 30% of interbank funding between June and September of 1982. As for the Argentine banks, the decline of interbank liabilities was

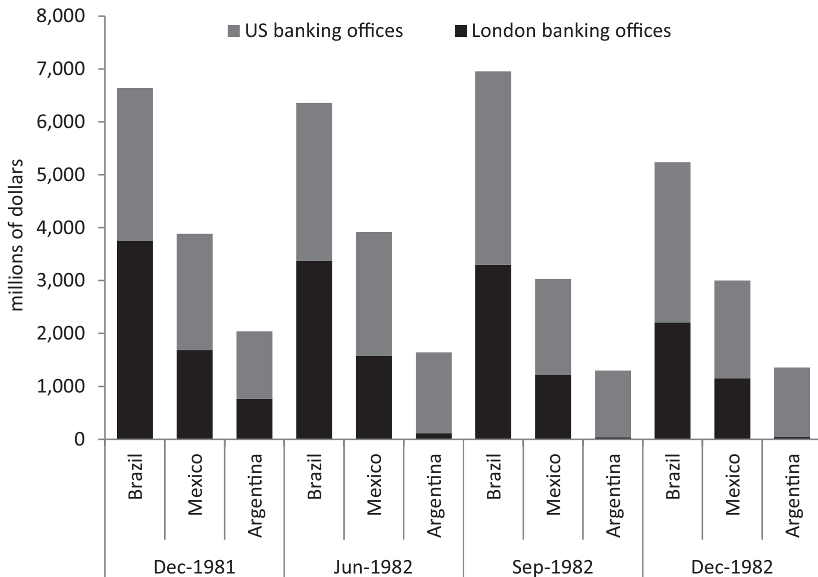

Fig. 1.3 Interbank liabilities of Latin American bank's foreign agencies and branches (*Source* London: Bank of England archive, Task Force, 13A195/1; USA: FFIEC 002 Call Reports)

largely concentrated in the London agencies, presumably related to the Falklands War that began in April 1982. The problems in the interbank deposit businesses were, however, not confined to Latin Americans, with a number of other foreign banking institutions, mainly from Portugal and South Korea, also encountering funding difficulties in the London Eurocurrency market. Although to a lesser extent, consortium banks also faced hard times funding themselves in the interbank market, and some of them were indeed forced to request substantial support from their shareholders.

As interbank money dried up, the funding pressures of the foreign offices of Latin American banks increased. International banks were their single most important suppliers of immediate liquidity, and, as discussed in Chapter 5, they had only limited capacity to adjust their assets since most of them were long-term loans or illiquid claims. Most of them did not have a liquidity cushion and were unable to fund themselves outside the international interbank market. They had no dollar retail deposit base, were not secured by the Bank of England in London or the Federal Deposits Insurance Corporation (FDIC) in the USA and could not borrow from their discount windows. Recourse to foreign exchange from head offices and parent central banks in a context of dwindling international reserves and balance of payment crises in their home countries was not a realistic possibility either. The contractions in interbank liabilities could, therefore, seriously damage the liquidity, and even the solvency, position of these agencies, creating the very real risk that they would no longer be able to reimburse their creditors on time.

But the possibility of a disruption of interbank payments had implications that went beyond the financial situation of the individual institutions. If a bank or an agency became unable to repay its liabilities, then the solvency of those banks which had provided it with interbank funds would also be called into question. Under such circumstances, there was a danger that the failure of one bank or agency, which in the absence of the interbank market would have been an isolated incident, would spread throughout the banking system and cause a domino effect collapse. The Mexican agencies had US$5.2 billion of outstanding interbank liabilities spread throughout thousand banks across different international financial centers and that amount reached about US$15 billion when

including Brazilian, Argentinean, Chilean and Peruvian banks.[36] Given the high volume, the uncollateralized nature and the pyramid structure of these interbank transactions, the potential systemic danger resulting from a payment disruption by Latin American banks was not negligible.

The situation of the agencies was indeed a matter of serious concern for policymakers and financial authorities from both debtor and creditor countries. From the beginning of debt renegotiations, Latin American central bankers and secretaries of finance insisted on the need to maintain interbank deposits at the offshore agencies of their domestic banks. To that end, spreads were revised upward and yields were increased substantially to encourage the banks to maintain or increase deposit levels, but the leakage continued. Agencies looked to cover the loss of funding through asset reduction, the use of headquarters' internal liquidity, emergency support from home country central banks and the use of overnight credit lines, but these solutions were insufficient. Eventually, creditor countries' supervisory authorities, especially the Federal Reserve and the Bank of England, intervened to persuade international banks to limit the reduction of their deposits to ensure that foreign branches of Latin American banks did not default on their obligations and maintain confidence in the system.

Different approaches were used to secure the renewals of interbank deposits at maturity. As sovereign debt lawyer Lee Buchheit explains, some countries, such as Argentina and Brazil, asked their creditors to sign formal agreements whereby creditor banks agreed to maintain their interbank deposit liabilities at their levels on the date of the moratorium declaration.[37] Other countries, like Mexico or the Philippines, agreed to a clause in their restructuring documents that stated that a default event would be triggered if the aggregate level of interbank liabilities placed with the offshore agencies and branches of their domestic banks were to drop below certain levels. For their part, debtor banks agreed to continue to pay interest on these liabilities when they came due and their home governments and central banks to make the necessary foreign exchange available to do so. The principle underlying these approaches was to avoid

[36] Brazil US$6 billion, Mexico US$5.2 billion, Argentina US$1.4 billion, Chile US$1.2 billion and Peru US$1.2 billion. FRBNY archive, Box 108403, The International Interbank Market and International Banking Lending, June 28, 1985.

[37] Lee C. Buchheit, 'But What Do We Do About All Those Interbank Lines?', *International Financial Law Review* 10 (1991), 15–16.

restructuring interbank debts, which could seriously disturb the international financial market, and caused problems for proposed rollovers.

These schemes were an integral part of the broader financial packages and restructuring programs implemented to handle debt payment crises and guarantee the stability of the international financial system. The strategy developed by the group of creditor countries governments, the IMF and international banks to deal with Mexico consisted in the restructuring of bank debt and the provision of new lending conditioned on a Fund-supported program.[38] The rationale behind this approach was to secure reimbursement by stretching out the payment schedule while raising the trade surplus and supplying additional credits as to cover the external financing gap of the countries. The Fund austerity measures were featured as aiming to address fundamental macroeconomic disequilibrium in troubled countries and to liberate resources and foreign exchange that could be used to service external debt. The approach and rescheduling deals developed to handle the Mexican crisis, which would be at the forefront of debt negotiations and financial firefighting during most of the decade, set a pattern of crisis management for other indebted countries coming into sovereign debt crisis onwards.[39]

The involvement of creditor countries and international agencies was key for coping with the crisis and preventing major problems in the banking system. After all, as Paul Volcker concedes, the debt management strategy provided lender of last resort assistance to the national and international banking system through the involvement and contribution of a multiplicity of actors.[40] The increase in official lending from creditor governments and international organizations, along with the savings that austerity programs generated in debtor economies, was then used to finance an outward transfer of resources to the benefit of creditor commercial banks. Latin American countries, which had previously been net recipients of resources from abroad, became net exporters of capital beginning in 1982. International commercial banks provided new loans as part of the restructuring agreements, but they received a much

[38] Harold James, *International Monetary Cooperation Since Bretton Woods* (Washington, DC, 1996), 347–408.

[39] Paul Krugman, 'LDC Debt Policy: 1', in Martin Feldstein (Ed.), *America Economic Policy in the 1980s* (Chicago, 1994), 691–722.

[40] Paul A. Volcker and Toyoo Gyohten, *Changing Fortunes: The World's Money and the Threat to American Leadership* (New York, 1992), 203.

larger amount from borrowing countries in debt service payments, which allowed them to rebuild their capital base and increase their reserves until they were in a better position to accept losses without compromising the confidence in the international banking system.

Domestic Front

Within this international framework, economic policy in debtor countries also played an important role in the increasing recourse to foreign finance and external indebtedness. In the case of Mexico, macroeconomic management, namely fiscal and monetary policy, contributed to the creation of the financial crisis of 1982 and influenced the subsequent debt renegotiations. In particular, the combination of loose fiscal control with a fixed foreign exchange rate regime underpinned a series of macroeconomic problems and imbalances that made the Mexican domestic economy vulnerable to changes in the international capital markets and the external shocks of the late 1970s and early 1980s.

After the devaluation of August 1976, which marked the end of two long decades of foreign exchange stability in Mexico, the national currency stabilized at the new parity of 22.5 pesos per dollar by the beginning of 1977. The currency crisis was the result of fundamental disequilibrium in the balance of payments related to the inflationary process, fiscal deficits and negative current account balances that had been increasingly affecting the domestic economy since the beginning of the decade. With the outbreak of the crisis, Mexican authorities looked for financial assistance from the USA and subscribed to a three-year standby agreement with the IMF. However, the Fund-stabilization program, which called for the usual monetary and fiscal austerity measures, was quickly abandoned in June 1978, and macroeconomic management dispensed with the targets of fiscal deficit, external indebtedness and wage increases in favor of more expansionary economic policies.[41]

Over the following years, as the oil reserves of the country expanded, the Mexican government became even more deeply engaged in a growth-led strategy based on strong fiscal stimulus. However, while current and capital public expenditures in terms of GDP rapidly increased

[41] Edward Buffie and Allen Sanginés-Krause, 'Mexico 1958–86: From Stabilizing Development to the Debt Crisis', in Jeffrey D. Sachs (Ed.), *Developing Country Debt and the World Economy* (Chicago, 1989), 141–68, esp. 141–47.

between 1978 and 1982, revenues expanded at a much more modest pace and the fiscal deficit soared.[42] Foreign borrowing came to finance the bulk of the budget needs, but the public sector made also use of domestic financing from the banking system as well as the sale of new financial instruments, the Treasury certificates (Cetes), to the public. The surge in public spending and the increasing role of the government in the domestic economy coupled with expansive economic policies measures boosted the aggregate demand and generated further inflationary pressures. During the 1977–1982 period, the rises in nominal wages and inflation followed a very similar pace, and the expansion of the monetary base and money supply was usually much faster than the evolution of the price level.

Within a currency board regime, high and rising inflation led to a considerably overvalued foreign exchange rate. Between 1977 and 1982, the Mexican peso appreciated in real terms against the dollar at an average annual rate of 6.5%, which represented a cumulative appreciation of 37.5% over the entire period. By the time of the devaluation of February 1982, the real exchange rate had attained similar levels to the level reached in the eve of the 1976 currency crisis. The appreciation of the real foreign exchange along with a deterioration of the country's terms of trade and a strong demand for imports driven by the process of large economic growth in the late 1970s had a strong negative impact on the trade balance. On the other hand, the rise of international interest rates worsened the current account deficit, which almost tripled from 2.4 to 6.2% of GDP between 1977 and 1981. The surpluses on the capital account, largely based on external borrowing, allowed for a balancing of the Mexico's external position even as the current account steadily deteriorated.

Under such circumstances, the policy of the Mexican government and the central bank to maintain the parity of the national currency with the dollar fueled the expectations of a future devaluation. Within a system of free foreign exchange convertibility and negative domestic real interest rates, such expectations translated into increasing amounts of capital flights, especially since the second half of 1981. From 1981

[42] Ernesto Zedillo, 'The Mexican External Debt: The Last Decade', in Miguel S. Wionczek (Ed.), *Politics and Economics of External Debt Crisis: The Latin American Experience* (Boulder, 1985), 294–324.

to mid-1982, the Mexican private sector fled the national currency and the outflow of dollars reached about US$16.5 billion.[43] In the domestic financial sector, depositors moved their savings from pesos to accounts denominated in dollars and started to withdraw the balances from the banking system and transfer the money abroad. The mechanism for capital flight was made possible by the engagement of Banco de Mexico in selling dollars at the parity rate while international reserves were replenished by the increasing recourse to foreign capital and external debt.

The wave of capital flight became indeed closely intertwined with the external indebtedness process and the macroeconomic imbalances mentioned above. As the government increased spending and the central bank expanded the monetary supply, the higher money balances in the hands of the private sector led to a weakening of the exchange rate as it converted cash into foreign currency.[44] The trend created inflationary pressures that the central bank unsuccessfully attempted to control by keeping the exchange rate from depreciating by selling dollars, thereby leading to a rise in the foreign assets holdings of the private sector that were largely taken out of the country. With a negative trade balance, an adequate level of central banking reserves was maintained only by foreign exchange inflows from oil exports and private and public sector borrowing in the international capital markets.

As the outflow of capital continued and fiscal and current account-deficits grew, Mexico experienced the largest run-up in foreign debt of the period. Between the beginning of 1980 to the end of 1982, total external debt more than doubled from US$40.2 to 84.8 million. While increasing by 12.6 and 20.3% in 1978 and 1979, total external indebtedness accelerated with growth rates of 26 and 47.6% in 1980 and 1981 respectively. The lion's share was due by the state, but the private sector was also increasingly borrowing abroad. In fact, private foreign debt increased from 22.9% of total external debt in 1977 to 33.3% in 1980 and 30.6% by the end of 1982. Mexico's large private industrial firms

[43]The phenomenon of capital flight against the Mexican currency has originated a literature on the "peso problem" and speculative attacks in unsustainable fixed foreign exchange regimes. See, for instance, William S. Krasker, 'The "Peso Problem" in Testing the Efficiency of Forward Exchange Markets', *Journal of Monetary Economics* 6 (1980), 269–76.

[44]Sachs, 'Introduction'.

and commercial banks had direct access to overseas financing, and they could therefore benefit from a wide range of foreign bank loans at more attractive rates and financial terms than scarce and expensive domestic funding despite the currency risk.[45]

Faced with such a deteriorating economic situation and the tightening of international credit, the government adopted a number of measures by mid-1981 aimed at improving the balance of payments and reducing the fiscal deficit. To ameliorate the external situation, the annual depreciation rate of the peso against the dollar was slightly raised, import controls were restored while export subsidies increased, and interest rates revised upwards more regularly. In terms of public finances, the government announced a reduction in the annual budget of the public sector and introduced some rules and regulations to avoid future budget increases.[46] The adjustment program proved, however, unsuccessful in addressing the underlying macroeconomic imbalances, and by the end of the year, the flight of capital and the deterioration of the country's external position had accentuated. As of early 1982, Banco de Mexico decided to withdraw from the currency market and let the peso float freely.

New stabilization programs were announced in the aftermath of the devaluation of February 1982. The measures to be implemented were similar to the ones adopted in the previous program, and they aimed to curb aggregate demand through restrictive fiscal and monetary policies.[47] But inflation continued to escalate and, fueled by political uncertainty in an electoral year, capital flight started again in mid-March and, after almost five months of stability for the peso, the Mexican currency depreciated by about 150% in August to a maximum of 114.7 pesos per dollar. With the waves of devaluations and the rise of international interest rates, the peso value of outstanding dollar obligations of Mexican borrowers soared, leading to the suspension of foreign debt service payments by the private sector first and the eventual moratorium declaration of the government afterward.

[45] Isabel Molina Warner, 'El endeudamiento externo del sector privado y sus efectos en la economía mexicana', *Comercio Exterior* 31 (1981), 1140–47.

[46] See Carlos Tello, *La nacionalización de la banca en México* (Mexico, DF, 1984), 77–81.

[47] Robert E. Looney, *Economic Policy Making in Mexico: Factors Underlying the 1982 Crisis* (Durham, 1985).

CHAPTER 2

Mexican Banks Go Abroad

In the early 1970s, when major US and European banks and other financial institution from around the world were operating in London and involved in Euromarket activities, Mexican banks had virtually no presence in the world capital markets. However, the first London-based consortium bank with Mexican ownership, the Eulabank, was founded in 1972 and two more, the Libra Bank and Intermex, were created over the next two years. With these institutions, which were established in partnership with some of the world's most prominent banks, Mexican banks made their way into international finance and learned a great deal about foreign banking and the business opportunities that they could develop in the Euromarkets. The participation in consortium banks gave Mexican financial institutions a first direct contact with foreign finance but also with a flavor of the potential benefits that they could derive from engaging in international lending and the petrodollar recycling process.

This chapter is concerned with the reasons why Mexican banks went abroad and the forces driving their increasing involvement with international finance between 1972 and the financial fallout of 1976. After decades of development and increasing penetration in the domestic economy during the postwar period, the Mexican banking sector suffered a drawback in the early 1970s and the volumes of assets and its broader intermediating capacity dramatically shrank since 1972. These were years of major changes in the international economic and financial order and also at a domestic level in Mexico, with inflation becoming

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a raising problem in a country that had long lived with strong economic development coupled with price and foreign exchange stability. For an incumbent administration with policy goals largely focused on improving income distribution through an increasing participation of the public sector in the economy, financing was necessary, and indeed an indispensable element, to carry out the government program. Particularly so in a context were large oil reserves were being discovered in Mexico and huge amounts of investment were needed to exploit them.

A combination of external and domestic factors was at the base of the decision of the largest banks of the country to go international. On the one side, the rise of international liquidity and the increasing involvement of foreign banks in lending to developing countries and particularly to Mexico put pressures on a domestic banking sector with limited capacity to supply credit. On the other hand, in a context of strong economic development and growing macroeconomic imbalances, the need of financing of the Mexican government and to a lesser extent the private sector were great, and they could borrow abroad what they could not fund domestically. The discussions of the Executive Committee of Banamex, one of the largest private financial institutions and a pioneer in Mexican international finance, show the central role that the domestic financial difficulties confronted by the domestic banking industry along with the increasing competition to foreign bank lending played in the decision of the bank to look beyond the national boundaries and get involved in the Euromarkets.

The incursion of Mexico's three largest private banks in the Euromarkets through their associated consortium banks proved a successful experience. In only a few years after their creation, all three Mexican consortium banks have managed to expand the volume of their assets in a considerable way and to engage in profitable international lending operation through the Euromarkets. Intermex, in particular, developed into an important player in intermediating foreign capital with Mexican borrowers, with government development banks eventually buying shares and thereby becoming also owners of the bank. In end-1976, when the peso was devalued after decades of fixed parity with the dollar, the international activities of Mexican banks concerned mainly its consortium banks and they had only small amounts of foreign liabilities in their balance sheets. Unlike what would occur six years later, the impact of the crisis did not represent a major shock to the domestic banking system.

The Historical Context of Mexican Banking

The modern Mexican banking system was formed during the decades following the revolution in a context of political and economic reorganization and reconstruction of the country. The Mexican Revolution that started in 1910 and extended over the decade was a major event in the Mexico's economic history and represented a break with respect to the old financial order. The banking industry, which had consistently grown and developed during the previous regime of Porfirio Diaz, was wiped out with the economic crisis that followed the outbreak of the revolution and remained in a state hibernation for a long period even after the end of the conflict and the restoration of political stability.[1] Between 1925 and 1941, the government initiated a process of financial redesign that allowed the banking sector to take off again and rebuild its presence and role in the national economy.

One fundamental piece in the new institutional framework of the financial system was Banco de Mexico, the country's central bank. Banco de Mexico was founded in 1925 with a Board of Directors comprising representatives chosen from both the public and private sectors. Although with limited monetary and regulatory functions in the years after its creation, it progressively gained modern central banking capacity and became the institution at the center of the financial system over the following decades.[2] Additionally, the Secretary of Finance had created the previous year the Comisión Nacional Bancaria (National Banking Commission), later renamed Comisión Nacional Bancaria y de Seguros (CNBS), as the supervisory agency for the banking sector. Its main purpose was to work as an auditing organization to inspect banks, collaborating with the central bank in the monitoring and regulation of the banking industry.

The Banking Law of 1941 was the second institutional pillar of the new financial system. A number of laws and regulations has been passed in the previous decades, such as the *Ley General de Instituciones*

[1] See Luis Anaya Merchant, *Colapso y reforma la integración del sistema bancario en el México revolucionario 1913–1932* (Zacatecas, 2002); Gustavo del Angel and Carlos Marichal, 'Poder y crisis: historiografía reciente del crédito y la banca en México, siglos XIX y XX', *Historia Mexicana* LII (2003), 677–724.

[2] On the origins and history of Banco de Mexico, see Eduardo Turrent Diaz, *Historia del Banco de México* (Mexico City, 2015); Ernesto Fernández Hurtado (Ed.), *Cincuenta Años de Banca Central: Ensayos Conmemorativos, 1925–1975* (Mexico City, 1976).

de Crédito y Establecimientos Bancarios of 1924 or the *Ley General de Instituciones de Crédito* of 1932 that superseded, but it was the promulgation of the *Ley General de Instituciones de Crédito y Organizaciones Auxiliares* in August 1941 what gave the banking system its final and definitive structure.[3] It established a model of specialized banking that ruled the banking industry until the mid-1970s, when the legislation went through its first substantial modification. Under pretty much the same spirit as the Glass-Steagall Act of 1933 in the USA, this law created different types of financial intermediaries, each one with a specific set of operational boundaries in terms of their funding and lending activities as well as other regulatory instruments such as reserve requirements.

Within this legal framework, commercial banks emerged as the most important domestic financial intermediaries.[4] The law provided these banks with the authority to receive sight and time deposits from the public and firms, while allowing them to grant credits with restriction on the maturity terms, especially regarding operations of more than one year. Commercial banks could also rediscount commercial papers as well as grant letter of credits and hold securities, but they were forbidden some operations such as mortgage loans, for example, a type of financing that was under the explicit legal responsibility of the so-called Mortgage banks. There were also *financieras*, a kind of investment or industrial bank and the second most important financial intermediary in Mexico, which could raise funds through bonds and lend with greater flexibility and longer maturity terms than commercial banks. Along with these institutions, the other, less important, financial firms defined by the 1941 banking law were thrift institution, trust organizations, clearing houses and credit unions among others.

Despite the strict segregation of financial activities by type of institution, commercial banks managed to enlarge the scale of their operations beyond the original grant of authority. They were usually affiliated with other financial intermediaries to expand the variety of financial services they could offer and provide products that were restricted to them by law. Thus, for instance, a bank interested in engaging in

[3] Gustavo del Angel, 'Paradoxes of Financial Development: The Construction of the Mexican Banking System, 1941–1982', Unpublished PhD diss., Stanford University, 2002, 63–85.

[4] Ibid., 86–110.

long-term financing would typically associate with or create a *financiera*, supply it with funds through interbank transfers, which the *financiera* could then use to grant the credit with greater ease. A similar principle and modus operandi were applied by banks willing to get involved in mortgage loans, issuing securities or providing insurance services. They would develop such activities through the entity allowed by the law to operate in these markets and work out internal funding arrangements with them. As a result, although these institutions were separate legal entities and had their own balance sheet, they were connected to each other through financial transactions and interlocking directorates, integrating the so-called '*grupos financieros*' (financial groups), which in many cases were, in turn, part of larger economic groups or business conglomerates.[5]

Two private banks emerged as the major financial institutions of the country during the period of reconstruction and consolidation of the modern Mexican banking industry. One was Banco Nacional de México, otherwise known as Banamex. Established in 1884, as a result of the merger between Banco Mercantil Mexicano and Banco Nacional Mexicano, the bank had acted as the main financial agent of the government of Porfirio Diaz with important monetary functions. It was reconstructed after the revolution under the command of the Legorreta family, expanding its network of branches all over the country and becoming a leading institution of the banking sector. The bank was at the head of Grupo Banamex, one of the largest financial groups of the country, which included Financiera Banamex, the second investment bank of Mexico, along with other financial institutions, such as the mortgage bank Financiera de Ventas Banamex or the insurance company Seguros América Banamex. During this period, even when they were minority shareholders, the Legorreta family kept the Directory of the bank and the control of the administration of the group.[6]

[5] On the relation between business groups and banks, see Gustavo del Angel, 'The Nexus Between Business Groups and Banks: Mexico, 1932–1982', *Business History* 58 (2016), 111–28; Ruber Chavarin Rodriguez (Ed.), *Banca, grupos económicos y gobierno corporativo en México* (Mexico City, 2010); Nora Hamilton, *México: los límites de la autonomía del Estado* (Mexico City, 1983).

[6] Banco Nacional de Mexico (2004). *Banco Nacional de México: su historia, 1884–2004.* Leonor Ludlow, 'La formación del Banco Nacional de México: aspectos institucionales y sociales,' in Leonor Ludlow and Carlos Marichal (Eds.), *La Banca en México, 1820–1920* (Mexico City, 1998), 142–80.

Banco de Comercio, also called Bancomer, was the other leading commercial bank in Mexico. Created during the early 1930s in Mexico City, the bank would quickly expand its activities to the national level, becoming a major actor in the banking industry and the main competitor of Banamex.[7] In 1955, Manuel Espinosa Yglesias came to the Presidency and centralized the corporate control and management of the bank and its affiliates in his figure. He then founded Financiera Bancomer along with the mortgage bank Hipotecaria Bancomer and the insurance company Aseguradora Bancomer, and later on the leasing company Arrendadora Bancomer and the brokerage house Casa de Bolsa Bancomer, becoming the second largest financial group in the country. Grupo Bancomer, as was also the case for Grupo Banamex, was not controlled by any other specific group or economic conglomerate, an atypical situation since most of the banks in the country maintained a close relationship with larger proprietary groups. They had, however, ownership links with other companies or industrial groups through cross-holding of equity stakes and interlocking directorates.

Mexico's third largest commercial bank was Banca Serfin. Created in 1977, the bank resulted from the merger of Banco de Londrés y México, the oldest Mexican commercial bank founded in 1864, with three other regional banks and *financieras* that were part of Grupo Serfin. This financial group was associated with Grupo Alfa and CyDSA, the two largest industrial groups in Mexico, which in turn belong to a network of larger business conglomerates in northern Mexico, the Grupo Monterrey, under the control of the Garza Sada family. The Banco Comercial Mexicano, that would later become Multibanco Comermex, was another large bank established in the post-revolutionary period to fulfill the needs of a particular economic conglomerate, the Grupo Chihuahua of the Vallina family, of which it became the leading financial arm. A similar relationship existed, for instance, between Grupo Peñoles and Banca Cremi, ICA and Banco del Atlántico, and Vitro and Banpais, in which the banks were at the center of the financial units of the group that usually included several others financial intermediaries.[8]

During the post-war era, as Mexico entered into a period of sustained economic growth, the banking sector grew and gradually consolidated its

[7] Gustavo del Angel, *BBVA-Bancomer. 75 años de historia* (Mexico City, 2007).

[8] Chavarin Rodriguez, *Banca*, 33–55.

position in domestic financial intermediation. Between 1974 and 1970, as documented by Gustavo del Angel, the number of financial firms and branches increased considerably, an expansion that was particularly remarkable in the case of commercial banks and *financieras*.[9] The development of the banking sector came along with an increasing amalgamation of financial firms and a reconfiguration of their links with business groups and economic conglomerates. This process of consolidation and integration of intermediaries within financial groups, which were recognized as distinct legal entities in December 1970, led to increasing integration and concentration of the banking industry into a small number of larger institutions. This process was strengthened with the multiple bank reform of the mid-1970s and the promotion of mergers among domestic financial institutions by Mexican authorities, which resulted in a reduction of the number of banks in the system and the consolidation of the leading position of the country's largest banks.[10]

As for international financial institutions, their activities and participation in the Mexican banking market were strictly limited by the law. Unlike during Porfirian times when foreign banks have a strong presence in Mexican finance, the system reconstructed in the aftermath of the revolution was almost entirely national. With the Law of Banking Institution of June 1932, foreign banks were legally prohibited from having branches and operating in Mexico, although they could maintain representative offices. Citibank was the main exception with full branch facilities and commercial banking activities in the country. The presence and activities of foreign banks nevertheless remained relatively discreet until the late 1960s, when they began to open offices and engage in lending activities in Mexico.[11] The number of representative offices of foreign banks expanded vigorously in the 1970s, growing from 26 in 1969 to approximately 140 in the late 1970s.[12] Although not permitted to collect savings from the public they, could associate with national banks and leverage this network of correspondent banks to conduct business in Mexico.

[9] Del Angel, 'Paradoxes', 88–92.

[10] Ibid., 152–201.

[11] Edmundo Sánchez Aguilar, 'The International Activities of U.S. Commercial Banks: A Case Study: Mexico', Unpublished PhD diss., Harvard University, 1973; Del Angel, 'Paradoxes', 139–48.

[12] Sylvia Maxfield, *Governing Capital: International Finance and Mexican Politics* (New York, 1990), 98.

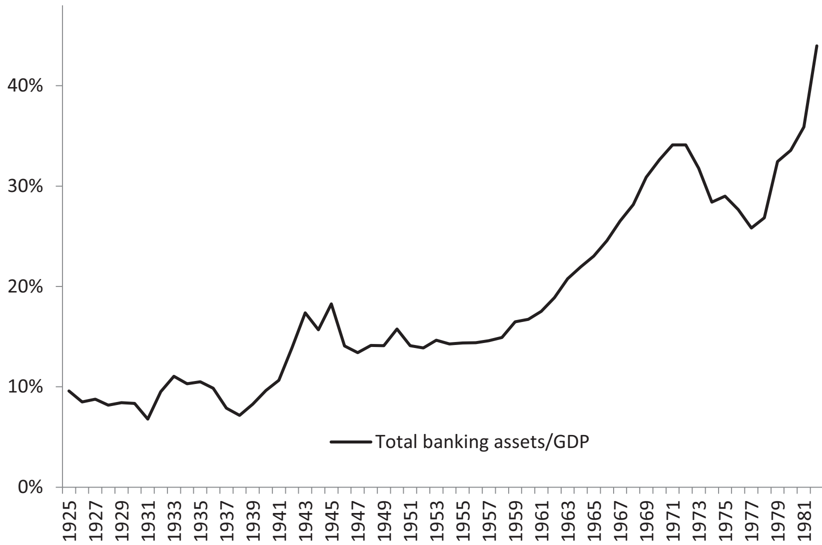

Fig. 2.1 Evolution of the Mexican banking sector, 1925–1982 (*Source* INEGI, *Estadísticas Históricas de México* [Aguascalientes, 1985])

The Financial Disintermediation Years

Following its redesign and reconstruction in the post-revolutionary decades, the Mexican banking sector entered a new phase of growth and increasing penetration in the domestic economy. Figure 2.1 shows the extent to which the banking industry developed and enlarged its financial activities during the postwar period. Between the late 1950s and early 1970s, at a time when the Mexican economy experienced a remarkable expansion, the banking sector deeply penetrated the national economy and strengthened its role in the economic development of the country. While in 1958, total assets of private financial intermediaries represented approximately 15% of the GDP or US$1.5 billion, by the end of 1972 they reached as much as 34.1% or US$15.3 billion.

The rise of Mexican banking activities came, however, to a halt in the early 1970s. After the historic peak in 1972, the total assets of the banking system progressively diminished as percentage of the GDP until 1977 when it reached 25.8%. The shrinking of banking assets in the national

economy was part of a broader trend in Mexico toward a reduction of intermediation levels within the domestic financial system, a phenomenon that Mexican scholars have identified as the "financial disintermediation process".[13] At an aggregate level, while total financial assets of the public and private sectors represented 27.4% of the GDP in the period 1960–1965, reaching 35.6% in 1966–1970 and up to 43.5% in 1972, they started to fell since then until about 30% in 1977.[14] For commercial banks, as well as the other financial institutions, the reduction of the holding of financial assets by the Mexicans private and public sector in relation to the evolution of the economic activity meant a contraction of their financial intermediation capacities.

In effect, the collection of deposits by the commercial banking system as a percentage of the Mexican GDP grew up to 1972 and decreased afterward. Computations by José Manuel Quijano show that during the period from 1956 to 1960 and 1964 to 1970, while commercial banks' domestic funding increased, respectively, by 10.2 and 18.1% annually in real terms, the average annual growth rate between 1971 and 1978 was a much more modest 1.7%.[15] In similar lines, Edward Buffie and Allen Sanginés-Krause estimate that the total stock of real bank funds fell 13.3% from 1973 to 1976.[16] By 1971–1972, about 93% of the banks' funding base consisted of local deposits and savings from the private and public sector, 4% were transactions between domestic financial institutions and the remaining 3% was made up by other domestic liabilities.[17] In a context where the Mexican economy expanded at an annual rate of

[13] See, in particular, José M. Quijano, *México: estado y banca privada* (Mexico City, 1987), 170–80, and 'El financiamiento al sector industrial: diagnóstico y propuesta de política', *Investigación Económica* 43 (1984), 137–97; Edgar Ortiz, 'La banca privada en México: formación de capital y efectos de la inflación-devaluación', *Comercio exterior* 31 (1981), 27–38.

[14] María E. Cardero, José M. Quijano, and José L. Manzo, 'Cambios recientes en la organización bancaria y el caso de México,' in José M. Quijano (Ed.), *La banca: pasado y presente* (Mexico City, 1983), 161–220.

[15] Quijano, *Estado y banca*, 177.

[16] Edward Buffie and Allen Sanginés-Krause, 'Mexico 1958–86: From Stabilizing Development to the Debt Crisis,' in Jeffrey D. Sachs (Ed.), *Developing Country Debt and the World Economy* (Chicago, 1989), 141–68.

[17] Banco de Mexico, 1972 Annual Report, Table 20, 73.

5.6%, this liability structure and weak fundraising performance implied a relative decline in the financial resources available to banks.

Archival records from Banamex, the institution responsible for about a quarter of the deposit base of the banking system, witness the difficulties that banks confronted in terms of domestic financial resources. During their weekly Wednesday meetings, the members of the Executive Committee discussed about the financial situation of the bank and periodically addressed the issue of the evolution of its funding base. As of August 1971, Banamex's General Director Agustin Legorreta reported that "[their] cash resources [were] nearly exhausted and that given the slow uptake of resources it [was] not possible that the situation [could] improve in the near future." He also mentioned that "the situation was not exclusive to [their] bank, but general to all the credit institutions of the country, particularly affecting small institutions, which have been failing to meet their legal deposits."[18] During the next years, the fundraising difficulties of the banks worsened, becoming a matter of considerable concern also for the national financial authorities, who reformed the Banking Law in December 1973 as to authorize Banco de Mexico to "equip the Mexican banking system with more and more flexible fundraising instruments." The purpose was, as its General Director Fernández Hurtado stated, to "provide domestic savers with a wider range of investment opportunities (…) and try to encourage fundraising (…) giving the Mexican banking system a more competitive position."[19]

The causes of the bank's domestic fundraising problems are to be found in the inflationary process that the country experienced along with the interest rate policy followed by the central bank. After a long period of relative price stability during the so-called era of "stabilizing development"—*desarrollo estabilizador*—between 1954 and 1972, inflation started to grow in the early 1970s and became a real problem since 1973. Inflation rates, which had oscillated between 2 and 5% during the 1960s, passed from 5.6% in 1972 to 21.4% in 1973 and to 20.7% in 1974 and kept at high levels over the following years. The devaluation of the US dollar after the end of Bretton Woods and the rise of the price of oil and other raw material products along with domestic factors,

[18] Banamex archive, Libro No. 2 de Actas de la Comisión Ejecutiva, August 11, 1971 Meeting.

[19] Banco de Mexico archive, Acta No. 2406, February 1974.

such as expansionary monetary and fiscal policies and some bottlenecks in the production structure, generated significant inflationary pressures in Mexico. In addition, unlike during the stabilizing development years, the fiscal and monetary policies adopted by the Echeverria and Lopez Portillo administrations between 1972 and 1982 were highly expansionary, fueling demand and the climb up of prices.[20]

For commercial banks, high and rising inflation was a problem to the extent that they were not allowed to adjusting interest rates on deposits and saving instruments upwards. In Mexico, as in many other Latin American countries, this was a period of heavy financial regulation, or domestic *financial repression*, and interest rates were not market-determined, but instead, established by the monetary authority. During the period of stabilizing development, when inflation was low, Banco de Mexico adjusted interest rates from time to time on an irregular basis as to maintain real deposit rates at positive levels. The management of interest rates did not change, however, in the new context of increasing inflation of the early 1970s. Nominal rates were only occasionally modified and with delay, remaining fixed for long periods, which implied that real interest rates became usually negative. Figure 2.2 shows this shift with nominal interest rates consistently below inflation rates after 1972, the last year with positive real interest rate. Negative real yields discouraged the public from saving and placing deposits with the banking system, thereby eroding its funding base and intermediating capacity.

A main implication of the fundraising difficulties confronted by the banks was the deterioration of their lending capacities. The ability of banks to lend was additionally affected by the changes introduced by Mexican financial authorities in reserve requirement regulations, which was one of the most important instruments of monetary policy in Mexico. Several increases to the reserve ratios were indeed passed by Banco de Mexico between 1970 and 1976 in order to mitigate the inflationary effects of a monetary base under continuous expansion.[21] Besides, since end-1975 and early-1976 the banking system experienced a considerable growth of the dollar-denominated liabilities, which were

[20] Carlos Bazdresch and Santiago Levy, 'Populism and Economic Policy in Mexico, 1970–1982,' in Rudiger Dornbusch and Sebastian Edwards, *The Macroeconomics of Populism in Latin America* (Chicago, 1991), 223–62.

[21] See, for instance, Banco de Mexico archive, Acta No. 2410, October 1974.

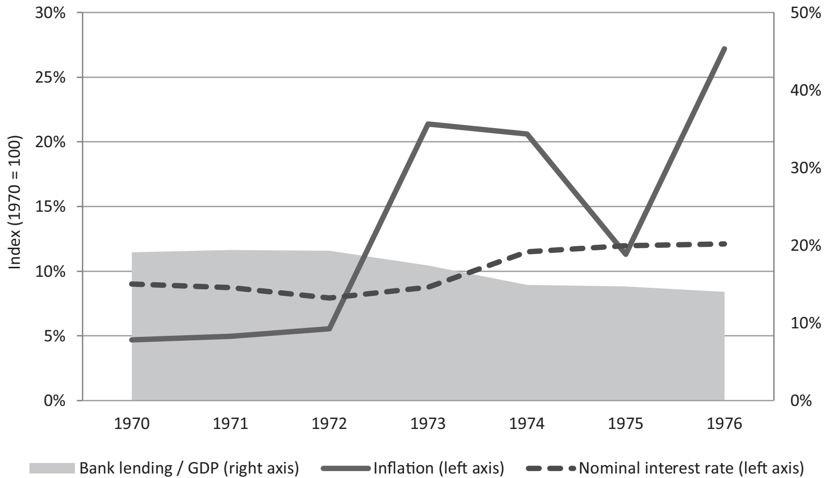

Fig. 2.2 Bank lending and real interest rates, 1970–1976 (*Source* Banco de Mexico's, Annual Reports [several issues])

subject to higher legal reserve requirements and thereby further contributed to the reduction of loanable funds.[22] As a result of these events, as represented in Fig. 2.2, the credit portfolio of the banks passed from representing around 19.1–19.4% of the GDP between 1970 and 1972 to 17.4% in 1973 and 14% by end-1976, a loss of 25% or 5 percentage points of the GDP in only four years.

For Mexican banks, as Banamex' General Director pointed out, the lack of funding was exacerbated in a context in which the demand for credit that banks faced from both the government and the private sector was raising. On the one hand, "many clients that [had] not normally used their credit lines [were] making use of them and others that normally did not resort to credit [were] demanding and it [was] difficult to deny it when they [had] kept strong deposits [in the bank] for years." On the other hand, "the public sector [was] increasingly urged of funds for the accomplishment of its projects and [was] exerting strong

[22] Banco de Mexico archive, Acta No. 2422, April 30, 1976.

pressures on the credit institution for obtaining them."[23] In acknowledgment of this situation, Banco de Mexico opened a rediscount line to commercial banks with "the purposes of, in the first place, reactivating the economy, and second, to compensate [them] for the lack of growth of the deposits."[24] This program, however, would not be enough to meet the strong demand for credit in Mexico, and Banamex as well as other commercial banks had to eventually restrict their lending.

Bank Finance and Development

The diminishing lending capacities and broader retrenchment of the domestic banking sector were problematic within a framework of strong expansion in the domestic economy. As of the early 1970s, Mexico was transiting a process of steady and long-term economic growth that had started in 1935 after the period of reconstruction and reorganization that followed the revolution of 1910. During those years, the country passed from being an agrarian and rural economy into a predominantly urban and industrial one, and domestic commercial banks, along with the national development banks created during the decades of the 1920s and 1930s, had an important role in the transformation.[25] This process was imbedded in the developmentalist strategy and import-substitution industrialization (ISI) policies of the Mexican government, as part of what Luis Bértola and José Antonio Ocampo call the state-led industrialization development, and financing was a crucial element of the program.[26]

Indeed, the years of the Echeverria presidency during the first half of the 1970s were of particularly strong economic growth. Following a brief slowdown of economic activity in 1971 due to temporary contractionary

[23] Banamex archive, Libro No. 2 de Actas de la Comisión Ejecutiva, August 11, 1971 Meeting.

[24] Banamex archive, Libro No. 2 de Actas de la Comisión Ejecutiva, November 3, 1971 Meeting.

[25] See, for example, Enrique Cárdenas Sánchez, *La política económica en México, 1950–1994* (Mexico City, 1996), and *La hacienda pública y la política económica 1929–1958* (Mexico City, 1994); Rafael Izquierdo, *Política hacendaria del desarrollo estabilizador, 1958–70* (Mexico City, 1995).

[26] Luis Bértola and José A. Ocampo, *The Economic Development of Latin America Since Independence* (London, 2012).

measures, the Mexican GDP expanded by 8.5 and 8.4% in 1972 and 1973, respectively, and at an average growth rate of 5% during the period 1974 and 1976. This was a period of substantial aggregate demand increase underpinned by dramatic expansionary fiscal and monetary policies. In a context of a popular rejection to the economic strategy of the stabilizing development, the Echeverria regime adopted a "share development" approach based on an increasing participation of the government in the economy to improve income distribution and the development of areas where private investment was not forthcoming.[27] Between 1972 and 1976, current expenditure by the public sector grew at an average annual rate of 14.2% in real terms and the share of total public expenditure in the GDP increased from 22.9 to 32% over the period.

The flip side of the vigorous expansion of the Mexican public sector was the increasing need for funding. A salient feature of this process was that, despite a small one-percent-rise of the sales tax rate at the beginning of the Echeverria administration, the increase of public expenditure occurred without passing any significant tax reform.[28] Between 1970 and 1976, the revenues of the Mexican public sector grew from 18.9 to 23.8% of the GDP and about two-thirds of this increase came for oil, which became an important source of revenues for the Mexican government with the rise of exports in the 1970s. This increment in revenues was, however, insufficient to match the buildup in spending previously described, which is reflected in the increasing fiscal imbalance experienced by the public sector. The fiscal deficit climbed from 2.3% of the GDP in 1971 to 6.3% in 1973, reaching as much as 9.3 and 9.1% by 1975 and 1976, respectively. Part of these deficits was financed by borrowing from Banco de Mexico as well as through the seigniorage revenues derived from escalating inflation, but it also entailed an increase of the demand for credit from other sources and financial institutions.

The domestic banking sector was an important provider of fund for the Mexican public sector. At that time, there were not Treasury bonds in Mexico—*Certificados de la Tesorería* or Cetes would be introduced toward the end of the decade, and the main mechanism that the government used to access public savings was through the legal reserve requirement system, which consisted of a very complex regulation

[27] Bazdresch and Levy, 'Populism and Economic Policy', 237–46.

[28] Ibid.

structure with different fundraising instruments subject to different ratios or coefficients. The funds that the banks set aside and deposited with Banco de Mexico where then channeled to specific credit programs according to regulatory procedures or lent to the Treasury to finance the public-sector deficit. However, in the midst of the financial disintermediation process and the poor performance of bank deposits of the post-1972 years, the reserve channel provided virtually no additional resources despite the fact that the ratios increased by about 63.2% on average over the period.[29] On the contrary, the funds available to finance the government through the reserve requirement system decreased since 1973, both in real terms and as a share of the GDP.[30]

Under such circumstances, the Mexican government was to increasingly seek for more direct financial assistance and credit lines from the domestic banking sector. By way of example, in August 1973, Legorreta reported a conversation with Banco de Mexico's General Director Fernández Hurtado concerning the financial needs of the Federal government, which were estimated in 2 billion pesos (approximately US$160 million) for the rest of the year. After dismissing the possibility of increasing reserve requirements, Fernández Hurtado requested financing from the banks, to which Legorreta proposed to prorate this amount among the six largest banks of the country. He requested the authorization of the Committee to confirm the contribution of Banamex—estimated in about 500 million pesos or US$40 million, indicating that "on the one hand it represent[ed] serious problems [for Banamex], but, on the other, not accepting could lead the country to other more serious consequences."[31] At a sector level, credits to the government doubled its participation in the loan portfolio of the banking system from 24.2 to 41.9% between 1970 and end-1976, which illustrates the heightening role of domestic banks in financing the public sector.[32]

However, the lending capacities of a banking sector in funding difficulties were to prove largely insufficient to meet the overwhelming financial needs of the Mexican economy. On the one hand, the flow of bank lending to the government as a share of the GDP increased between

[29] Buffie and Sanginés-Krause, 'Mexico 1958–86', 146.

[30] Quijano, *Estado y banca*, 143–52.

[31] Banamex archive, Libro No. 5 de Actas de la Comisión Ejecutiva, August 29, 1973 Meeting.

[32] Banco de Mexico, Annual Reports (several issues).

1970 and 1973 when it reached its maximum value of 6%, decreasing during the following years up to 4.7% in 1976. In real terms, after a last increase in 1973, bank lending to the Mexican government fall between 1973 and 1976 at an average annual rate of 4%.[33] On the other hand, although the public sector was the largest demander of funds during this period, banks also faced a rising demand for credit from the private firms. Within a process of strong economic growth, the business opportunities and investment needs of the non-public sector also grew, with many of the most important private companies and business groups of the country, such as VISA or the Alfa Industrial Group, considerably expanding their scale of operations and indebtedness levels.[34]

In the context of rising demand for credit and insufficient domestic supply, the financing that domestic banks were not able to provide came to be supplied from abroad. Data on public external debt compiled by Rosario Green shows that the recourse to foreign borrowing by the Mexican government started to accelerate vigorously beginning in 1973. While between 1970 and 1972 the Mexican public sector had raised US$2.08 billion in the international capital markets, in 1973 alone, it borrowed US$2 billion, and as much as US$12.5 billion during the following three years.[35] In other words, in each successive year between 1973 and 1976, the Mexican public sector took on five times more foreign loans than during the entire 1970–1973 period. Figure 2.3 plots the amounts borrowed by the Mexican government abroad along with the evolution of the GDP and the ratio of domestic bank lending to GDP measured in terms of index. The chart makes evident the increasing recourse to foreign finance as opposed to the decreasing lending capacity of domestic banks and high economic growth in Mexico.

The bulk of the foreign financing that flowed into Mexico came from international banks operating in the Euromarkets. Although the country had been borrowing abroad prior to the early 1970s, the boom in international lending began in earnest, as Fig. 2.3 illustrates, at the

[33] Quijano, *Estado y banca*, 143–52.

[34] Roberto Gutierrez R., 'El endeudamiento del sector privado de México. Expansión y negociación', *Comercio exterior*, 36 (1986), 337–43.

[35] Rosario Green, *Lecciones de la deuda externa de México, de 1973 a 1997: de abundancias y escaseces* (Mexico City, 1996), Table I.12, 42. See also Romeo Flores Caballero and María de los A. Moreno, 'El endeudamiento externo de México, 1970–1974', *El Trimestre Económico* 43 (1976), 805–17.

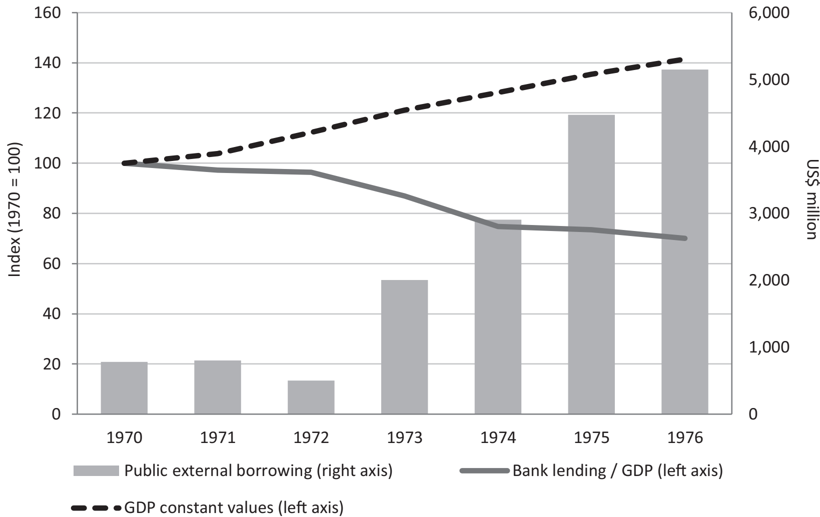

Fig. 2.3 Economic growth and domestic versus external financing (*Source* GDP and Bank lending: Banco de Mexico's, Annual Report [several issues]; Public external borrowing: Green, *Lecciones de la deuda externa* [see text])

time of the oil shock of 1973 and took off of the petrodollar recycling process. Mexico was an attractive destination for international commercial banks, not only because of its impressive record of economic growth over the last decades, but also because of its political stability under the PRI party and the monetary discipline reached during the previous stabilizing development regime. In addition, important oil fields had been discovered after 1972, allowing the country to pass from being a net importer of crude and its derivatives to become a net exporter by 1975, which reinforced the confidence of foreign investor in Mexico as a creditworthiness borrower. The radical change and increase in the supply of foreign funds to Mexico along with a strong demand of credit and the lack of domestic bank funding converged to mark a turning point in the country's external indebtedness process as of 1973.[36]

[36]See Secretaria de Hacienda y Crédito Público, *Deuda Externa Pública Mexicana* (Mexico City, 1988).

The Decision to Internationalize

The increasing role of international commercial banks in lending to Mexico became an important threat for the domestic banking industry. The high amounts of petrodollar liquidity available to banks operating in the Euromarkets that could be lent to clients in developing countries led to an increase in competition with new foreign players entering into a domestic market eager for financing. For Mexican banks, which were in the phase of financial disintermediation, the increase in competition implied the possibility of a loss of market share to foreign institutions in terms of lending to both the public and private sectors. In the case of leading domestic commercial banks like Banamex and Bancomer, which were at the head of the most powerful financial groups of the country, this situation did not only affect lending interests but their economic and business position more generally.

The archival records of Banamex provide a clear illustration of how Mexican bankers perceived and reacted to the new environment. In early 1972, there were already some important worries among the members of Banamex's Executive Committee about the lending difficulties of the bank in a context of increasing supply of credits from foreign banks. As Agustin Legorreta explained to his colleagues, "with the economic development of the country and the constant creation of big industrial companies, such as Fundidora de Hierro y Aceros de Monterrey S. A., Celanese Mexicana S. A., Industria Eléctrica de México S.A. and others, more and more often we found ourselves faced with the impossibility of meeting the demand for credit with domestic resources."[37] In the eyes of Legorreta, the weak lending capacity of the bank was problematic because foreign banks were ready to provide the funding the country was demanding to finance its economic development in considerable amounts and at more competitive rates. Additionally, unlike domestic lending, international loans were not regulated and thereby foreign banks enjoyed from much greater flexibility to grant credits than Mexican banking law allowed to the institutions operating inside the country.

[37] Banamex archive, Libro No. 3 de Actas de la Comisión Ejecutiva, February 9, 1972 Meeting.

Under such circumstances, the alternative available to Mexican banks was to turn towards the international capital markets and looked to what their foreign counterparts were doing. Banamex, a pioneer and leading institution in Mexican international finance, had had a first experience in international lending and Euromarket deals already in the early 1970s. In 1971, it participated with US$2 million in a syndicated Euroloan of US$100 million to Nafinsa and Banobras, the two big Mexican development banks. The credit was jointly granted with N. M. Rothschild & Sons, Rothschild Intercontinental Bank and Bancomer, the other leading Mexican bank involved with foreign finance.[38] In September of that year, Banamex's Executive Committee approved the participation of the bank, up to a maximum of US$1 million, in a new syndicated deal of US$20 million to Banobras, an operation arranged and managed by Bank of London and South America (BOLSA). Banamex was the only Mexican institution invited to take part of this deal, and the Committee considered that, for reputational reasons, it was important to participate in this kind of operations with foreign institutions to finance the public sector.[39]

However, to face competition from foreign banks and to engage in international lending, Mexican banks needed a volume of funds that they could only find abroad, namely in the Eurocurrency markets, and that required for international presence. Up to that point, as Agustin Legorreta explained, "all the businesses in which Mexican banks have intervened to finance large companies in the country with resources from abroad have been promoted and arranged by large American banks such as the Chase Manhattan Bank and the Bank of America," and "Mexican banks [were] undoubtedly not in a position to displace those large foreign banks, and [had] to limit themselves to taking small shares in these operations." To him, "the economic development of the country made Mexican banks feel the increasing need to turn the eyes toward the international currency markets, because if they do not intervene in them, they would be condemned to be a mere supplement to foreign

[38] Banamex archive, Libro No. 2 de Actas de la Comisión Ejecutiva, September 22, 1971 Meeting; Sergio Negrete Cárdenas, 'Mexican Debt Crises: A New Approach to Their Genesis and Resolution', Unpublished PhD diss., University of Essex, 1999, Table B14, 361.

[39] Banamex archive, Libro No. 3 de Actas de la Comisión Ejecutiva, September 22, 1971 Meeting.

banks."[40] It is within this particular juncture of poor domestic funding and rising competition from foreign banking institution that Mexican banks decided to go abroad and step into the Euromarkets.

Banamex's Executive Committee considered three possible ways to enter and intervene in the Eurodollar market. A first possibility was to open a branch or an agency of the bank in London, the home of the Eurocurrency money markets and the operational center of the petrodollar recycling activities. The second one was to organize an independent banking institution in London under the direct control of the bank. Finally, there was the option to associate with other European and American banks to create an institution, namely a multinational or consortium bank, in which Banamex held an important share. To Legorreta, this seemed the most convenient solution because of the advantages that working together with large international banks represented in terms of network and reputation, which would facilitate the access to the Eurocurrency markets.[41] At an international level, Banamex was not big and experienced enough as to expect to raise foreign liquidity on its own, and an associated bank was seen "as an instrument for intervening in the international money markets and so to be able to complement [their] supply of services and serve both the public and private sector of the country."[42] In the following months, the Executive Committee commissioned Alejandro Medina Mora and Agustin Legorreta himself to travel to the USA and Europe, and meet with representatives from the world's largest banks, such as Rothschild, Bank of America, Deutsche Bank among others, to discuss about the possibility of participating as shareholders in the project of a multinational bank.

Opening a multinational bank and getting involved with foreign finance required, however, the approval, or at least the consent, of Mexican authorities. By that time, the participation of domestic banks in the international capital markets was not regulated, but the Federal government saw with "good eyes" (sic) the intervention of Mexican banks

[40] Banamex archive, Libro No. 3 de Actas de la Comisión Ejecutiva, February 9, 1972 Meeting.

[41] Ibid.

[42] Banamex archive, Libro No. 5 de Actas de la Comisión Ejecutiva, June 20, 1973 Meeting.

in the international capital markets.[43] To the knowledge of Legorreta, the SHCP have been also considering the possibility of creating a consortium bank, similarly to the European Brazilian Bank (Eurobras) founded by the Brazilian government, with the joint participation of official and private banking institutions.[44] In fact, by that time Nafinsa, which was the main development bank of the Federal government, had already established contacts with the Deutsche Bank and other international banks to discuss a similar project. According to Legorreta, the presence of Mexican banks in the Euromarkets was desirable for the government because that could help to support the secondary markets of Mexico's international debt, which up to then had been only deficiently managed and with only occasional participation of Mexican institutions, but it also represented an access to direct or syndicated loans to finance its fiscal deficit and economic development program.

Over the following years, the Mexican government and financial authorities passed some important measures to formalize and legally frame the increasing international activities of domestic banks. In this regard, a salient feature of the current banking legislation as of the early 1970s, was the absence of any specific provisions about the activity of Mexican financial institutions in foreign markets, either regarding the opening of branches or associated entities or with respect to asset and liability operations with residents abroad. In this regard, the banking reform of 1974 introduced important changes, as Banking Law Professor Francisco Borja Martinez explains, by explicitly contemplating, and thereby recognizing, the possibility that domestic banks could participate in the capital stock of foreign financial institutions and open agencies and branches upon receiving authorization from the SHCP.[45] This amendment to the legislation empowered Mexican banks willing to expand their business abroad and to gain international presence and deeper engagement with the Euromarkets.

[43] Banamex archive, Libro No. 3 de Actas de la Comisión Ejecutiva, February 9, 1972 Meeting.

[44] Banamex archive, Libro No. 3 de Actas de la Comisión Ejecutiva, August 9, 1972 Meeting.

[45] Francisco Borja Martínez, 'Desarrollo del derecho bancario mexicano (1968–1977),' in *Jurídica. Anuario del Departamento de Derecho de La Universidad Iberoamericana,* Tomo I (1978), 414–37, esp. 431–34.

These changes aligned with other measures taken by the Mexican financial authorities at that time that tended to liberate the domestic financial sector. In their study on the legislation regarding the domestic financial system and capital account transactions, Graciela Kaminsky and Sergio Schmukler find that between 1973 and 1974 Mexico passed from a repressed regime to a rather liberalized one.[46] In terms of the capital account, the process of liberation included a relaxation on offshore borrowing by domestic financial institutions and non-financial corporations. As for the domestic financial sector, there was a softening of the regulation on interest rates, the allocation of credit as well as a simplification on the reserve requirement system used to control bank lending. Deregulation continued in the following years through the permission to operate with foreign currency deposits—the so-called mexdollars—and increases on dollar borrowing and lending limits. The introduction of multipurpose banking in 1975, which will be addressed in further detail in Chapter 3, was a step forward because it lifted regulations that had previously pushed specialized financial institutions to operate in a single financial market, providing banks with greater flexibility in their intermediation activities.

Mexican Consortium Banks

The outcome of the multinational bank project launched by Banamex in early 1972 was the creation of the International Mexican Bank Limited in London in April 1974. Intermex, as it was known, took the legal form of a consortium bank and its main purpose, as stated in the advertisements published in the newspapers and financial press after its inauguration, was to attract investments and provide international financial services to Mexico as well as other Latin American countries.[47] As most of the consortium banks actives in London at that time, its operational base was the Euromarket and their main activities, which consisted of granting credits to the private and public sector, marketing of commercial paper, and security underwriting, were largely of international nature.

[46] Graciela L. Kaminsky and Sergio L. Schmukler, 'Short-Run Pain, Long-Run Gain: Financial Liberalization and Stock Market Cycles', *Review of Finance* 12 (2003), 253–92.

[47] See, for instance, *The Ottawa Citizen*, April 8, 1974, 11.

The bank was created with a paid-up capital of £2.5 million—about US$ 6.25 million, which was subscribed by seven partner banks from six different countries. Banamex was the main shareholding bank with 38% of the shares, followed by Bank of America and Inlat (DESC Industrial group) with 20 and 13%, respectively, and Deutsche Bank, Union Bank of Switzerland (UBS), Banque de France et Pays Bas (Paribas), and Dai-Ichi Kangyo Bank Ltd.—the largest bank in Japan—with 7.25% each. While Banamex provided with background and experience about Mexican borrowers, the other shareholders contributed by opening money markets in their home countries and London. The chairman was Agustin Legorreta from Banamex and the appointed Managing Director was Gerard Legrain, a 37-year-old French banker based in London since 1972, who had previously worked for Citibank and spent some time in Mexico as part of his professional career. The position of Deputy Managing Director was occupied by another Banamex official, Francisco Willy, who had acted as commissioner for starting up the company and developing a network of contacts among bankers in the City. As for the Executive Commission, which was the decision-making body of the institution, it was composed by one representative from each of the shareholders, and Saúl Carreño was the representative of Banamex.[48]

Over the next few years, Intermex managed to significantly expand its business and became indeed an important actor in international lending to Mexico. At the end of 1974, its first year of operations in London, the total assets of the bank reached £19.6 million, climbing up to £59.3 million by end-1975 and as much as £149.1 million in 1976, which represents a 7.6-time increase in only two years (see Table 2.1). Although engaged in the underwriting of Mexican issues on the international bond markets and the trading of Mexico's international debt on the secondary markets, the principal activity of Intermex consisted in the arrangement of, and participation in, Eurolending or syndicated credits to the Mexican government and private companies. In terms of resources, their liabilities passed from £17.1 million in 1974 to £54 million in 1975, of which 15% consisted of deposits from clients while the remaining 85% were funds raised in the international money markets through interbank transactions with other Euromarket participants. Such strong expansion of the lending and borrowing activities of the bank eventually

[48] Banamex archive, Libro No. 6 de Actas de la Comisión Ejecutiva, April 17, 1974 Meeting.

Table 2.1 Finances of Mexican consortium banks, 1972–1976 (£ million)

	1972	*1973*	*1974*	*1975*	*1976*
Libra Bank					
Total assets	n.a.	110.6	142.6	172.5	273.9
Capital & Reserves	n.a.	6.6	7.6	9.2	10.8
Pre-tax profit	n.a.	0.6	2	3	4.2
Dividend	n.a.	0	0	0	0.4
Intermex					
Total assets			19.6	59.3	149.1
Capital & reserves			2.5	5.3	6.4
Pre-tax profit			0.1	0.7	2.2
Dividend			0	0	0
Eulabank					
Total assets			n.a.	42.3	103.7
Capital & reserves			n.a.	8.8	10.2
Pre-tax profit			n.a.	0.7	1.8
Dividend			n.a.	0	0

Note 'n.a.' indicates not available
Source Roberts, *Take Your Partners* (see text)

required new contributions from shareholder banks to increase in its capital base, which doubled from £2.5 to £5 million between 1974 and 1975.

The growth of Intermex entailed the expansion in the volume of businesses but also the returns that it earned. Pre-tax profits were not spectacular the first year, but they reached £742 thousands in 1975 and increased to as much as £2.1 million in 1976, which represented a return on assets of about 1.5%. Although modest in terms of assets, Intermex profits were significantly more attractive when compared to the capital contribution made by the partner banks. As Alejandro Medina Mora explained to the members of the Banamex's Executive Committee when looking for further support and the approval of a new increase in its capital base, the bank "has generated resources for its partners, in addition to the fact that it has been operating successfully, since with a capital of 5,000,000.00 pounds sterling last year it closed with a profit of 1,100,000.00 pounds sterling."[49] In light of these results, Banamex's Committee would not only accept an increment of the capital base of

[49] Banamex archive, Libro No. 10 de Actas de la Comisión Ejecutiva, January 5, 1977 Meeting.

Intermex in London but eventually agreed to the opening of associated banking entities in the other financial centers.

In 1977, the shareholding banks created Intermex International, a Nassau-based twin consortium bank with US$4.5 million of paid-up capital.[50] Together with its London counterpart, the two banks became part of the Intermex Group, a Luxembourg Holding Company, which also had an office in Mexico City. The restructuring of the company came along with some changes in its ownership, with Paribas and Inlat dropping out in 1977, and the Mexican government's development banks Nafinsa and Banco Nacional de Comercio Exterior buying 26% of the bank (13% each) in 1979. The shares of these development banks, along with the 25% of Banamex, gave Mexico a 51% controlling interest on Intermex. As for the other owner banks, Bank of America kept 20% of the shares, UBS and Deutsche 12% each and Dai-Ichi Kangyo Bank the remaining 5%.

Apart from Intermex, there were two other London-based consortium banks with Mexican ownership. In 1972, the Libra Bank had been founded by Bancomer (with 8% of the shares) in joint venture with Brazilian Banco Itaú and eight other developed countries' banks, which included Chase Manhattan—the largest shareholder and provider of the managing director, the Royal Bank of Canada, National Westminister, among others. The bank offered a full range of commercial and investment banking services through its headquarter in London as well as its network of offices in five Latin American countries and New York. Between its creation and the outbreak of the Latin American debt crisis of 1982, the bank experienced uninterrupted growth in its assets, which expanded at an average annual rate of 33.8%, and profits, which represented a return of about 2.2% on assets on average. Its principal activity consisted in making and granting loans to governments, public and private corporations and bank borrowers in Latin America. As of end 1973, it has managed or co-managed loans of more than £245 million and £342 million in 1974 mainly to Latin American countries and by 1982, Latin American sovereign debt represented as much as up to 75% of its assets.[51]

[50] 'Intermex Group', International Banking: A Survey. *The Economist*, March 4, 1978, 45.

[51] Richard Roberts, *Take Your Partners: Orion, the Consortium Banks and the Transformation of the Euromarkets* (London, 2001), 265–66.

Finally, there was the Euro-Latin American Bank or Eulabank, which was half-owned by Latin American banks and the other half belong to European banks. On the Latin American side, Banca Serfin was the Mexican representative with less than 6% of the shares, but there also banks from Colombia, Peru, Uruguay, Chile, Venezuela, Argentina, Brazil and, from 1979, Bolivia. The bank was set in 1974 to strengthen the economic ties between Latin American and Europe by providing long-term investment to meet the growing demand for finance in the region. Like Intermex and the Libra Bank, its principal activity was the arrangement of and participation in medium- and long-term Eurocurrency lending and project finance to Latin American public and private sectors.[52] With £42.3 million of total assets in 1975, the bank strongly expanded the volume of business up to £103.7 in 1976 and £160 million in 1977 and continued to grow over the following years up to 1982.

These consortium banks, and in particular Intermex, would take a predominant role during the upcoming years in channeling Eurocurrency liquidity to Mexico through international loans. Based on data collected from the World Bank's *Borrowing in International Capital Markets*, which compiles all publicized foreign loans on a year basis, José Manuel Quijano examined the involvement of Mexican banks in international lending to Mexico and found that between 1974 and 1978, Mexican banks participated in approximately one-third of the total credit raised by Mexican public and private sector borrowers in the syndicated Euroloan market both as leaders or associated members of the syndicate management group. Intermex was the bank with the largest involvement, taking part in a total of 15 syndicated lending operations to Mexico for an amount of about US$2.45 billion. On the other hand, the Libra Bank took part in 7 loans of US$1.7 billion, while the Eulabank had the lowest involvement in sovereign lending to Mexico, participating in only 4 operations of about US$400 million.[53] These figures represent the total amount of the syndicated operation and although do not show the specific contribution of the Mexican consortium banks to the loan, they give an indication of their relative importance and the role they had in intermediating foreign capital for borrowers in Mexico.

[52] Ibid., 252–53.

[53] Quijano, *Estado y banca*, 243–49.

Similar results can be derived from the dataset on Eurocurrency credits to the Mexican public sector constructed by Sergio Negrete Cárdenas. He covers the period 1973–1982 and draws on a number of additional sources that supplement the World Bank publication, such as the Euromoney database, the quarterly reports from the SHCP to the Congress, and the Tombstones published in the financial press, since none of them had a systematic record of all the lending operations carried out during the period. According to his database, Intermex participated in a total of 24 syndicated loans, of which 14 went to state development banks. It ranked at the fifth position in the list of more than 250 banks taking part of these lending operations to the Mexican public sector, just behind the top leaders Bank of America and Bank of Tokyo with 28 and the Bank of Montreal and Citibank with 27. On the other hand, the Libra Bank participated in 17 operations, ranking 17th among the leaders, and the Eulabank in only one loan in 1974.[54] These data show the preponderant role played by Mexican consortium banks, especially Intermex, when compared to other major international lenders to the Mexican public sector.

The Financial Fallout of 1976

As the end of his mandate approached, President Echeverria became confronted to an eventual balance of payment crisis. Since the beginning of the 1970s, and particularly after the oil price rise in 1973, the economy had been accumulating serious macroeconomic imbalances that made difficult to maintain the fixed foreign exchange policy followed by the Mexican central bank since 1955. On one side, the acceleration of inflation with a widening margin over that prevailing in the USA—the country's principal trading partner, led to an appreciation of the real exchange rate, which resulted in a deterioration of the trade balance and a widening deficit as observed in Table 2.2. On the other side, rising public deficit levels were accompanied by inflationary financing and a sharp increase of foreign indebtedness that contributed to the worsening of the current account. The combination of these factors, along with the dollarization of bank deposits and the wave of capital flights that developed in such a context, generated strong pressures against the peso.

[54] Negrete Cárdenas, 'Mexican Debt Crises', Table B17, 400–4.

Table 2.2 Mexico's macroeconomic indicators, 1972–1976

		1972	*1973*	*1974*	*1975*	*1976*
Real sector						
GDP (Bil. US$)		45.4	55.8	73.1	89.7	90.8
Growth rate (%)		8.5	8.4	6.1	5.6	4.2
Public sector						
Expenditure/GDP (%)		22.9	25.8	27.0	31.9	32.0
Revenues/GDP (%)		18.7	20.2	21.1	23.2	23.8
Fiscal deficit[a]/GDP (%)		–4.5	–6.3	–6.7	–9.3	–9.1
Monetary variables						
Monetary base (M1)[b] (AGR, %)		21.2	26.7	20.1	21.1	35.7
Money supply (M4)[c] (AGR, %)		17.9	14.1	18.1	26.8	14.2
Inflation (annual, %)		5.6	21.4	20.7	11.3	27.1
Interest rate	Nominal (YA, %)	7.9	8.3	10.4	11.0	10.0
	Real (YA, %)	2.3	−10.4	−8.0	−0.2	−12.1
Exchange rate	Nominal (YA, %)	12.5	12.5	12.5	12.5	15.4
	Real (1980=100)	103.2	101.3	111.3	114.3	104.4
International reserves (EY, Bil. US$)		1.4	1.5	1.5	1.6	1.4
External sector						
Trade balance/GDP (%)		–2.4	–3.3	–4.5	–4.1	–2.9
Current account/GDP (%)		–2.9	–3.2	–4.7	–5.0	–4.0
Capital account/GDP (%)		–0.3	0.9	2.1	1.8	1.6
Capital flight[d] (Bil. US$)		–0.6	0.7	0.8	0.9	3.0
Terms of trade (1972=100)		100.0	114.7	90.2	77.1	86.5
External indebtedness						
Public sector (Bil. US$)		4.8	6.8	9.7	14.6	20.8
Private sector (Bil. US$)		2.6	3.2	4.5	5.5	4.9
Commercial banks (Bil. US$)		0.0	0.0	0.0	0.2	1.6
Total external debt (Bil. US$)		7.4	10.0	14.2	20.3	27.3
External debt/GDP (%)		16.3	17.9	19.5	22.6	30.1

Note AGR stands for 'Annual growth rate', YA for 'Year average' and EY for 'End year'
[a]Financial deficit includes also "financial intermediation" expenditures, so that it is not equal to the difference between total revenues and total expenditures (fiscal deficit)
[b]Coins and banknotes in hands of the public plus cheque accounts in domestic currency
[c]M1 plus cheque accounts in foreign currency, short-term, up to three-month, saving instruments, medium and long term, over three months, saving instruments
[d]Calculated as a "residual" of the balance of payments
Source Banco de Mexico's Annual Report (several issues); Negrete Cárdenas, 'Mexican Debt Crises'; Leopoldo Solís and Ernesto Zedillo, 'The Foreign Debt of Mexico' in Gordon W. Smith and John T. Cuddington (Eds.), *International Debt and the Developing Countries* (Washington, DC, 1985)

By the end of August 1976, the Mexican government eventually decided to abandon the fixed exchange rate regime of the peso against the US dollar after 22 years of parity. Banco de Mexico ceased supporting the peso at 12.5 per dollar, withdrew from the foreign exchange

market, and consequently the price of the dollar increased to 20.5 pesos. During the following couple of months, the authorities attempted to manage the float, but instability continued and the rate was allowed to fall to its low point of around 25.5 pesos per dollar in October. After several changes in intervention policy, including a period in which commercial banks also withdrew from the market, the exchange rate stabilized in the range of 22 and 23 pesos per dollar since January 1977, which represented a final devaluation of about 75–85% with respect to the years of exchange parity. The management of the crisis and the stabilization of Mexico's external financial position required the use of emergency credit lines arranged with the USA and the subscription of an IMF-adjustment program.[55]

For the domestic banking system, the outbreak of the currency crisis created liquidity problems that contributed to aggravate the funding difficulties that the banks were already confronting. In September 1976, following the flotation of the peso, representatives from Mexican private banks held some meetings and informal discussion with the General Director of Banco de Mexico, who proposed a series of measures to support the banking system. On the one hand, as Legorreta reported to Banamex's Committee, the central bank would make easy line application of financial regulation, and "tolerate for an indefinite period of time the current situation regarding the relation of liabilities to capital and reserves," which meant "not requiring the revaluation of liabilities denominated in foreign currency, since all credit institutions would be short in capital and reserve."[56] With a 85% devaluation of the peso, such revaluation would imply an increase in banks' liabilities that may push the ratio of liabilities to total capital and reserves beyond the limits set by financial authorities, bringing the institutions into a situation of noncompliance with the domestic banking legislation.

On the other hand, Banco de Mexico opened new financing lines at market interest rates for domestic banking institutions in needs of liquidity. The purpose was to prevent credit institutions from being forced to liquidate their portfolio in the event of a withdrawal of funds. To introduce liquidity into the system, Banco de Mexico made available to the

[55] Paul Kershaw, 'Averting a Global Financial Crisis: The US, the IMF, and the Mexican Debt Crisis of 1976', *The International History Review* 22 (2018), 292–314.

[56] Banamex archive, Libro No. 10 de Actas de la Comisión Ejecutiva, September 27, 1977 Meeting.

banks two billion pesos in October, one billion in November and other billion in December for investment purposes. These resources were to be distributed "in proportion to the portfolio of each institutions, and [would have] a cost of 13½% annual for deposit banks and *financieras* and of 12½% annual for mortgage banks, the destination of the investment remaining at their discretion." The measure was not meant to improve the lending capacity of the banking system but rather to provide it with means to financially assist firms confronting cash flow difficulties, especially those with dollar liabilities. In the case of Banamex, according to Legorreta computations, the program would imply additional resources of about 800 million pesos for the group, which would be carefully used for "those companies that have been the most affected by the devaluation."[57]

As it turned out, given the raising foreign indebtedness of the last years, the devaluation of the peso generated some debt payment problems on Mexican companies with dollar obligations. The government took steps to assist them in overcoming cash flow problems and allowed them to take immediate tax credit on losses. In January 1977, Banco de Mexico made available additional funding for 1.7 billion of pesos (about US$770 million) to assist companies with liquidity problems, and the credit facilities provided the previous year were extended until end-August.[58] By mid-1977, the new General Director Romero Kolbeck called the attention of the members of the Board of Banco de Mexico to the presence of a mechanism in the business sector that "consisted in obtaining credits in national currency and using those amounts to pay liabilities in foreign currency."[59] This practice, as Mexican financial authorities acknowledged, generated significant pressures on the foreign exchange, but, on the other side, allowed some important firms under financial distress to keep the business going and stay afloat.

The lender of last resort measures implemented by the central bank proved eventually successful to avoid major payment disruptions and losses in the credit portfolio of the banking system. The series of non-performing loans to total loans reconstructed by Gustavo del Angel for the Mexican banking industry during the postwar period show that

[57] Ibid.

[58] Banco de Mexico, 1977 Annual Report, 45; Banco de Mexico archive, Acta No. 2428, January 1977.

[59] Banco de Mexico archive, Acta No. 2432, July 1977.

after 1972, when a peak of 6% was reached, the ratio decreased to up 5% in 1975 and about 4.8% in 1977.[60] It does not seem therefore that the devaluation and financial crisis of end-1976 resulted in major loan delinquencies, loan defaults or foreclosures. For the Mexican government, as Sergio Negrete Cárdenas has argued, the 1976 financial fallout was a short-lived and unnoticed debt crisis with no major consequences.[61] After a brief interruption in international lending to Mexico, the emergency financing provided by the USA and the IMF long-standing stabilization agreement along with the discovery of giant oil fields in the Gulf of Mexico renewed the confidence of the market on the country, and allowed the government to pursue its economic development program and continue to raise foreign capital.

Although it created some repayment problems on domestic loans, the devaluation did not have major effects on the balance sheet of the banking sector. By the time of the crisis, the participation of Mexican banks in international financial intermediation was in its early stages, and external obligations represented only a small share of their liabilities. Most of the banks' dollar liabilities were deposits denominated in foreign currency of the Mexican private sector, the mexdollars, and not external debt. Their balance sheets, therefore, were not significantly exposed to the devaluation or other kind of shocks that could develop in the world capital markets. Up to that point, most of their international activities have been made through their associated London-based consortium banks, which were separate institutions with their own capital base and legally independent from the shareholder banks. In terms of the balance sheets, the financial exposure between them was limited to standby facilities and funding lines granted by Mexican banks and the shares exhibited as part of their assets. Thus, to the extent that these consortium banks were not engaged in significant cross-border operations with their shareholders or any other banks in Mexico, their activities in the international capital markets were not a major source of vulnerability for the Mexican banking system.

[60] Del Angel, 'Paradoxes', Table 2.12, 57.

[61] Negrete Cárdenas, 'Mexican Debt Crises', 209–15.

CHAPTER 3

Deeper into Foreign Finance

The early experience of leading Mexican banks in the international capital markets during the first half of the 1970s was encouraging. Through the participation in the associated consortium banks in London, Mexican banks learned the basics of the Euromarket and international lending and over the following years their involvement with foreign finance increased. While in 1977 only Bancomer had a branch in London, three new branches were opened in the next few years and by 1982 Banamex, Banca Serfin and Multibanco Comermex have also a presence in the City on their own. Moreover, as part of their internationalization strategies, these banks were also expanding their network of banking offices in the USA, opening agencies in New York and Los Angeles, and as of 1982 the six largest banks of the country had a direct foot in the major international financial centers of the time.

This chapter analyzes the factors behind, and the rationale for, the deeper involvement of Mexican banks in the international capital markets between 1977 and 1982. Following the 1976 crisis, Mexican financial authorities passed a number of reforms and introduced policy changes aiming to strengthen the position of the banking sector and improve its funding base and lending capacities after half a decade of continuous loss of presence in the domestic economy. Empowered with a larger variety of fundraising instruments and the new interest rate policy followed by Banco de Mexico, Mexican banks succeeded to increase their

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domestic funding and regained the ground they have lost during the financial disintermediation years. Domestic resources were important, but the recovery of the banking sector also relied on increasing recourse to foreign funding, which consisted mainly of deposits or credit lines that the country's leading banks could raise in the interbank wholesale markets through their network of agencies and branches in the international financial centers.

For Mexican banks, international finance provided with the possibility to access new resources at cheaper rates than the cost of domestic saving. With inflation and interest rates in Mexico at double-digits levels while the peso-dollar nominal exchange held practically fixed from 1977 until early 1982, the potential financial gains of arbitraging between the domestic and foreign costs of funding were significant. It represented also a way through which they could face the competition from foreign banks, which were prepared to provide massive amounts of financing at lower rates in a context of high demand for credit and foreign exchange in Mexico. These were the years of the oil boom and strong economic activity based on a fiscal expansionary policy and increasing recourse to external indebtedness. From the perspective of a Mexican borrower, the incentives were largely oriented toward looking for financing overseas since the credit available in the domestic market was scarce and expensive compared to what it could be found in the international capital markets.

Through the network of foreign agencies and branches, Mexico's largest banks became increasingly intertwined with the external indebtedness process that led the country into default. Between 1977 and 1982, when increasing amount of capital flew into Mexico and external debt grew at an average rate of 22.4% per year, their international lending operations expanded considerably. During this period, Mexican banks positioned themselves as important world players in the syndicated Euroloan market, and they became actively involved in intermediating foreign capital with Mexican borrowers. These banks appear indeed in high positions in the rankings of leaders in syndicated Euroloans to the Mexican public sector, and they were additionally participating in similar operations with the private companies as well as granting direct loans to both the private and public sector. As part of broader economic and financial conglomerates, the direct international presence of the banks facilitated the access of the other companies of the groups to foreign credit.

The Recovery of Domestic Banking

After half a decade of contracting activities and continued financial shrinkage, the Mexican banking industry started to improve its presence in the national economy from 1977 onwards.[1] The level of total banking assets, which had reached 25.8% of the GDP in 1977—the lowest value in the decade, increased to 32.4% in 1979, and 35.9% in 1981. The revival of domestic banking came along with a recovery of financing and lending activities and the loan portfolio of the banks expanded from 12.8 to 19.2% of the GDP between 1977 and 1982. As of the beginning of 1982, the domestic banking sector had not only regained the ground it has lost during the years of financial disintermediation, but its weight in the national economy was even greater than the historic high it had reached in 1972 as can be observed in Fig. 2.1 of the previous chapter.

For the domestic banking sector to succeed in reversing the declining trend of the past years, it was necessary to increase its fundraising capacity. Aware of that situation, Mexican financial authorities had already adopted some measures and modified the Banking Law by the end of 1973, authorizing the central bank to equip the Mexican banking system with more and more flexible fundraising instruments. New saving regimes were introduced with the explicit purpose of providing, as General Director Fernández Hurtado put it, "domestic savers with a wider range of investment opportunities, in terms of timing and performance." The strategy was "to encourage fundraising by putting emphasis, not so much on important increases in the return on investment, but on a more adequate timing structure."[2] The stand of Banco de Mexico was to address the fundraising problems of the banks through the creation of new saving instruments and not by raising interest rates, which could result in excessive costs for the institutions and thereby undermine their incentives toward improving domestic bank funding.

Gustavo Romero Kolbeck, who was appointed new General Director of Banco de Mexico in December 1976, brought in important policy changes to deal with the funding problems of the banking sector.

[1] María E. Cardero, José M. Quijano, and José L. Manzo, 'Cambios recientes en la organización bancaria y el caso de México', in José M. Quijano (Ed.), *La banca: pasado y presente* (Mexico City, 1983), 161–220.

[2] Banco de Mexico archive, Acta No. 2406, February 1974.

Since the beginning of his mandate, he would closely monitor the situation of the banks and assess their fundraising performance in terms of both domestic and foreign currency, emphasizing the need to strengthen the financial and lending position of the domestic banking system for the economic development of the country.[3] To achieve this goal, Banco de Mexico proceeded to a restructuring of the financial instruments already in place and the introduction of new ones to further stimulate domestic saving, putting special focus on long-term investment services in national currency, namely term deposits at one year and over a year. In March 1977, the central bank also instructed commercial banks to refrain from taking term deposits in dollars and made this fundraising instrument an exclusivity of *financieras,* although many of them were directly linked to banks through financial conglomerates to which they belonged and could therefore made these resources available to other institutions of the group by means of internal transactions as described in the previous chapter.[4]

These changes were accompanied by a fundamental shift in the interest rate policy followed by the central bank, who abandoned the previous regime of fixed rates in favor of a system of flexible maximum rates subject to periodic review. In the effort to boost domestic savings, nominal interest rates were increased, which, in addition "to the a reduction in the growth rate of prices during the second half of 1970, determined that, for the first time since 1972, interest rates on longer-term deposits turned positive in real terms."[5] Although flexible, the ceilings nominal interest rates remained fixed for relatively long periods since they were adjusted only occasionally and with delay, a situation that changed in August 1979 when they started to be reviewed on a weekly basis and following inflation more closely. As for the interest rate of dollar instruments, which had remained relatively compressed and almost unchanged until 1975, the new policy was to determine it daily at one point above the interest rate of its equivalent instruments in the Euromarkets as to encourage the placement of domestic savings in Mexico rather than in the international financial system.

[3] See, for instance, Banco de Mexico archive, Acta No. 2430, March 1977.

[4] On the composition of financial groups, see Nora Hamilton, *México: los límites de la autonomía del Estado* (Mexico City, 1983).

[5] Banco de Mexico, 1977 Annual Report, 45.

These measures proved indeed successful and boosted the domestic funding base of the banking system. In its 1977 Annual report, Banco de Mexico asserted that "the increase in interest rates and the revision of its structure led to a substantial increase in the rate of non-monetary term deposits, denominated in local currency," which "became quite high in the last months of the year, reaching an unprecedented level."[6] Likewise, a positive change was observed in the structure of liabilities, as bank obligations with a maturity of one year or more, which were acquired by domestic savers, increased very rapidly. The move from a balance sheet structure highly concentrated in liquid resources toward a one with a larger participation of long-term funding was also among the aims of the new financial authorities. At an aggregate level, domestic bank funding increased by 18.6% in real terms in 1977 and continued to expand at an annual average rate of 8.8% between 1978 and 1982. In terms of the GDP, the domestic liabilities of the banking sector passed from representing 24.1% in 1977 to 29.7% in 1979 and 35.2% in 1982, just above the height of 32.1% reached in 1972 at the time when the financial disintermediation process began.

The ultimate purpose of financial authorities in stimulating domestic saving with the banking system was to enhance the supply of credit as to sustain medium-term economic development. When Romero Kolbeck came into the presidency of Banco de Mexico, the effects of the devaluation of 1976 were hitting the financial position of private companies indebted abroad, and there was the problem of firms obtaining domestic credit in national currency used then, in many cases in an anticipated manner, to cover liabilities in foreign exchange. In the eyes of Mexican financial authorities, a main negative implication of this practice, which added to the problems and pressures on the foreign exchange market mentioned at the end of the previous chapter, was that it generated a crowding out effect on lending for new productive projects and this damaged the prospects for growth. Some of the new financial instruments introduced by Banco de Mexico, and in particular those denominated in foreign currency, were specifically designed to overcome the adverse effects that this mechanism produced on the availability of funding for domestic financing and real investment purposes.[7]

[6] Ibid., 18.

[7] Banco de Mexico archive, Acta No. 2432, July 1977.

A step forward into the improvement of bank lending capacities was the reform of the reserve requirement regime. On April 1, 1977, the complex existing structure of multiple coefficients was replaced by a new system with one single reserve ratio for all liabilities in national currency. Contrary to the policy followed during the 1970–1976 period when reserve ratios were progressively increased, the process of homogenization in the aftermath of the reform came along with a general reduction of their levels. Up to March 1977, the average reserve requirement ratio had been about 50%, but it was reduced to 38.5% in April and then again to 37.5% in August of that year. The purpose was to simplify a system that had become very complex, but it was also expected to release considerable amounts of resources that could become available to banks for financing new projects.[8]

The Role of Foreign Funding

Though domestic funding was important, the recovery of the Mexican banking sector after 1977 was also underpinned by a growing recourse to external resources. Figure 3.1 shows the significant role that foreign capital had in the increasing penetration of the domestic banking system in the Mexican economy between 1977 and 1982. In 1975, obligations of the commercial banking system with foreign creditors represented US$176.8 million and they reached US$491.6 million in 1976, a 2.7 time increased in one year. Although still limited in scope and scale, bank foreign obligations considerably escalated thereafter, climbing from US$630 million in 1977 to US$2.6 and 10.1 billion in 1977 and 1981, respectively. The increase was absolute, but also in relation to domestic economic activity: in 1975, the liabilities of the banking system with the external sector represented only 0.2% of the Mexican GDP, but they rose up to 2.6% in 1977 and as high as 8.7% by end-1982.

The rise of external liabilities came along with important changes in the funding structure of the domestic banking system. As of 1977, foreign capital accounted for only 3.1% of the funding of the banking sector and the remaining 96.9% were domestic resources. However, the weight of the external sector as source of funding progressively increased over the following years, representing 9.1% of the total liabilities of the banking sector in 1979 and as much as 20.2% in 1982. Thus, although both

[8] Banco de Mexico, 1977 Annual Report, 41–42.

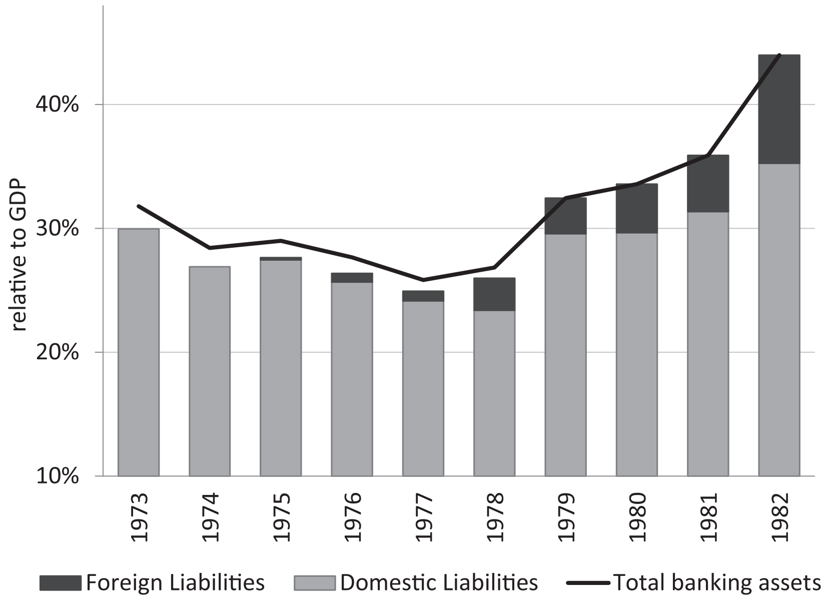

Fig. 3.1 Domestic and foreign funding in Mexican banking, 1973–1982 (*Source* Banco de Mexico's Annual Reports [several issues])

domestic and foreign funding considerably improved during this period, the rate of expansion between them was significantly different. While the former grew at an annual average rate of 15.8% in real terms between 1977 and 1982, the later did it a much faster 74.2%. These figures show the extent of the increasing reliance of the Mexican banking industry on foreign capital to finance the expansion of its assets and to regain its place in the national economy.

The external liabilities of the Mexican banking sector consisted essentially of credit facilities granted by foreign banking institutions. Data published by Banco de Mexico in its 1983 Annual report shows that as of the end of December the total obligations of the domestic banking system to the foreign sector were estimated at 1444.6 billion Mexican pesos, equivalent to about US$10 billion.[9] As much as 82.7% of this

[9] The controlled foreign exchange market rate, which was 143.9 by end-1983, has been used for the conversion. The free market rate was 12.1% higher.

amount consisted of loans from foreign banks, while the balance was other kind of liabilities, such as checking and saving accounts or credit balances. Lending among banks, or interbank operations more generally, was a prominent component of international banking and Euromarket activities back then and a main source of funding for many institutions operating in the world capital markets. As the Study Group on the international interbank market set up by the BIS in 1982 stated, up to three-quarters of international lending at that time (estimated at around US$1500 billion) was made up of interbank positions, and this represented transactions between banks in the same financial center as well as cross-border operations.[10]

By December 1983, cross-border lending to banks in Mexico accounted for 352.5 billion pesos or about 30% of the liabilities of the domestic banking system to foreign banks. The geographic distribution of these liabilities shows that 98.3% of them were concentrated in Mexico City, the main economic pole and financial center of the country, while the remaining 1.7% were located in the states of Nuevo León, Jalisco, Baja California and Sonora.[11] There is no much information about the composition of such cross-border interbank liabilities, but the work of Edmundo Sánchez Aguilar on the international activities of US commercial banks in Mexico during the 1960s and early 1970s provide some valuable insights on their possible origin.[12] His study demonstrates that, despite being legally forbidden to operate branch offices in the Mexican territory—except for Citibank, US banks were conducting businesses and carrying out significant banking activities in the country through their representative offices and corresponding banking relationship with local financial institutions. This implies that, apart from the international loans granted to the Mexican government and private companies, US banks may have also had cross-border claims on the Mexican banking system. Although Sánchez Aguilar do not investigate the nature of this relationship, it is highly likely that US banks had deposit balances or other type of accounts or financing lines with domestic banks,

[10] BIS archive, File I/3A(3)M vol. 1: Policy issue paper, Draft of 25.12.1982. See also BIS, 'The International Interbank Market: A Descriptive Study', *BIS Economic Papers*, No. 8 (1983), 17–19.

[11] Banco de Mexico, 1983 Annual Report, Table 63, 291–92.

[12] Edmundo Sánchez Aguilar, 'The International Activities of U.S. Commercial Banks. A Case Study: Mexico', Unpublished PhD diss., Harvard University, 1973.

which resulted from the businesses they were developing in the country. In the case of Citibank, which had full permission to operate as a commercial bank, the cross-border interbank transaction may have also represented internal or inter-office lending between the US headquarter and the branches in Mexico.

Aside from this cross-border flows into the domestic banking system, international interbank transactions between Mexican and foreign banks took also place outside the country. The records of Banco de Mexico show that by end-1983, Mexican banks had 21 offices overseas and that they were responsible for as much as 842 million pesos or 70% of the lending granted by foreign banks to Mexican banks.[13] In a similar vein, data reported in the FFIEC Country Exposure Lending Survey exhibits that US$1.5 of the 4.5 billion owned to US banks by Mexican banks in December 1983 were placements with or had been borrowed by their foreign offices.[14] For some time, as the following section develops, Mexico's leading banks have been expanding their network of foreign banking offices as part of their internationalization strategies. The presence in the world's major financial centers, namely London and New York, through agencies and branches allowed parent banks to have direct access to international wholesale money markets and raise funds that could then be used to finance international businesses or brought back home through internal transfers with the head office.

One important reason for Mexican banks to engage in the international wholesale money markets was that it offered with an attractive funding alternative. At that time, interbank placements or credit lines were arranged at LIBOR or the US prime rates plus a modest premium in the range of 25% points—at times of non-financial distress, depending on the risk associated with the borrowing bank. Figure 3.2 plots the evolution of the domestic cost of funding (measured as an average of the interest rate of all bank's domestic fundraising instruments) along with the interbank interest rates in the USA and London, as well as the monthly depreciation of the peso-dollar nominal exchange rate from 1977 to 1982. The chart shows that international interest rates were significantly below domestic levels and that the exchange rate remained fixed for most of the period. This indicates that it was cheaper

[13] Banco de Mexico, 1983 Annual Report, Table 63, 291–92.

[14] FFIEC, Statistical Release, E.16(126), May 24, 1984.

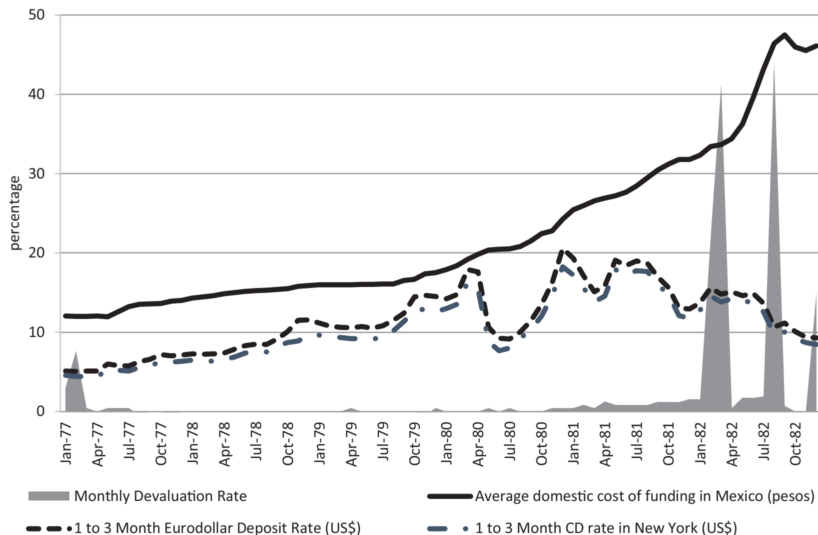

Fig. 3.2 Domestic and international cost of borrowing for Mexican banks, 1977–1982 (*Source* Banco de Mexico, Series Financieras Históricas)

for Mexican banks to borrow dollars abroad than to raise pesos in the domestic market. The cost of funding in London and New York was, on average, between 40 and 60% lower than in Mexico between 1977 and 1980, and this difference became indeed greater in subsequent years as the spread between domestic and international interest rates widened.

An additional factor that encouraged the increasing recourse to foreign finance as source of funding was the absence of a reserve requirement regime for such operations. Unlike sight or term deposits from the non-financial sector, regulation did not require the banks to keep legal reserve on the placements or deposits they received from other banks. Neither Banco de Mexico nor the US Fed or the Bank of England established legal reserve requirement on the cross-border or domestic interbank transactions between Mexican and international banks. Therefore, for Mexican banks borrowing from foreign banks was not only cheaper than raising domestic funds, but it also provided liquidity that could be used with virtually no constrains. This low-cost funding was particularly important because it allowed Mexican banks to compete with the attractive rates offered in the international Eurocredit market and avoid the loss of domestic clients to foreign banks. The much higher cost of

fundraising in Mexico made domestic credit more expensive than international loans, and thereby less appealing to Mexican public and private borrowers when considering funding possibilities in front of them.

Agencies and Branches Overseas

After the incursion in the world capital markets through associated consortium banks during the first half of the 1970s, Mexican banks began to set up their own agencies and branches in the course of the following years. As of 1977, the presence in London of Mexican banks was still largely indirect and limited to the participation of the three largest private financial institutions in the ownership of Intermex, Libra Bank and Eulabank, and only Bancomer had its own branch in the City. However, three new branches were opened over the next five years and by the end of 1982 the four largest banks of the country had a direct foot in London. Likewise, the presence in the USA also increased, passing from three agencies in 1977 up to 10 in 1982, with the six largest Mexican commercial banks operating in the US marketplace at that time. The expansion of leading domestic banks through the creation of banking offices overseas represented a further step into international finance and marked a new stage in the internationalization process of the Mexican banking system.

The case of Banamex provides with a representative example of the reasons, and the rationale, behind the international expansion of Mexican banks through the opening of agencies and branches overseas. In April 1974, soon after the inauguration of its consortium bank Intermex, Banamex's General Director Agustin Legorreta brought to the table of the Executive Committee a proposal to open an agency or branch in Los Angeles, California, as part of the development of the international operations of the bank. Up to that time, relationship with the outer world has been mainly conducted through representative offices in Paris, Madrid, Frankfurt, Tokyo and Los Angeles itself as well as an agency that the bank had in New York since 1929.[15] But a major problem with representative offices, as Alejandro Medina Mora explained to the members of the Committee, was that they worked under strict supervision from local authorities, had very limited operational capacity and no authorization to conduct direct banking business. In this regard,

[15] Banamex archive, Libro No. 6 de Actas de la Comisión Ejecutiva, April 24, 1974 Meeting. There were also two inactive offices in El Salvador and Montevideo, Uruguay.

all they could do was to participate in the formation of business and refer them to the parent bank in Mexico or its correspondents in the host country.

The purpose of the Los Angeles branch project was precisely to further develop international businesses and to open a direct dollar-based funding channel for the head office. By that time, the direction of the bank along with the Marketing Department, as Medina Mora reported to the Committee, "have come to the conclusion that it was necessary to have access to resources in dollars and to do that it was necessary to strengthen [their] presence in the United States." The project consisted therefore in replacing the representative office in Los Angeles by a branch or agency since this would allow for raising funds in the USA. According to the US legal provisions, the agency would not be able take local retail deposits, but it could act as financial intermediary for US residents doing business in Mexico or for Mexican residents that needed to make or collect payments in the USA. More importantly, a branch or agency status made the banking office "eligible for loans from American banks that could be invested in the United States, Mexico or in another country."[16] Medina Mora referred to some controversies in the USA about foreign banks where voices were being raised to limit their operations, arguing that time was important and it was necessary to take position soon in case potential limitations were passed in the neighboring country.

With the authorization of the SHCP in Mexico and the banking department of the State of California, the Los Angeles agency was finally opened in February 1975. In parallel, Banamex was also reactivating the agency in New York and moved it from a shared office in Wall Street to a suite in Park Avenue. These agencies would very quickly develop their banking activities and by 1976, as Medina Mora pointed out in an Executive Committee meeting, they "have come to constitute a very important support for [Banamex's] corporate banking clientele, through the financing they received with the dollars raised by [those] offices."[17] To reinforce the international presence and increase its fundraising capacity as well as its Euromarket operations, Banamex decided to open a new representative office in London in 1978, which was upgraded into branch status the following year. This branch, which was the first one

[16] Ibid.

[17] Banamex archive, Libro No. 8 de Actas de la Comisión Ejecutiva, March 24, 1976 Meeting.

overseas, was considered essential to improve the capacity of the bank to generate international businesses since it could access the London Eurocurrency interbank market, characterized by a massive size, the wide range of money market instruments, and extensive international transactions. In April 1981, the branch was upgraded and given Recognized Bank Status by the Bank of England, which granted full authorization to conduct banking activities in the UK.[18]

Banca Serfin, Mexico's third largest bank after Banamex and Bancomer, also expanded abroad and opened banking offices in the main international financial centers during this period. In 1978, the bank set up an agency in Los Angeles and established a new one in New York two years later. Much like in the case of Banamex, the agency served to meet the business generated between Mexico and the USA, but more importantly it allowed for engaging in international lending since it "gave the bank the opportunity to develop a dollar lending base."[19] In 1980, the bank decided to increase its presence in London, which until then was limited to its participation in the Eulabank, through the creation of a branch, since it "wished to set up on its own and plan[ed] to involve itself more heavily in the Euromarkets."[20] Nigel Godwin, a 20-year-experience banker who had been responsible for enlarging money market operations and developing commercial lending at the Royal Trust Company—the Royal Bank of Canada's London subsidiary, was hired as managing director to run the branch. Foreign exchange operations, Eurocurrency interbank deposits and syndicated lending were all on the short list of the bank and the London office was the platform from where to undertake such activities.

The other leading Mexican banks of the time also heightened the international profile and extended their overseas representation over the last third of the 1970s and during the early 1980s. By 1982, Bancomer, as its counterparts Banamex and Serfin, was also operating in the US money markets through agencies in Los Angeles and New York, as well as in London after upgrading its representative office to branch in 1979. Multibanco Comermex, the fourth largest bank in Mexico, also arrived in London in 1979 and took a branch status immediately, appointing

[18] Banamex archive, Libro No. 13 de Actas de la Comisión Ejecutiva, May 13, 1981 Meeting.

[19] 'Banca Serfin: A Second VISA', *The Banker*, November 1980, 80.

[20] Ibid.

Patrick Greeve in the position of managing director, a banker with long-standing experience as international money market dealer.[21] In addition to the London branch, the bank also opened agencies in Los Angeles and New York in 1979. Finally, there were Banco International and Banco Mexicano Somex, which did not have banking offices in London, but were present in the USA through agencies created in New York in 1982.

Along with Mexico's six largest commercial banks, the other domestic financial institution with international presence was Nafinsa, the largest Mexican government development bank. Nafinsa has set a representative office in London in 1976 and would open a new one in New York in the early 1980s, but they were never converted into branches or agencies during this period. This does not imply, however, that Nafinsa had a negligible role in the Euromarkets since it was closely involved in many of the lending deals arranged between international banks and Mexican borrowers. According to the testimony of Santiago de León, the officer responsible for setting up the office in London, the representative office was very active during the syndication years, collaborating with international banks in defining the credit terms with the borrowers as well as the formation of the management group.[22] Yet, although it could not engage in the US money and international Eurocurrency markets through its representative offices, Nafinsa had an indirect participation in international lending as shareholder of Intermex, of which it owned 13% since 1979. More important, however, was its role on the other side of the market, since Nafinsa was a major international borrower and a main recipient of the syndicated loans granted to Mexico during the decade preceding the 1982 debt crisis.

Unlike commercial banks that borrowed from foreign banks through wholesale interbank market transactions, Nafinsa and the other Mexican state-owned development banks participated in the international capital markets as sovereign borrowers. This means that they raised funds in the Euromarkets in the same way that the Mexican Federal government and public enterprises did, which was through medium- and long-term direct or syndicated loans. Figure 3.3 shows the evolution of

[21] 'New Faces in the City', *The Banker*, November 1979, 93.

[22] 'New Faces', *The Banker*, November 1977, 107.

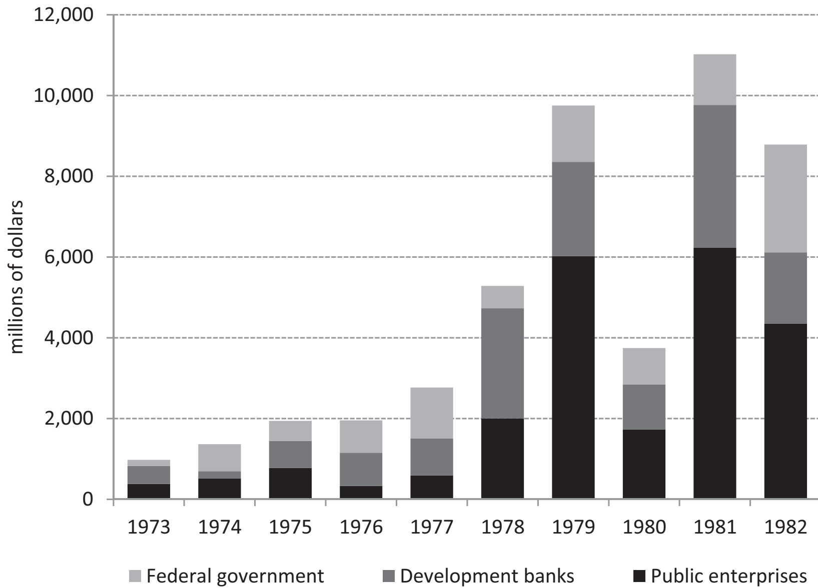

Fig. 3.3 Eurocurrency syndicated borrowing by the Mexican public sector, 1973–1982 (*Source* Negrete Cárdenas, "Mexican Debt Crises," Table B14, 361–86)

the total Eurocurrency syndicated credits granted to the Mexican public sector between 1973 and 1982 based on data compiled by Sergio Negrete Cárdenas.[23] Development banks accounted for as much as US$14.5 billion or 30.5% of the total amount borrowed during this period, while the Federal government and public enterprises represented US$10.1 and 22.9 billion, respectively. With US$5.1 billion, Nafinsa was the major borrower among development banks, followed by Banco Nacional de Obras y Servicios Públicos (Banobras), Banco Nacional de Crédito Rural (Banrural) and Banco Nacional de Comercio Exterior (Bancomext) with US$3.5, 2.1 and 1.9 billion each. Foreign capital was indeed a main funding source of Nafinsa and other development banks

[23] Sergio Negrete Cárdenas, 'Mexican Debt Crises: A New Approach to their Genesis and Resolution', Unpublished PhD diss., University of Essex, 1999, Table B14, 361–86.

and it served to finance the economic program and broader policy goals of the Mexican government.[24]

Mexican Banks in International Lending

This second phase in the internationalization process of Mexican banks developed within a new institutional framework for banking activity in Mexico. In 1975–1976, the Mexican government passed and enacted the Multiple Bank Law, which reformed the system of specialized banking defined by the Banking Law of 1941 into one of universal banking. Under this legislation, banks and the finance companies of the business group could merge and integrate their activities into a one single banking entity called *banco múltiple*—multiple bank, multipurpose bank or multibank. Unlike in the previous regime, a multiple bank was legally allowed to operate with all kind of financial instruments for raising funds and grant credits and to offer a wider range of financial services to its clients. Motivated on the motion of economies of scale and scope in banking, Mexican financial authorities encouraged the amalgamation of financial firms into commercial banks, mergers and fusions among medium and small banks, and the consolidation of the banking system around a smaller number of larger units.[25]

An important implication of the multiple bank reform was that it stimulated the international activities of the country's largest banks and facilitated their integration into the world capital markets.[26] To the extent that the new regime implied the consolidation of balance sheets of many institutions, the operational reach of the bank that resulted from that process and the size of the assets in its books were considerably

[24] Carlos Marichal, 'Crisis de deudas soberanas en México: empresas estatales, bancos y relaciones internacionales, 1970–1990', *Historia y Política* 26 (2011), 111–33. On the experience of Nafinsa during this period see Pablo J. López, 'Nacional Financiera durante la industrialización vía sustitución de importaciones en México', *América Latina en la historia económica* 19 (2012), 129–63.

[25] Sara G. Castellanos, Gustavo A. del Angel, and Jesús G. Garza-García, *Competition and Efficiency in the Mexican Banking Industry: Theory and Empirical Evidence* (New York, 2016), 38–45.

[26] María E. Cardero, José M. Quijano, and José L. Manzo, 'Cambios recientes en la organización bancaria y el caso de México' in José M. Quijano (Ed.), *La banca: pasado y presente* (Mexico City, 1983), 161–220, esp. 207–10; Sylvia Maxfield, *Governing Capital: International Finance and Mexican Politics* (New York, 1990), 97–103.

incremented. Empowered with a more flexible banking structure and a bigger volume of business, multiple banks were better equipped to position themselves abroad as larger business units at a time when size and name were important factors in determining the ability of an institution to conduct Euromarket business activities and raise fund in the international interbank money markets. Looking as stronger financial entities, Mexican banks found themselves in improved conditions to attract more funding for conducting their international financial operations and negotiate more favorable borrowing and lending terms, which allowed them to be in better shape to face the competition of foreign banks in the credit supply to Mexican borrowers.

Figure 3.4 shows the effect of the consolidation of balance sheet entailed by the Multiple Bank Law in the eyes of the international financial community. It exhibits the volume of bank assets as reported by *The Banker*, one of the most important magazines on banking and international finance at the time, and its position in the ranking of the

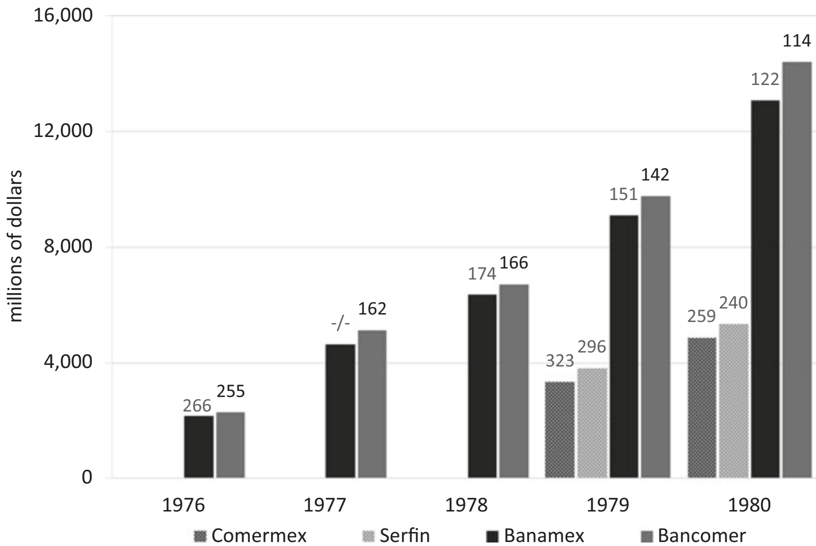

Fig. 3.4 Assets and ranking position of Mexican banks at an international level (*Note* Bars indicate the volume of total assets and the number on top of the bar is the corresponding position in The Banker's ranking of the world's biggest banks. *Source* The Banker magazine [several issues])

Top 300—then Top 500—in world banking. Bancomer, which evolved into multiple bank in 1977, more than double its size as a result of this transformation, climbing up from the 255 to the 162 position in the list of the world's biggest banks. Banamex was also converted into multiple bank in 1977 with its assets increasing by 115.6% and improving its rank from 266 to 174 between 1976 and 1978. Both banks escalated into higher positions as further mergers and fusion occurred and their assets expanded in the upcoming years, with Banca Serfin and Multibanco Comermex—both multiple banks since 1977—becoming part of the list of top world banks in 1979. Banco Internacional and Banco Mexicano Somex, which were the other two Mexican banks involved with international finance, evolved into multiple banks in 1977 and 1978, respectively, but the size of their assets did not reach big enough levels as to be considered in *The Banker*'s ranking.

Mexican banks became, indeed, considerably involved with the Euromarkets in the aftermath of the Multiple Bank Law and by 1982 they have positioned themselves as important world players in international lending. As a matter of fact, the ranking on the world's leading banks in syndicated lending published by the AGEFI International Financing Review in December 1982 shows the presence of four Mexican banks in the top one-hundred. With a participation in the lead management group of nine syndicated loans for about US$5.2 billion, Banamex ranked 68th—the highest ranked Mexican bank, overcoming its consortium bank Intermex, which had participated in 11 operations for US$3.6 billion during that year and occupied the 85th position. The other three Mexican banks in the list were Bancomer, Multibanco Comermex and Banco Mexicano Somex, which were involved in the management of 10, 4 and 3 operations for US$4.2, 2.6 and 2.5 respectively, standing at the 77th, 99th and 100th position of the ranking of the world leader banks in syndicated lending as of end-1982.[27]

These figures show that Mexican banks had indeed a meaningful place in the world capital markets, and this allowed them to become major players in international lending to Mexico. Sergio Negrete Cárdena's database on the syndicated Eurocurrency credits granted to the Mexican public sector shows that between 1973 and 1982, Banamex participated in the lead management group of 14 lending operations of about US$11.9 billion and Bancomer in 9 of US$5.2 billion, with many of

[27] ANEGI No. 449, 26 December 1982, 98.

these deals having the joint presence of both banks. The ranking of leaders in syndicated loans to Mexico, which was headed by Bank of America and Bank of Tokyo, had Banamex occupying the 25th position among a total of 214 banks participating as lead managers in these operations, while Bancomer shows up a little further down at the position 40. Banco Internacional, Banca Serfin and Multibanco Comermex had a more discreet role, participating in the lead management group of only 6, 3 and 2 syndicated loans to the Mexican public sector respectively, while Banco Mexicano Somex does not appear in the management group of any of the Eurolending operations compiled by Negrete Cárdenas.

Although visibly important, the actual involvement of Mexican banks in intermediating foreign capital with final borrowers in Mexico is underrepresented by these data. A first remark to be done is that, aside from the syndicated loans granted to the public sector, Mexican banks were also conducting similar lending operations with the private sector which are not contemplated in Negrete Cárdenas' database. The lists of publicized Eurocurrency credits published in the World Bank's *Borrowing in International Capital Markets* shows that large private non-financial enterprises, such as the Alfa Industrial Group, Celanese Mexicana, Cementos Mexicanos, Compañía Mexicana de Cobre, among others, were also borrowing term loans from syndicates that had Mexican bank participation in the lead management group.[28] Mexico's large companies were borrowing abroad from foreign banks, but also from Mexican banks since many of them were part of larger economic and financial conglomerates and, as the next section explains in further detail, the international presence of the banking institution of the group provided them with a more direct access to the world capital markets.

Secondly, Negrete Cárdenas and World Bank's databases exhibit only banks that were part of the lead management group, and thereby do not capture the participation of Mexican bank from outside. A syndicated loan would typically involve a larger number of banks than those leading the operation, but it is difficult to track all of them since they usually not appear in the publicized lists. The US$1.2 billion medium-term Eurodollar loan granted to the Mexican government in November 1977 provides a clear example of this situation. This huge operation, which was jointly managed by 33 international banks, has not been

[28] See, for instance, World Bank, Borrowing in International Capital Markets, EC-181/793, Third Quarter 1979, 252–56.

computed has having Mexican participation since there were not Mexican banks in the lead management group. However, with the exception of Banco Mexicano Somex, the other five Mexican banks involved in international finance at the time—Bancomer, Banamex, Banca Serfin, Multibanco Comermex and Banco International—participated in the loan by contributing funds together with other 112 banking institution.[29] A similar misrepresentation appears when considering the syndicated lending operations with the Mexican private sector and other international borrowers.

Finally, syndicated loans represented only a fraction of all international lending, since it was also common practice among banks to provide direct Eurocurrency credits. Archival documents from Banco de Mexico demonstrate that, for instance, in 1983 the Compañía Nacional de Subsistencias Populares (CONASUPO), a parastatal entity in charge of the Mexican alimentary security program, had outstanding external loans for US$1296.4 million. Of this amount, only US$297 million or 23.3% were syndicated loans while the remaining US$999.4 million or 76.6% consisted of direct credits. Notably, although there were not Mexican banks among the creditors of syndicated bank debt, Bancomer, Banamex and Multibanco Comermex were owned US$95, 25 and 41.8 million in external direct loans, respectively.[30] In a similar vein, the minutes of the Executive Committee of Banamex show that the Credit Committee, the organ responsible for the authorization of the bank's lending operations, would regularly decide over the approval of direct credit lines from the overseas agencies and branches. To quote but one example, in September 1979 the Committee authorized a six-month direct loan of US$100 million from the bank's New York agency to the Mexican government, an "operation that did not require authorization from the National Banking Commission [CNBS]."[31]

[29] Tombstone of the loan in Negrete Cárdenas, 'Mexican Debt Crises', 464.

[30] Banco de Mexico archive, C961Exp2.Leg.1., Letter from the Mexican Secretary of Treasury, September 6, 1983. At an aggregate level for the Mexican public sector, direct loans represented about a third of total bank external debt and the remaining two-third were syndicated loans.

[31] Banamex archive, Libro No. 12 de Actas de la Comisión Ejecutiva, September 12, 1979 Meeting.

Mounting External Banking Debt

The expansion in the foreign network of Mexican banks and their participation in international lending to Mexico occurred, as previously said, in a context of strong economic growth and demand for credit. After the slowdown of economic activity in 1977, the Lopez Portillo administration dropped the adjustment program signed with the IMF and engaged in a more expansionary policy package based on the exploitation of the country's oil wealth that proved greater than expected. Between 1978 and 1981, the country entered into a boom of petroleum and economic activity expanded at rates between 8.3 and 9.2%, with investment spending by the private and public sector as a share of the GDP increasing from 11.7 to 14.1% and from 7.2 to 10.8%, respectively.[32] The growth strategy was largely based on heightening recourse to international credit and as a result Mexico's external debt, which amounted to US$30.6 billion in 1977, grew up to US$50.8 billion in 1980 and US$84.1 billion in 1982, which represents an average annual expansion of about 22.4% over the period.

The international presence of Mexican banks had a role to play in allowing the country to gain access to foreign borrowing. As of early 1977, Bancomer participated in the lead management group of a US$350 million syndicated loan to the state oil company Petroleos Mexicanos (PEMEX), in what was one of the first Eurocurrency credit operations with Mexico after the impasse of international lending that followed the financial crisis of 1976, marking the return of the country to the Euromarkets. In July, another landmark loan was put together by the Libra Bank along with Lloyds Bank International to grant US$425 million to Nafinsa, an operation that also included the participation of Banamex, Bancomer, Banco Internacional and Intermex among the management group banks.[33] As described in the previous section, there was also a strong presence of Mexican banks in the US$1.2 billion syndicated credit to the Federal government in November 1977, which was the first "jumbo loan" to a Mexican borrower. According to

[32] Edward Buffie and Allen Sanginés-Krause, 'Mexico 1958–86: From Stabilizing Development to the Debt Crisis', in Jeffrey D. Sachs (Ed.), *Developing Country Debt and the World Economy* (Chicago, 1989), 141–68, 147–55.

[33] Negrete Cárdenas, 'Mexican Debt Crises', 368.

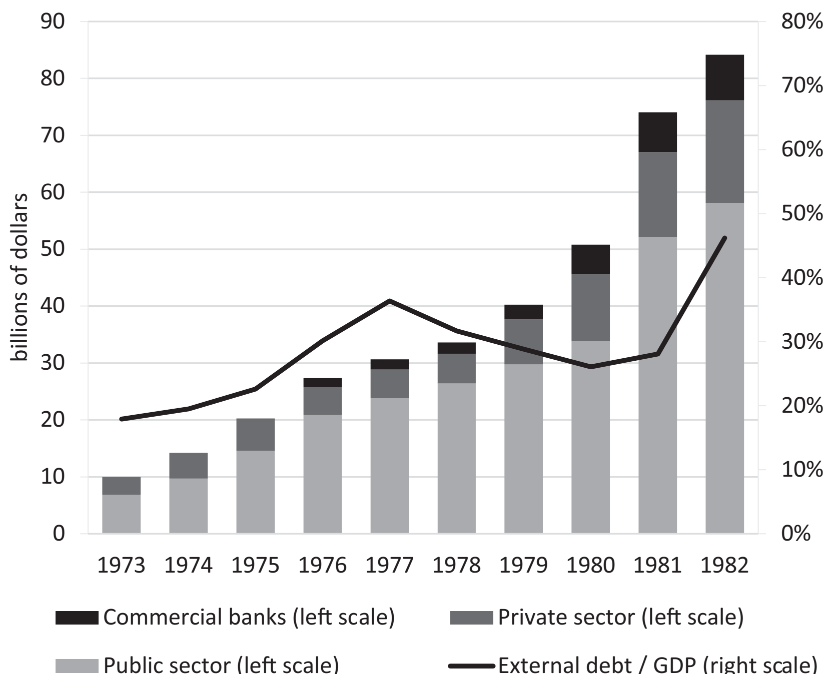

Fig. 3.5 Evolution of Mexico's external indebtedness by borrower, 1973–1982 (*Source* Solís y Zedillo, "The Foreign Debt of Mexico," 260)

Negrete Cárdena's records, by end-1977 Mexico had received at least 15 syndicated loans from the Euromarkets, and at least six of them, if not more, counted with the involvement of Mexican bank in leading the operation or providing funds from outside the management group.

The role of Mexican banks in the external indebtedness process of the country was to be incremented over the following years. Figure 3.5 plots the evolution of Mexico's external debt by borrower, distinguishing between the public sector, the commercial banks and the private non-financial sector. The chart shows the extent to which Mexican bank foreign borrowing accelerated during the period, escalating from about US$1.8 billion in 1977 to US$8 billion in 1982, a 4.5-time increase in only five years. The increase was not only in absolute values, but also in relative term since commercial banks' foreign liabilities represented around 6% of the country's total external debt in 1977 but

they increased to about 10% in 1981–1982. In terms of domestic economic activity, the external debt of the Mexican banking sector oscillated between 1.9 and 2.1% of the GDP in the period 1977 and 1979 and progressively grew to 2.6% in 1980 and up to 4.4% by the end of 1982.

In their position as international financial intermediaries, the bulk of the funds that Mexican banks borrowed abroad were to be used to finance loans or other credit facilities to final borrowers. Thus, the international credits and syndicated loans that Mexican banks granted to the domestic public or private sector were possible in the extent that they indebted themselves abroad. External indebtedness was indeed the mean that allowed Mexican banks to internationalize and participate in foreign lending.[34] The corollary interpretation of this is that Mexican private and public borrowers could serve from the domestic banks with international presence to raise additional funds to what they were able to get from foreign banks. After all, by 1982 as much as 91% of the loan portfolio of the foreign agencies and branches of Mexican banks, which were the main borrowing arm of the head office in the international capital markets, was owed by borrowers in their home country, while the credits owed by clients in foreign countries represented the remaining 9% of the portfolio.[35]

In terms of the borrowing possibilities, the international presence of Mexican banks seems to have been more instrumental for the private sector. In 1982, Mexico's external debt excluding the banking sector reached US$76.1 billion, of which 76.4% were foreign obligations of the Mexican public sector while the remaining 23.6% belonged to private companies. Notably, the loan portfolio of the foreign agencies and branches of Mexican banks with Mexican borrowers was 40% in the hand of the private sector and 60% in the government and other public entities. This means that, compared to the public sector, private firms were borrowing relatively more from Mexican banks than from other international lenders in a period of considerable expansion of private foreign liabilities. Between 1977 and 1982, the external debt of the private sector grew at an average annual rate of 29.2% (19.5% for the public sector)

[34] Karim Lissakers, *Banks, Borrowers, and the Establishment: A Revisionist Account of the International Debt Crisis* (1991), 60–65.

[35] Banco de Mexico archive, C3147Exp.4, Oficina de evaluación y control de la información bancaria, Crédito otorgado por agencias y sucursales de bancos mexicanos en el exterior.

and the expansion of the country's most important industrial conglomerates, such as the Alfa Group or the Visa Group—owner of Banca Serfin, relied largely on foreign borrowing.[36] This is in line with the behavior observed in other Latin American countries, such as Diaz-Alejandro has described for Chile, where banks were the financial arm of business groups to borrow from the international capital markets and finance their expansion.[37]

An additional important factor for explaining the rise of private external debt during the last third of the 1970s and early 1980s had to do with the cost of borrowing. At that time, Banco de Mexico regulated the interest rates on fundraising instruments—not on assets, and banks would usually determine its lending rates as to be above the average domestic cost of borrowing by a spread that ranged between 2.3 and 9% between 1978 and 1982. Under circumstances of tightening financial conditions, banks would typically reduce grace periods, require anticipate payment or charge fees and other commissions, which could result in effective rates 22% over nominal rates in some cases.[38] International lending operations followed a similar pricing policy, but in this case the interest rate of reference was LIBOR or the US prime rate and the spread normally ranged between 0.5 and 2.5% (depending on liquidity market conditions and country risk) with additional fees and commissions of about one percent maximum. The fierce competition among foreign bank lenders to Mexico kept the spreads at much moderate levels than in the domestic marketplace and because the cost of bank fundraising in Mexico was persistently higher that in London and the USA, it was cheaper for Mexican companies to borrow abroad than domestically provided that the devaluation of the peso was lower than the differential between the rates as observed in Fig. 3.2.

The extent that the difference in the cost of credit led Mexican borrowers to downplay the risks of a devaluation is reflected in the lack of use of another available mechanism that, unlike syndicated loans or

[36] Cardero, Quijano, and Manzo, 'Cambios recientes en la organización bancaria', 240–75.

[37] Carlos F. Diaz-Alejandro, 'Good-Bye Financial Repression, Hello Financial Crash', *Journal of Development Economics* 19 (1985), 1–24.

[38] Antonio Amerlinck Assereto, 'Perfil de las crisis recientes del sistema financiero mexicano', *Comercio Exterior* 34 (1984), 953–69, esp. 967.

direct foreign borrowing, allowed for hedging currency risk. In mid-1977, as a response to the currency crisis of the previous year, Banco de Mexico established a system that provided currency exchange coverage on credits contracted by private companies with international banks.[39] Through this facility, the borrower received the amount of the foreign credit in an account with a local bank, which brought the currency to the central bank and changed it for pesos that were then used to provide a loan in the national currency at the domestic market interest rate through the same bank. When the loan was to be repaid, the bank brought the pesos to the central bank which changed them back into the foreign currency at the original exchange rate. In the opinion of SHCP Official Antonio Amerlinck Assereto, the mechanism had little acceptance because for the companies "the market interest rate for the loan in pesos was (..) a very high price that had to be paid to Banco de Mexico."[40] On the other hand, the position of Mexican financial authorities, as stated by Romero Kolbeck, was not to "compel companies to hand over their foreign currency borrowings, and, in fact, [they didn't] like doing that sort of deal, but it [was] a facility [they had] to provide for people who [were] scared."[41]

From a microeconomic perspective, the rationale behind international borrowing relied on interest rate arbitrage operations between domestic and foreign markets. The slow convergence, even divergence, of domestic inflation and interest rates toward international levels, plus the fixed permanent nominal exchange rate, also yielded great incentives for private capital inflows into Mexico and the country's leading banks were intermediating these flows. At a time in which the domestic resources of Mexican banks proved insufficient to satisfy the loan needs of both the public and private sector, the incentives to expand fundraising abroad further encouraged and exacerbated the rise of the external indebtedness.[42] As Agustin Legorreta explained to the Executive Committee in the early 1980s, "[the bank] could not serve nor meet the needs of their big clients if [they] could not count on resources

[39] Banco de Mexico archive, Acta No. 2433, August 1977.

[40] Amerlinck Assereto, 'Perfil de las crisis recientes', 967.

[41] Mexico—A Survey Euromoney, March 1981, 29.

[42] Maxfield, *Governing Capital*, 105–107.

coming from abroad."[43] Either because of disregard for devaluation risk or moral hazard considerations on either real or speculative investments, both the Mexican banking and non-banking sector found convenient to borrow in dollars abroad at cheaper rates than domestically in pesos.

Banks Within the Macroeconomic Imbalances

With impressive results for investment and growth, the development strategy of the Lopez Portillo administration accentuated some fundamental macroeconomic imbalances that had been affecting the Mexican economy since the time of the 1976 financial crisis. Lopez Portillo's economic program was indeed pretty much in line with that of the previous government, with emphasis on the need of an enlarged role of the public sector in the economy and similar redistributive goals that relied on increasing public spending. The growth strategy was also largely based on an expansion of aggregate demand driven by strong fiscal stimulus and a lax monetary policy. As a result, the deficit of the public sector increased sharply from 6.1 to 14.1% of the GDP between 1977 and end-1981 and external debt continued to expand at high rates, accelerating especially toward the end of the period.[44]

Likewise, the external accounts of the country significantly deteriorated during those years. Despite the dynamic expansion of the exports of oil as well as non-oil products, the trade balance deficit maintained between 1.3 and 2.3% of the GDP during the entire period. In the context of high inflation and fixed parity of the peso relative to the dollar, the appreciation of the real exchange rate coupled with vigorous economic growth made also imports to increase strongly. The current account deficit, as displayed in Table 3.1, grew even more dramatically because of the expansion in debt service payments that resulted from the accumulation of external obligations and the increase of international interest rates in the late 1970s and early 1980s. As in 1976, with unrestricted convertibility, a dollarization of short-term deposits and the development of a new wave of capital flights came to affect

[43] Banamex archive, Libro No. 12 de Actas de la Comisión Ejecutiva, March 12, 1980 Meeting.

[44] Leopoldo Solís and Ernesto Zedillo, 'The Foreign Debt of Mexico', in Gordon W. Smith and John T. Cuddington (Eds.), *International Debt and the Developing Countries* (Washington, DC, 1985), 258–88.

Table 3.1 Mexico's macroeconomic indicators, 1977–1982

		1977	*1978*	*1979*	*1980*	*1981*	*1982*
Real sector							
GDP (Bil. US$)		84.2	106.1	139.7	194.8	263.8	182.1
Growth rate (%)		3.4	8.3	9.2	8.3	8.5	−0.5
Public sector							
Expenditure/GDP (%)		30.0	31.4	33.0	33.5	39.7	44.5
Revenues/GDP (%)		24.6	28.9	26.7	26.9	26.7	28.9
Fiscal deficit[a]/GDP (%)		−6.1	−6.0	−6.8	−7.5	−14.1	−16.9
Monetary variables							
Monetary base (M1)[b] (AGR, %)		26.3	31.6	33.7	33.4	33.3	54.1
Money supply (M4)[c] (AGR, %)		31.9	35.2	38.1	43.7	48.4	75.8
Inflation (annual, %)		20.7	16.2	20.0	29.8	28.7	98.8
Interest rate	Nominal (YA, %)	10.7	10.5	15.0	22.6	30.8	45.8
	Real (YA, %)	−8.0	−4.9	−3.8	−5.0	1.8	−25.1
Exchange rate	Nominal (YA)	22.6	22.8	22.8	23.0	24.5	57.2
	Real (1980=100)	83.3	86.9	89.5	100.0	115.7	86.3
International reserves (EY, Bil. US$)		2.0	2.3	3.1	4.0	5.0	1.8
External sector							
Trade balance/GDP (%)		−1.3	−1.7	−2.3	−1.6	−1.5	3.9
Current account/GDP (%)		−2.4	−3.0	−3.4	−5.4	−6.2	−3.2
Capital account/GDP (%)		−2.0	−0.8	0.6	5.8	10.1	5.5
Capital flight[d] (Bil. US$)		0.7	0.2	0.3	0.01	12.4	7.3
Terms of trade (1972=100)		81.1	69.1	70.9	82.2	87.8	85.3
External indebtedness							
Public sector (Bil. US$)		23.8	26.4	29.8	33.9	52.2	58.1
Private sector (Bil. US$)		5.0	5.2	7.9	11.8	14.9	18.0
Commercial banks (Bil. US$)		1.8	2.0	2.6	5.1	7.0	8.0
Total external debt (Bil. US$)		30.6	33.6	40.3	50.8	74.1	84.1
External debt/GDP (%)		36.4	31.7	28.8	26.1	28.1	46.2

Note AGR stands for 'Annual growth rate', YA for 'Year average' and EY for 'End year'

[a]Financial deficit includes also "financial intermediation" expenditures, so that it is not equal to the difference between total revenues and total expenditures (fiscal deficit)

[b]Coins and banknotes in hands of the public plus cheque accounts in domestic currency

[c]M1 plus cheque accounts in foreign currency, short-term, up to three-month, saving instruments, medium and long term, over three months, saving instruments

[d]Calculated as a "residual" of the balance of payments

Source Banco de Mexico's Annual reports (several issues); Negrete Cárdenas, 'Mexican Debt Crises'; Leopoldo Solís and Ernesto Zedillo, 'The Foreign Debt of Mexico'

the external position of the country, bringing additional pressures on the balance of payment.

The direct involvement of Mexican banks in the external indebtedness process of the country contributed to accentuate the macroeconomic

disequilibrium in the Mexican economy. As intermediators between international finance and domestic borrowers, Mexican banks were in the middle of the borrowing and lending boom that came to a definitive end with the outbreak of the debt crisis in August 1982. On the one hand, together with the Federal government, the public agencies, and the non-banking private sector, as borrowers in the international wholesale markets, they were part of the country's demand for foreign capital. On the other hand, because they relent part of these funds to final borrowers in their home country or other developing countries, they were also on the supply side, as providers of syndicated or direct foreign loans. Mexican banks were, therefore, likely to be accentuating, and further exacerbating, the dynamic of external debt accumulation and overlending to Mexico, by simultaneously pushing both the demand and supply of credit upwards.

Additionally, since commercial banks were in control of important capital flows in the balance of payment, they had an influence on the foreign exchange market. Through their agencies in the major international financial centers, Mexican banks had direct access to dollar funding that could be brought to the country to bridge the peso gap in times of balance of payment difficulties and foreign exchange needs. However, to the extent that the banks would have to reimburse those dollars abroad, this also implied a higher demand for foreign exchange in the future. Moreover, since the dollars came from wholesale interbank credit lines, which are essentially short-term and highly susceptible to market conditions, they introduced an element of additional vulnerability into the foreign exchange market. If interbank funding lines come under stress because of a shock or change in market expectations, as it eventually happened, Mexican banks would confront an immediate need for dollar liquidity to repay their short-term debts and this would generate further pressures on the peso.

International financial intermediation performed by Mexican banks had also an influence on monetary variables and the behavior of money supply. Unlike domestic fundraising instruments in local and foreign currency, interbank credit lines were not subject to legal reserve requirements in Mexico. Because reserve requirements were used by Banco de Mexico as tool to conduct monetary policy, the increasing reliance of Mexican banks on borrowing from foreign banks relative to domestic resources affected the capacity of monetary authorities to control the evolution of money supply. Increasing dollars brought from abroad into

the domestic banking system was an element contributing to monetary expansion, which was one of the factors at the base of the inflationary process affecting the country. Between 1977 and 1982, both the monetary base and the money supply grew at very fast, indeed increasing, rates as can be observed in Table 3.1. The monetary expansion of this period was even more dramatic than the one experienced in the years preceding the 1976 financial fallout.

Finally, these macroeconomic imbalances were further aggravated by the process of capital flights that affected the country in earnest since 1980. In a context of high domestic interest rates and fixed exchange rate with free convertibility and no capital controls, the Mexican economy was vulnerable to the development of speculative financial activity in Mexico and from abroad. José Manuel Quijano illustrates with a hypothetical example the kind of destabilizing capital movement that might have been affecting the country. As he explains, an American investor in the USA willing to invest US$1 million in January 1981 could exchange them for 23.3 million pesos in Mexico at the market rate of that moment and place that amount in a three-month deposit at an interest rate of 27.1%, receiving 2.5 million pesos in his Mexican account by the end of April. He could then exchange this money back to dollars at the current rate of 27.9 and obtained US$1.04 million in return that he could transfer back to the USA. Once the operation concluded, the hypothetical investor would have obtained an annual return in dollars of 26.3%, a much higher yield than what he could get in other markets.[45] The economy became therefore prone to this type of inflow and outflow of short-term capital speculative investments—the so-called swallow capital, an operation that could also be undertaken by Mexican investors with domestic savings, creating considerable financial instability.

The Mexican banking system was naturally in the middle of this mechanism. In particular, given the lack of international networks for small domestic banks and the limited presence and ability of foreign banks to perform banking activity in Mexico, leading domestic banks operating in the world capital markets appeared exceptionally well placed and connected to intermediate such operations. These banks had a direct international channel for transferring funds between the head offices in Mexico and the agencies or branches overseas, but they could also

[45] José M. Quijano, *México: Estado y banca privada* (Mexico City, 1987), 112.

perform cross-border transactions with banks in the USA, Europe and other countries. In the eyes of Carlos Tello, the architect of the bank nationalization program of September 1, 1982, Mexican banks "operated and implemented the speculation and capital flights."[46] As the expectations of a devaluation loomed, the country entered into a destabilizing dynamic that came to govern the pace of external indebtedness, exacerbating the macroeconomic imbalances and eventually leading to the outbreak of the crisis in 1982.

On February 17, 1982, the Mexican peso devalued after almost six years of virtual fixed parity with the US dollar. Between January and end-March 1982, the exchange rate fell from 26.4 to 45.5 pesos per dollar, which represented a 75% devaluation, and it will continue to fall during the rest of the year. The currency crisis created some debt payment problems in the private sector, compromising their ability to fulfill its foreign financial obligations. Finally, on Friday August 20, 1982, in a meeting with representatives of the international financial community at the Federal Reserve Bank of New York, Mexican officials announced a temporary debt moratorium on principal payments that brought the country into default and launched the international debt crisis of the 1980s. Unlike in 1976, the financial crisis of 1982 was not limited to a currency crisis or external debt payment problems, but, as the rest of the book will make clear, it also embraced the domestic banking system.

[46] Carlos Tello, *La nacionalización de la banca en México* (Mexico City, 1984), 65.

CHAPTER 4

The Condition of Mexican Banking

Between 1977 and 1982, as the country's leading banks grew internationally, the Mexican banking sector significantly increased its weight in the national economy after half a decade of financial disintermediation. Yet the recovery experienced by the banking industry came along with important changes in its balance sheet structure and financial condition. On the one hand, current accounts and saving deposits persistently diminished their share as source of funding, while the maturity structure of medium- and long-term domestic fundraising instruments was considerably shortened. On the other hand, the expansion experienced by banking activity was largely reliant on heightened recourse to indebtedness rather than equity. There were no substantial improvements in reserve levels either and, as a result, the commercial banking sector became twice more leveraged over the period.

This chapter analyzes the roots of the deteriorating health of the Mexican banking sector in connection with the international expansion of leading commercial banks in the late 1970s and early 1980s. It addresses the question of how involvement with foreign finance and the banks' fundraising strategy affected their financial position. A financial statement analysis is performed with risk indicators reconstructed from bank balance sheets, as published in the Multibank Bulletin of the Financial Analysis Unit of the National Banking and Insurance Commission (CNBS). The analysis also draws on data from annual reports and a compendium of historical financial statistics

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https://doi.org/10.1007/978-3-030-15440-0_4

from Banco de Mexico, as well as additional information from the Financial Yearbook of Mexico (*Anuario Financiero de México*) published by the Mexican Banker Association and the Financial and Stock Market Yearbook (*Anuario Financiero y Bursátil*) of the Mexican Stock Exchange.

In the literature on Mexican banks during the period preceding the debt crisis and their nationalization in 1982, the banking sector has been traditionally portrayed as operating under normal returns and low risks.[1] The analysis that follows raises doubts about such interpretation and shows that there were clear signs of a deterioration in the health and financial position of the Mexican banking system well before the onset of the crisis, with the banks engaged in international lending and foreign funding being the ones with the greatest propensity to be the most adversely affected by these problems. The group of the six Mexican banks involved with international finance displayed worse capital adequacy levels and a more instable funding base than the banks that were operating only at a national level. While the most prominent banks of the country could leverage on foreign resources to expand their activities, the entire domestic banking system became riskier and more vulnerable.

A Weakening Funding Structure

Deposits, defined in its wider sense as the amount of money placed in the banking system by the public, have traditionally been the most important source of funding for commercial banks. In 1977, the total liabilities or funding base of the Mexican commercial banking system reached US$20.3 billion. Of this amount, local deposits from the private and public sector accounted for 91.3%, while 4.9% were transactions between domestic financial institutions—Banco de Mexico, development banks and other commercial banks, 3.1% were loans from foreign banks and

[1] Gustavo del Angel, 'Paradoxes of Financial Development: The Construction of the Mexican Banking System, 1941–1982', Unpublished PhD diss., Stanford University, 2002, 18–62; 'La banca mexicana antes de 1982' in Gustavo del Angel, Carlos Bazdresch and Francisco Suárez Dávila (Eds.), *Cuando el estado se hizo banquero: consecuencias de la nacionalización bancaria en México* (Mexico City, 2005), 43–56; Stephen Haber and Aldo Musacchio, *Los buenos tiempos son estos: los efectos de la incursión de la banca extranjera en México después de un siglo de crisis bancarias* (Mexico City, 2014).

the remaining 0.7% was made up by other domestic liabilities.[2] Deposits from the public included the usual checking and saving accounts along with term deposits and a large variety of other saving financial instruments such as financial bonds, certificate of deposits, mortgage securities among others. At that time, as Agustin Legorreta acknowledged, "private banks in Mexico had the monopoly of the country's saving, since there were not [in Mexico], unlike in the United States, Treasury bills and the [bond] issues by the Mexican state and official institutions represented a small proportion of national saving."[3]

With the arrival of Romero Kolbeck at Banco de Mexico in end-1976, as the previous chapter discussed, a financial policy package was introduced with the express purpose of increasing the funding base of the banking system. The rationale behind the measures implemented was to increase both the yield of financial instruments and the variety of investment possibilities available in the domestic market to savers as to capture increasing volumes of funds. Financial authorities looked above all to stimulate and attract long-term savings by setting the rates paid to depositors of all kinds for deposits longer than one year (except for those of more than two years) at levels that allow for protecting savers from the effects of inflation. The rate was freed, and the banks could offer the return they wanted below the ceiling established by Banco de Mexico. The central bank also set the interest rate for deposits of less than one year denominated in foreign currency, but in this case following the evolution of the rates prevailing in London and New York. The policy was to fix the domestic rate one or two points above the international ones so that funds will be invested in Mexico rather than abroad.

In 1978, after the implementation of these new financial policies and the initial recovery of domestic fundraising, the deposit structure of the Mexican banking system looked as follows. Liquid deposits, which consisted of sight deposits or checking accounts and a variety of saving deposits with short term (maturities of one month or less) in national and foreign currency, accounted for half of the deposit base of the banks in approximately equal shares. The remaining half were not liquid liabilities and consisted of term deposits with maturities ranging between three

[2] Banco de Mexico, 1977 Annual Report, Table 18, 94–96.

[3] Banamex archive, Libro No. 11 de Actas de la Comisión Ejecutiva, September 21, 1977 Meeting.

months and two years. Term deposits denominated in pesos have been the most dynamic fundraising instruments during the year, with a particular strong increase recorded in the liabilities with one year of maturity or more as reported in the Banco de Mexico's 1978 Annual report.[4] In terms of its internal composition, third and sixth month's deposits accounted for about 12 and 17% of total time deposits, respectively, while deposits with maturity of up to one year were the most important components with a share of 52% and those with a maturity over a year were in the second place with a 19% share.

But this funding structure changed, and significantly deteriorated, over the following years. First, between 1977 and 1982, liquid saving instruments from the non-financial sector with the domestic banking system persistently reduced their share as source of funding. Figure 4.1 displays the evolution of checking account deposits and short-term time deposits in terms of the total liabilities of the Mexican banking system. The chart shows that the contraction in liquid funding instruments is almost entirely explained by the decline of checking account deposits, which dropped from representing 22% of bank funding in 1977 to 11.5% in 1982. As for the short-term deposits, their share remained quite stable at around 17–18% of total liabilities during the whole period. Within a highly inflationary context, the cost of holding liquidity in checking accounts or sight deposits that pay no interest was important, and it seems therefore logic that depositors may have reduced such holdings and looked to place their savings in financial instruments that provided a return that allowed for minimizing the loss of currency value due to inflation or had prefered to increase consumption instead.

A second change relates to the increasing role of foreign finance as a source of funding that developed within the Mexican banking system. As explained in the previous chapter, the external fundraising instruments consisted essentially of credit lines from foreign banks operating in the Eurocurrency or US money markets and were mainly conducted through the network of foreign agencies and branches of leading Mexican banks. Figure 4.1 shows that the increasing participation of external funding in the liability structure of the banking system compensated the falling share of current account and sight deposits. This means a substitution between domestic and international liquidity, but such a change was not

[4] Banco de Mexico, 1978 Annual Report, 65–68.

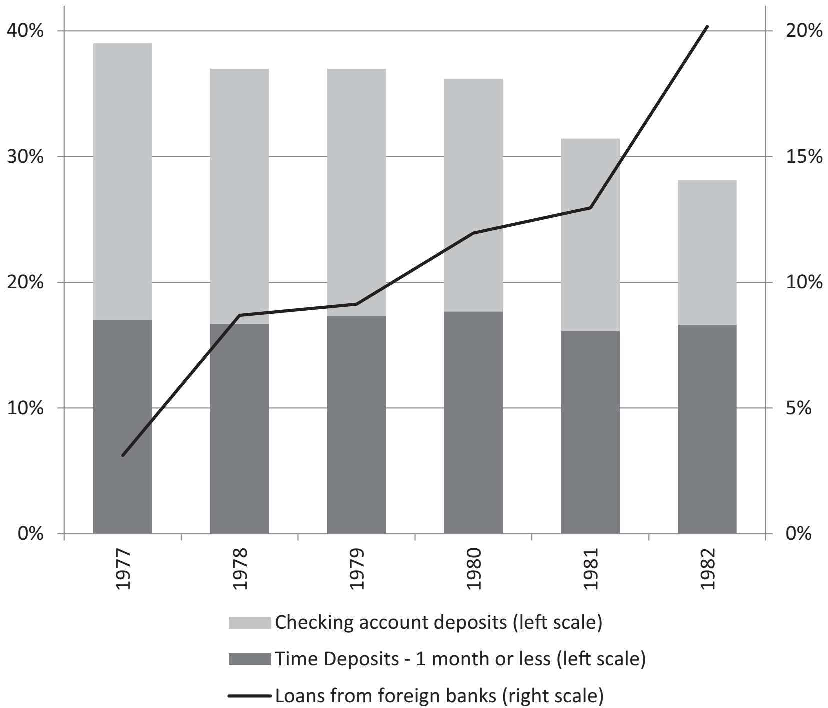

Fig. 4.1 Liquid funding structure of the Mexican banking system, 1977–1982 (% of total liabilities) (*Source* Banco de Mexico, Annual Reports [several issues])

a positive one for the domestic banking system. While current accounts were the least expensive non-equity source of funding for commercial banks and were mostly denominated in national currency, the credit lines from foreign banks were in dollars and paid interest rates. Wholesale interbank credit lines were also more volatile and much less stable than the deposits from the domestic non-banking sector, and therefore introduced a new element of vulnerability in the system.

Finally, although stable in terms of the volume of funding, the internal composition of long-term liabilities also suffered important transformations over the period. Figure 4.2 shows the evolution of the maturity structure of long-term deposits in terms of the total liabilities of the commercial banking system between 1978 and 1982. While time deposits of one year and over were the most important fundraising

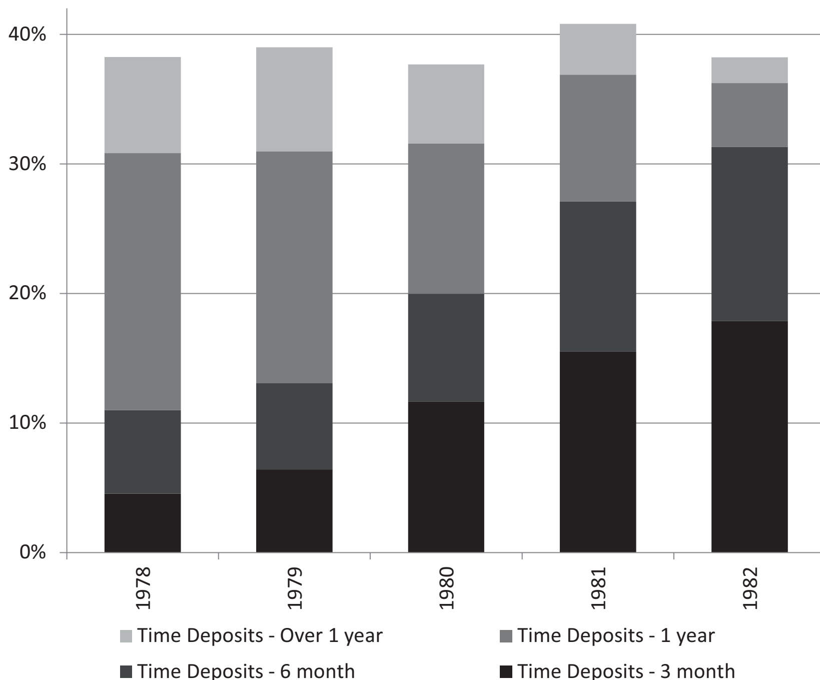

Fig. 4.2 Long-term deposits structure of the Mexican banking system, 1978–1982 (% of total liabilities) (*Source* Banco de Mexico, Annual Reports [several issues])

instruments and accounted for about 70% of total illiquid liabilities in December 1978, they represented 26% by end-1981 and around 18% in 1982. Conversely, time deposits with maturity of less than one year accounted for 30% in 1978 but as much as 82% by 1982. Within this category, shorter term accounts, namely three-month deposits, were the more dynamic components, increasing their share from 12 to 47% over the period. The shortening in the maturity structure of term deposits signified also a weakening in the liability side of the banking system balance sheet, since a funding base with a high concentration on long-term deposits is naturally more stable than one that is dominated by short-term placements.

The transformation of the maturity structure of term deposits and its concentration on three-month deposits was the result of the yield

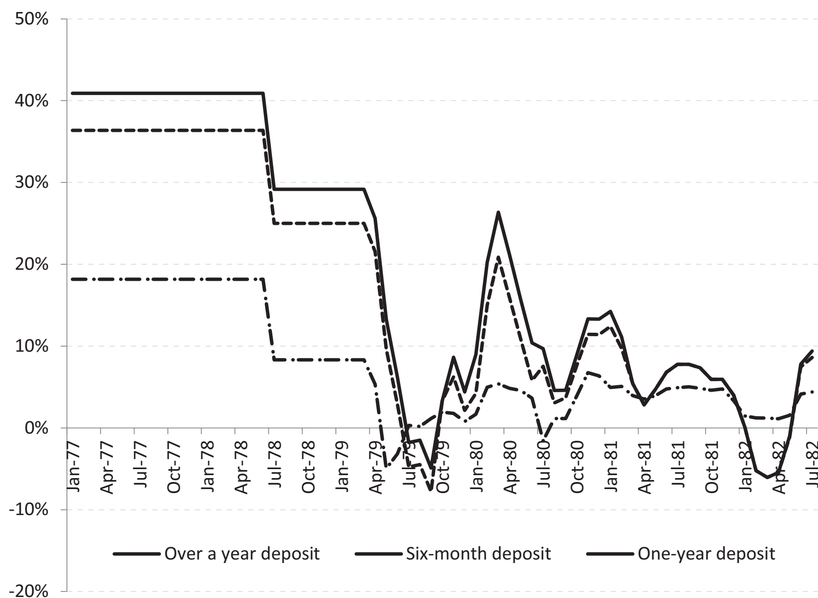

Fig. 4.3 Yield of long-term saving instruments relative to the three-month deposit rate (*Note* Computed as the spread between the interest rate of long-term and three-month deposits as a share of the three-month deposit rate. *Source* Banco de Mexico, *Series Financieras Históricas* [Mexico City, 1994])

structure of the different term instruments. Figure 4.3 plots the evolution of the spreads between the interest rates of term deposits at different maturities with respect to the three-month deposit in percentage terms. In 1977, the yield of deposits at over one year was 40% higher than that of three-month deposits, and those of up to one year and six months were 36 and 18%, respectively. The chart shows a considerable reduction in spreads in mid-1978 and a steep decline since the first quarter of 1979. Moreover, between April and October 1979 spreads became negative in some cases, meaning that the yield of three-month deposits was actually higher than that of deposits with longer maturities. Spreads become more volatile from then on and exhibit indeed a downward trend toward the end of the period. Thus, the concentration of three-month deposits seems to have been the outcome of a yield structure in which nominal rates of saving instruments at different maturities were not so different

and even tended to converge. It seems logic that, in the context of rising inflation and diminishing spreads between long- and short-term deposits, investors or savers had preferred financial instrument with shorter maturity.

As a result of these changes, by 1982 the funding base of the Mexican banking system was much bigger than in 1977, but it was structurally less solid and more instable. On the one hand, low-cost liquid deposits in pesos diminished its share as source of funding while recourse to relatively more expensive foreign liquidity in dollars increased. These were the years where banks around the world started to use liability management strategies, which led to increasing reliance on short-maturity debt borrowed from other banks to fund the expansion of its assets.[5] On the other hand, the interest rate policy followed by the central bank resulted in a concentration of term deposits with short maturities, implying a weakened and less stable funding base. In the end, this new liability structure of the banking system made it more vulnerable to shifts in the international capital market and or negative external shocks that may affect the placement decisions of domestic depositors or foreign banks.

Impoverished Capital and Greater Risks

Along with the changes in the funding base, the Mexican banking system suffered from a more general deterioration of its balance sheet structure. Notably, the capital base of the banking industry experienced progressive impoverishment throughout the period. Figure 4.4 shows the evolution of the leverage level, calculated as the ratio of paid-in capital and reserves to total assets, between 1977 and 1982. It passed from about 4% in the first quarter of 1977 to around 2.5% in mid-1981 and 1.6% after the devaluation of February 1982. In other words, the assets of the banks expanded 3.1 times faster than their capital and reserves. To the extent that banks' capital base serves as a cushion for unexpected losses and keep defenses strong in case of major shocks, these changes meant that the Mexican banking system became more vulnerable to a rise in defaults on its loans or a market downturn on the prices of the assets

[5] See, for instance, Stefano Battilossi, 'Financial Innovation and the Golden Ages of International Banking: 1890–31 and 1958–81', *Financial History Review* 7 (2000), 141–75.

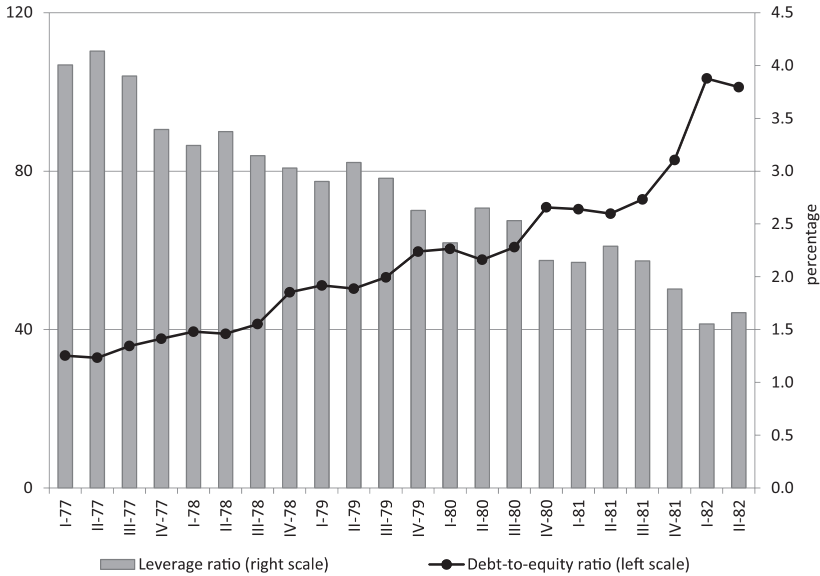

Fig. 4.4 Risk indicators for the Mexican banking system, 1977–1982 (*Note* Debt-to-equity ratio = liability/equity; leverage ratio = (equity + reserves)/assets. *Source* Banco de Mexico's, Annual Reports [several issues])

they held. On the contrary, an expansion of the balance sheet financed with more capital would have determined a better position to bear losses.

Figure 4.4 also displays the debt-to-equity ratio, measured by dividing the total liabilities of the banking system by its level of paid-in capital. The ratio reveals the financial obligations of the sector as a percentage of its total market value, indicating the amount of debt it has been used to finance the development of its activities. The ratio passed from 33.4 in the early 1977 to around 60 in 1980, and to 82.8 by end-1981; that is a 2.5 increase in the 5-year period of exchange rate stability. However, given the growing share of dollar external liabilities, the ratio reached much higher values after the devaluation of the peso in February 1982. This also shows the extent to which the banking industry had dramatically increased its reliance on debt to finance the expansion of the assets in the aftermath of the disintermediation years. Moreover, not only was the banking sector taking on more debt rather than equity to increase

its businesses, but it was not proportionally improving its reserves levels either as the deterioration of the leverage ratio indicates.

The case of Intermex, Banamex's consortium bank, provides an interesting comparative benchmark. The headquarter of this bank was in London, and their activities were therefore subject to UK banking regulation and the supervision of the Bank of England. Archival records from Banamex contain the discussions held among the members of the Executive Committee regarding the evolution of the business activity of the bank in relation to its capital base and the requirements of the Bank of England. At the end of 1974, the year of its creation, Intermex had a capital base of £2.5 million and liabilities that represented 10 times its capital. By 1975, the liabilities had increased up to 19 times the level of paid-in capital, which pushed shareholder banks to increase its capital to £5 million, diminishing the debt-to-equity ratio to 14.[6] In 1977, Intermex's liabilities had climbed to around £130 billion "giving a debt to equity ratio of 26 to 1, which was outside the policy of the Bank of England, who consider[ed] a ratio of 20 to 1 between debts and capital manageable."[7] With these figures in the background, the numbers exhibited by the Mexican banking system look quite worrisome: Debt to equity was already 50% higher than the level the Bank of England considered prudent by early 1977.

In Mexico, the capacity of the banks to expand its liabilities and take debt was determined according to the amount of capital and total reserves of the institution. The banking law did not set a ratio or limit, which was supervised by the SHCP, but established the different types of liabilities to be considered in the computation. The reforms introduced to the Mexican banking law during the first half of the 1970s affected the capacity of banks to leverage on debt in an ambiguous way. On the one hand, the new legislation permitted banks to exclude funding used to finance liquid and risk-free assets from the computation of the capacity of the banks to expand its liabilities, allowing for increasing leverage at a consolidated level. On the other hand, in an attempt to avoid a highly leverage financial system,

[6] Banamex archive, Libro No. 8 de Actas de la Comisión Ejecutiva, February 8, 1976 Meeting.

[7] Banamex archive, Libro No. 10 de Actas de la Comisión Ejecutiva, January 5, 1977 Meeting.

the law looked also to control from capital pyramids effects through which different financial institutions from an economic group used a same unit of equity when computing their indebtedness capacity.[8] These were years where financial regulation did not still require banks to control risks and hold adequate equity through capital requirements as it would be the case during the 1980s, with the worldwide expansion of prudential regulation that followed the Basel Accord.[9]

Naturally, lending was the banking sector's main activity and a main component of its balance sheet, with a loan portfolio representing between 50 and 55% of the assets during those years. In terms of its currency composition, the loan portfolio was mainly denominated in national currency, although dollar lending gained importance and persistently increased its share toward the end of the period. While in 1977, dollar lending accounted for about 20% of total lending—the balance consisted of credits denominated in pesos, by the beginning of 1982, however, its weight has increased to 30% and to 42% after the devaluation of February. Figure 4.5 represents the evolution of the ratio of loans in pesos and dollar to capital for the Mexican banking sector between 1977 and 1982. The chart shows that peso loans remained quite stable relative to capital, oscillating between 13.8 and 17.2 during the period. The private sector was the main destination of these credits, accounting for as much as 92.5% of the total lending in pesos on average, while the public sector and other financial institutions represented 5.3 and 2.2%, respectively.

On the other hand, lending in dollars considerably expanded in terms of the capital base of the banking system. As shown in Fig. 4.5, the dollar loan portfolio to banks' capital doubled between 1977 and end-1981, jumping to much higher levels after the 1982 February devaluation. By end-1981, as in the case of loans in local currency, the Mexican private sector was the main recipient of dollar credit lines, accounting for 52.7% of banks' dollar loan portfolio. The Federal government and public dependencies represented 23.2%, financial institutions 4.8% and

[8] Mariana M. de Sousa, 'The Embedded-Agency Approach to Bank Regulation: The Case of Latin America', *Documento de trabajo CIDE* No. 210 (2011).

[9] Eugenio Rivera and Adolfo Rodríguez, 'Competencia y regulación en la banca de Centroamérica y México. Un Estudio Comparativo', *CEPAL—Serie Estudios y Perspectivas* No. 71 (2007).

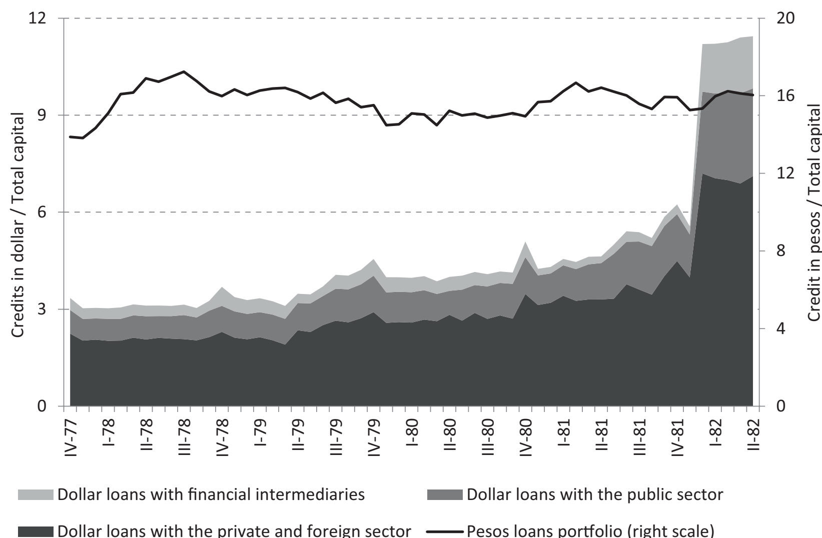

Fig. 4.5 Evolution of the loan portfolio of Mexican banks relative to capital, 1977–1982 (*Source* Banco de Mexico, *Series Financieras Históricas*)

remaining 19.3% were loans to the external sector since, as part of their international operations, Mexican banks were also lending to other Latin American countries and non-Mexican borrowers. These figures give a clear idea of the extent that the higher leverage of the banking industry related to the internationalization of the system and the increasing involvement with dollar rather than pesos lending operations.

The banking industry came indeed to increasingly leverage on external indebtedness to fund its assets, namely loans, during this period. While only 3% of the assets of the domestic banking system were funded by borrowing from foreign banks in 1977, the proportion increased to 11.6% in 1980 and about 20% in 1982. On the other hand, the share of banking assets funded by domestic sight and term deposits in local and foreign currency oscillated around an average of three quarters. The rise of foreign borrowing and lending without proportional increases in the reserves or capital base affected the safety and soundness of the banking system. Because during downturns, bank with a highly leveraged balance sheet usually suffer from loss of confidence much earlier

than less-leveraged institutions, an increase in the leverage ratio indicates therefore that the financial system becomes more vulnerable to episodes of market panic and external shock that could provoke insolvencies.[10]

International Roots in Banking Fragility

It should be clear by now that during the upswing of Mexican banking since 1977, the system at large became more fragile and vulnerable to shocks or changes on market conditions both in Mexico and abroad. On the one hand, the deposit base significantly shortened and foreign borrowing increased its share as source of funding. On the other hand, the sector was increasingly undercapitalized and the balance sheet more and more dollarized. The internationalization of Mexican banking and the integration of the domestic financial system in the world capital markets were at the center of this process since it had a direct impact on the capacity of the banking industry to leverage on foreign liquidity and expand its lending activities. However, not all Mexican banks were operating at an international level, and it is not evident the extent to which international finance contributed to the increasing fragility of the banking system or if there were other factors at the base of these problems.

This section looks more deeply into the role of international finance in the deteriorating health of the Mexican banking system. It does so by assessing whether higher risk in the banking industry was a homogenous phenomenon or not, and the extent to which it affected some banks or group of banks more than others. In this regard, the distinction is made between banks involved with international finance ("internationally oriented banks") and those operating only in the domestic market ("domestic oriented banks"). Had international financial intermediation been a significant source of additional vulnerability, the group of internationally oriented banks would be expected to exhibit higher levels of risks than domestic-oriented banks. Conversely, if no major differences are observed in the evolution of leverage or capitalization levels, then foreign borrowing and international lending may not have been the origin,

[10] See, for instance, Nicola Gennaioli, Andrei Shleifer, and Robert Vishny, 'Neglected Risks, Financial Innovation, and Financial Fragility', *Journal of Financial Economics* 104 (2012), 452–68.

or at least not the most important cause, of the increasing weakness that the Mexican banking system experienced during the last quarter of the 1970s and the early 1980s.

A financial statement analysis is performed at the bank level with financial ratios reconstructed from the balance sheets of the banks as published by Mexican banking authorities. In December 1978, the Financial Analysis Unit of the CNBS started to publish the "*Boletín mensual de indicadores y estados financieros de las instituciones de crédito*," which contains the balance sheets of multiple banks in Mexico on the monthly base.[11] The period covered in this analysis begins in the second quarter of 1979, the sixth month after the first Bulletin was issued, up to the second quarter of 1982, before the announcement of the Mexican government's debt moratorium and the later nationalization of the banking system. The first two quarters are discarded because at that time an important number of financial institutions were still in the process of merging and becoming multiple banks, and therefore, the bulletins do not include data on their balance sheet. In the end, the analysis includes 23 multiple banks for which there is complete and consistent balance sheet information for the entire period.[12]

By the beginning of 1982, the Mexican commercial banking system reached US$80.3 billion in total assets and liabilities. There were 35 multiple banks that accounted for 93.3% of this amount as represented in Fig. 4.6, while the remaining 6.7% belong to 12 deposit banks, six *financieras*, five capitalization companies and a Mortgage bank that have not evolved into multiple banks and kept their previous legal standing.[13] The 23 multiple banks of the sample represent as much as US$71.9 billion or 95.8% of all multiple banks. The group of internationally oriented banks includes the six larger banks of the country—Bancomer, Banamex, Banca Serfin, Multibanco Comermex, Banco Internacional and Banco Mexicano Somex, which were involved with foreign finance in the terms

[11] Since 1980 the bulletin was published under the name of "*Boletín de indicadores financieros de la banca múltiple privada y mixta*."

[12] Including the last quarter of 1978 and the first of 1979 would have required a considerable reduction of the sample in order to have a complete time series of the banks.

[13] CIEN-A19/E-89/Marzo de 1983, "*La banca antes de la nacionalización*".

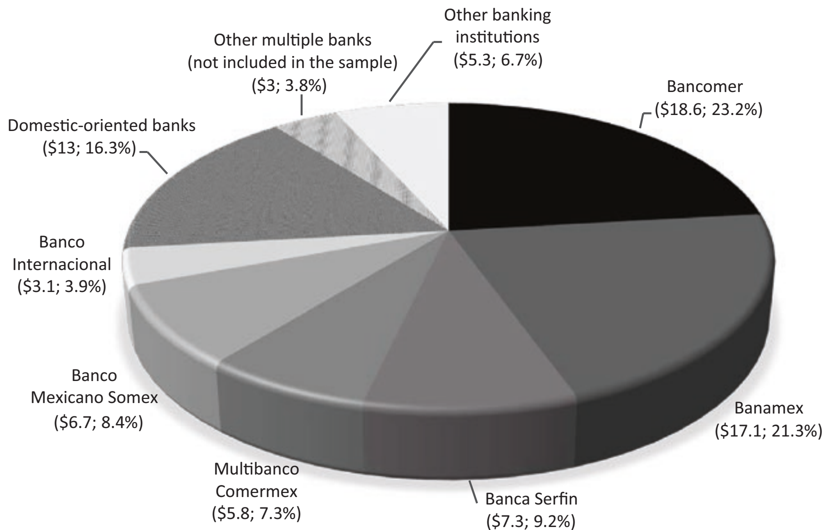

Fig. 4.6 International and domestic-oriented institutions in the Mexican banking market (total assets in December 1981 in US$ billion and %) (*Source* CNBS, Boletín de indicadores financieros de la banca múltiple privada y mixta [December 1980] and Banco de Mexico's 1981, Annual Report)

discussed in previous chapters.[14] Together they represent 81.8% of the sample and about 73.2% of the entire commercial banking system. On the other hand, the group of domestic-oriented banks was made up of 16 of the 23 banks in the sample but held only 18.2% of the assets and liabilities, with Banco del Atlántico, Banpais, Banco BCH and Bancreser among the biggest players.[15]

[14] For the purpose of the analysis, Banca Promex is also considered as internationally oriented bank since it was part of the banking group Mexicano-Somex.

[15] The other domestic-oriented banks included in the sample are Banca Cremi, Multibanco Mercantil de México, Banca Confia, Crédito Mexicano, Banco Regional del Norte, Actibanco Guadalajara, Unibanco, Banco Continental, Banco Mercantil de Monterrey, Banco del Noroeste, Banco Sofimex, Banco Occidental de Mexico.

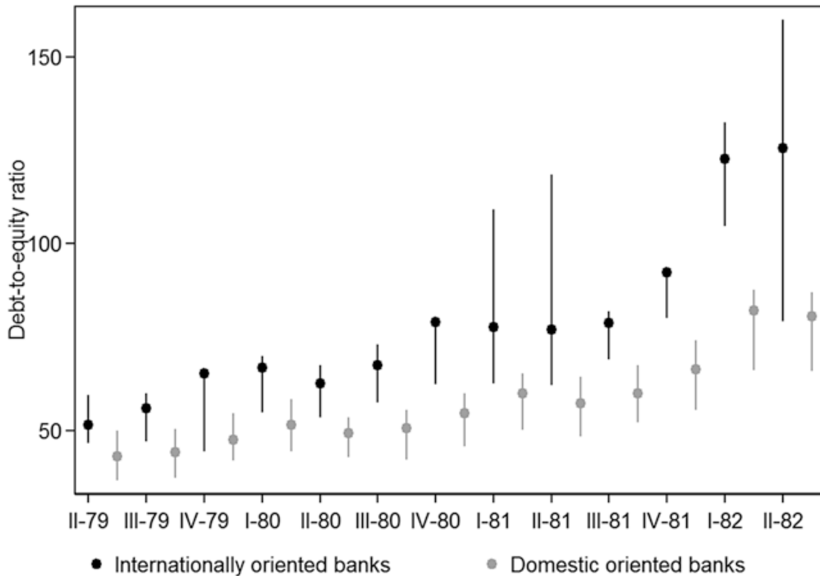

Fig. 4.7 Debt-to-equity ratio of international vs. domestic-oriented banks, 1979–1982 (*Note* Debt-to-equity ratio=liabilities/total equity. *Source* CNBS Multibank Bulletin [several issues])

Figure 4.7 shows the evolution of the debt-to-equity ratio for the group of internationally and domestic-oriented banks. The chart plots the mean weighted by the size of the banks (measured by total liabilities) and the 50% central distribution per quarter for each group between 1979 and 1982. The value of the ratios for internationally oriented banks stands persistently above the levels observed for domestic-oriented bank, with the gap between them growing toward the end of the period. The interpretation of this is that the former had been much more aggressive than the latter in financing their expansion with debt instead of shareholders' equity, and that they became significantly more leveraged during the years preceding the outbreak of the debt crisis. While access to the international capital markets gave to Mexican leading banks the possibility of finding additional sources of funding to further expand their businesses, domestic-oriented banks could only rely on local resources that were much more limited and expensive. Thus, although the balance sheets of both groups of banks became increasingly leveraged

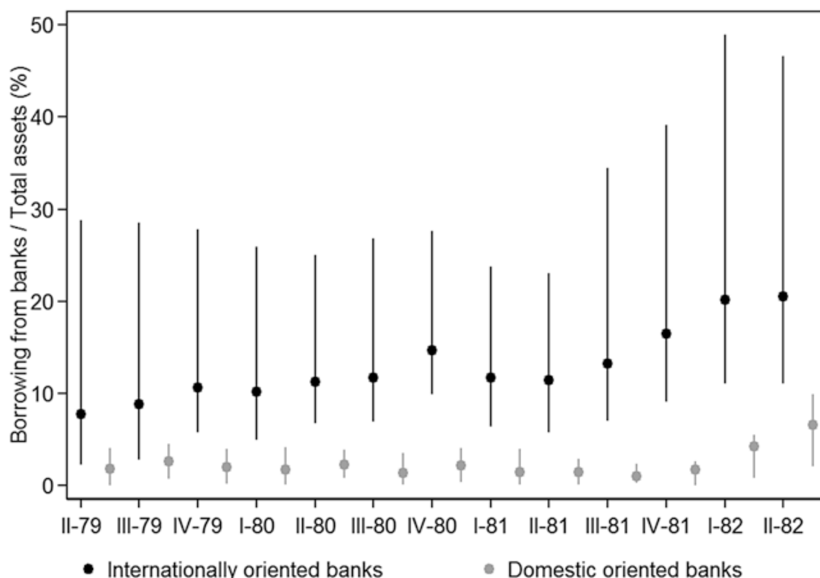

Fig. 4.8 Borrowing from banks to total assets of international vs. domestic-oriented banks, 1979–1982 (*Source* CNBS Multibank Bulletin [several issues])

throughout the period, those with access to foreign funding, which were the most systematically important banks, display considerably more worrisome levels.

In a similar vein, Fig. 4.8 plots the mean and 50% central distribution of the fraction of assets funded by interbank loans for the group of internationally versus domestic-oriented banks. The chart shows considerable differences between the two groups of banks, with the former displaying higher levels than the latter. These results reflect the fact that banks operating abroad could raise foreign liquidity by borrowing from foreign banks, while interbank funding for banks operating only in the national market was restraint to the Mexican money markets, which provided much-limited funding possibilities than its massive US and London counterparts. Interbank credit lines were unsecured, they were more volatile than deposits from the public, and thereby the higher volumes of interbank borrowing in relation to assets are an important indicator of reckless banking practice and risky behavior. Moreover, unlike money market transactions within Mexico, foreign interbank credit lines

entailed an additional source of vulnerability related to fluctuations in the foreign exchange and international interest rates. Not only were internationally oriented banks twice more leveraged than domestic-oriented banks, but their liabilities, namely the interbank funding lines, were also riskier.

This comparative analysis of the financial ratios shows that the group of internationally oriented banks demonstrated higher levels of risks than banks that operated only at a national level, and that international finance was at the center of these problems. By increasingly relying on funding lines from foreign banks, Mexico's leading banks expanded its assets without improving its reserves and capital levels, becoming more leveraged and exposed to external shocks or shifts on international market conditions. The risks behind the involvement with foreign indebtedness become more evident after the devaluation of February 1982. The debt-to-equity ratio and interbank funding to assets considerably increased for both groups of banks, but the deterioration of the ratios is much worse for internationally oriented banks given their larger engagement with dollar liabilities and exposure to currency risk. Thus, in terms of liability management, the financial statement analysis at the bank level shows that higher risk in the domestic banking sector was not a homogenous phenomenon and that it affected more to banks involved in foreign finance than those operating only in the domestic market.

Liquidity Position and Funding Base

Along with its role in the impoverishment of capitalization levels, international finance had also a negative repercussion on the liquidity position of Mexico's leading banks. Figure 4.9 plots the evolution of the quick ratio for the group of internationally and domestic-oriented banks between 1979 and 1982. The ratio is calculated as the coefficient between banks' current assets, namely cash, deposits with Banco de Mexico and government and private securities, and their current liabilities, which include sight deposits and loans from other banks. The figure shows higher levels of risk for the group of international banks, since lower levels of the ratio indicate a more limited ability to meet their short-term obligations with liquid assets, and thus a worse short-term liquidity position. In comparative terms, the liquidity position of internationally oriented banks was about 50% weaker than that of domestic-oriented banks. From 1981 onwards, it appears that domestic-oriented

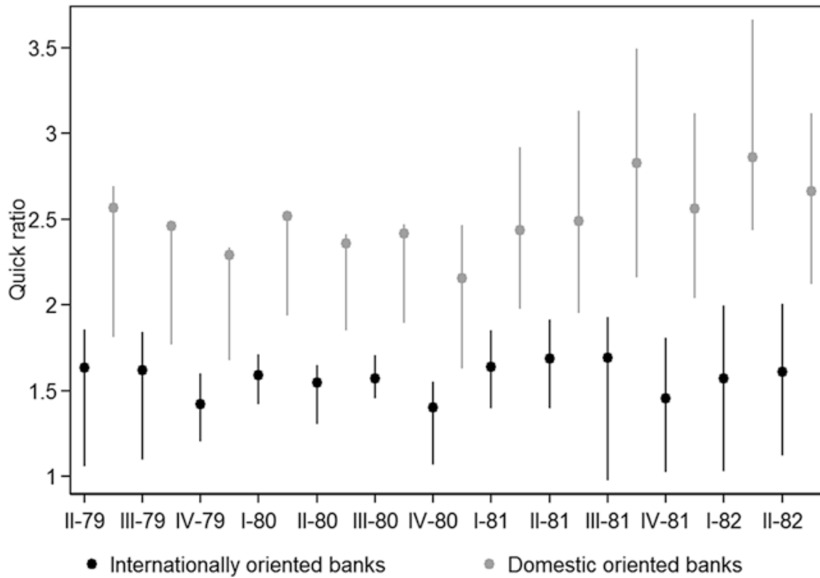

Fig. 4.9 Quick ratio of international vs. domestic-oriented banks, 1979–1982 (*Note* Quick ratio = current assets/current liabilities. *Source* CNBS Multibank Bulletin [several issues])

banks came actually to improve their ability to meet their financial obligations with liquid assets.

What explains the weaker liquidity position of internationally oriented banks is the combination of less liquid assets and a funding base more focused on short-term fundraising instruments. Previous research has elaborated condensed indicators of risk for Mexican banks during these years derived from a large number of balance sheets ratios widely used in finance to conduct financial statement and banking analysis.[16] In this work, the bank's asset liquidity indicator shows that, after a period of no major differences, there was a considerable improvement in the liquidity of the asset portfolio for the group of domestic-oriented banks and a relative worsening for banks involved in international finance from mid-1981 on.

[16]Sebastian Alvarez, 'Venturing Abroad: The Internationalisation of Mexican Banks Prior to the 1982 Crisis', *Journal of Latin American Studies* 49 (2017), 517–48, esp. 545–48.

In addition, the maturity composition indicator of the banks' funding base, which is related to the ratios of bank loans and time and sight deposits to total liabilities, also displays important discrepancies between the two groups. The funding structure of internationally oriented banks had a larger concentration in short-term financing than banks operating only at a national level all over the period.

The higher reliance on short-term funding observed for the group of internationally oriented banks is not explained by the modifications observed on the retail deposit base. Figure 4.10 shows the changes in the share of different fundraising instruments on total liabilities for Banamex, Bancomer and Banca Serfin, the three largest Mexican international banks, between 1978 and 1981. The chart shows a clear reduction in the contribution of sight and saving deposits and other liquid financial instruments such as *pagarés* (promissory notes) or its predecessors.[17] In the case of Banamex, for instance, sight and saving

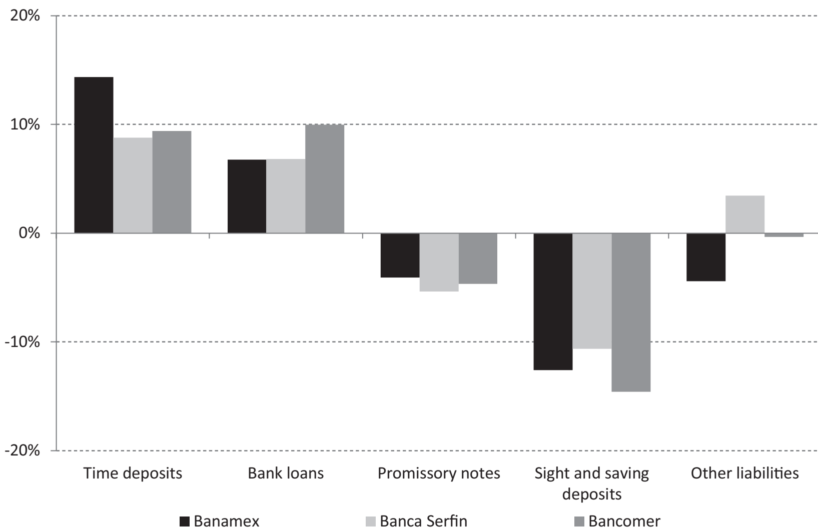

Fig. 4.10 Change in the share of funding instruments to total liabilities, 1978–1981 (*Source* CNBS Multibank Bulletin [several issues])

[17] Up to 1977, banks could raise funds through mortgage and financial bonds or certificates, but these instruments were progressively taken out of circulation and replaced by promissory notes from firms and the public.

deposits passed from accounting 38.9% of its funding base in 1978 to 26.3% by end-1981, that is a fall of 12.6 percentage points. As for the promissory notes, the drop was of 4.1 percentage points, which added to sight and saving deposits represents an accumulated fall of 16.7 percentage points in liquid fundraising instruments with the domestic private and public sector.

On the other hand, time deposits and bank loans increased their participation as source of funding, compensating for the declining share of domestic liquidity. For Banamex, time deposits, which had maturities of three months up to over a year, incremented their share on total liabilities by 14.4 percentage points between 1978 and 1981. However, this shift in the composition of retail funding does not explain the larger concentration on short-term funding of Mexican international banks because the term deposits had longer maturities than the instrument they were outweighing. It is the increasing reliance on wholesale interbank funding what accounts for such outcome. In fact, short-term bank loans increased from 2.7% of total liabilities in 1978 to 9.5% in 1981 for Banamex and from 4.9 to 14.9% and 2 to 8.8% for Bancomer and Banca Serfin, respectively. The behavior of other liabilities, which was essentially made up of *reportos* or repurchase agreements, shows no clear trend and appears more erratic across banks and along time.

Figure 4.11 plots the relationship between the change in the contribution of sight deposits and bank borrowing to the funding base for the sample of 23 Mexican multiple banks between 1978 and 1981. The chart makes clear that along with Banamex, Bancomer and Serfin, the other three Mexican international banks, Multibanco Comermex, Banco Internacional and Banco Mexicano-Somex, experienced a reduction in the share of sight deposits to total liabilities in this period. For these banks, recourse to interbank loans as source of funding also increased. In fact, internationally oriented banks appear as a separate, distinct group in the lower right corner of the chart, with changes in the shares of both fundraising instruments above average variations.[18] This shift from liquid retail deposits to wholesale interbank liquidity implied higher risk given the more volatile and instable nature of money market transactions, particularly so when it involved cross-border transactions and currency risk.

[18] Recall that Banca Promex belonged to the banking group Mexicano-Somex.

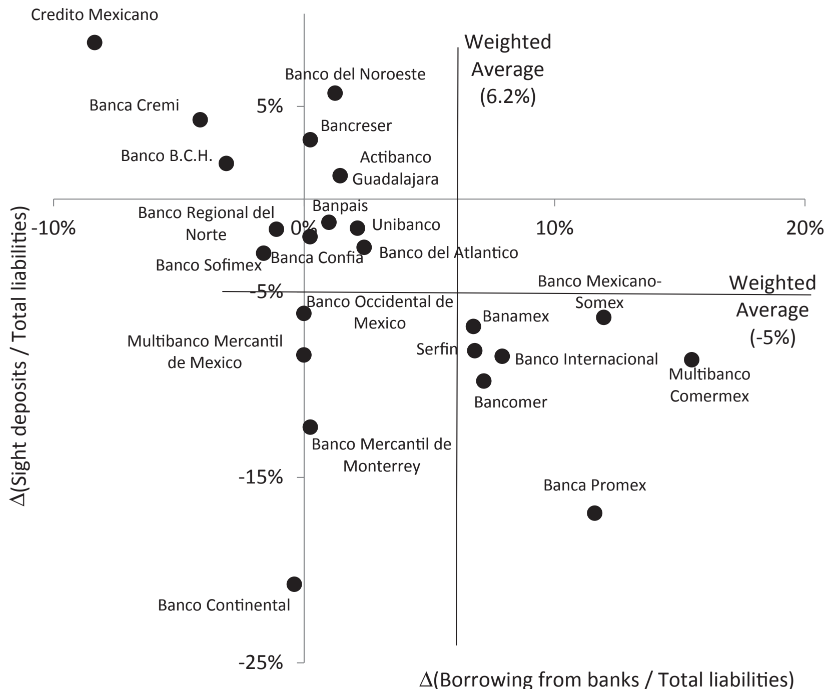

Fig. 4.11 Change in the share of deposits and bank borrowings to total liabilities, 1978–1981 (*Note* Calculations for Banco Mexicano-Somex, Banco Internacional and Banco del Noroeste relate to 1979 and 1981. *Source* CNBS Multibank Bulletin [several issues])

On the contrary, the other banks experiencing significant declines in the share of sight deposits to total liabilities do not display higher levels of bank borrowing. Figure 4.11 shows that Banco Occidental de Mexico, Multibanco Mercantil de Mexico, Banco Mercantil de Monterrey and Banco Continental had virtually no variation in the share of bank borrowing as source of funding. As in the case of Banamex, Bancomer and Serfin, their balance sheets exhibit offsetting changes on time deposits accounts but the size of the change was much larger. The new composition of retail deposits did not imply a less stable and riskier funding base as in the case of internationally oriented banks since time

deposits had much longer term. As for the rest of the domestic-oriented banks, changes were much less dramatic, and no pattern seems to appear between retail and wholesale liquidity, with some of them actually incrementing their share of sight deposits as source of funding during this period.

The change of the funding structure operated within internationally oriented banks reveals a substitution between domestic retail liquidity and international wholesale liquidity. This behavior explains the decline in the share on total liabilities of checking account deposits and the offsetting increase of borrowing from foreign banks observed at the level of the banking industry as described at the beginning of this chapter and represented in Fig. 4.1. Since the group of international banks accounted for about three-fourths of the domestic banking system, they drive the behavior observed in the aggregate data. Declining sight deposits were replaced by larger interbank foreign borrowing that entailed higher risk levels not just for the group of international banks, but for the entire domestic banking system.

With strong economic growth and an increasing domestic saving rate in Mexico, the fall of liquidity in real terms and as a share of the total bank liabilities is counter-intuitive.[19] Either because economic agents were deviating liquidity and savings somewhere else and/or the banks deliberately reducing recourse to them, it begs the question of where all this money was going. This is an important concern in connection with the wave of capital flights affecting the country during those years, which was believed to be intermediated through the banking system. As explained in Chapter 3, high domestic interest rates combined with an overvaluation of the local currency and free foreign exchange convertibility generated a movement of savings toward term deposits and the flow of liquidity abroad to capitalize the gains. With the leading banks of the country increasingly integrated abroad, it is possible that the money these banks were losing in their deposit accounts was being transferred abroad, but this is an issue that requires further investigation.

[19] Domestic private savings relative to Mexican GDP passed from 13.5% in 1977–1978 to 14.6% in 1980 and 18.4% by the beginning of 1982.

Loan Portfolio and Devaluation

Unlike with liabilities, the increasing reliance on debt, and particularly foreign indebtedness, to finance the expansion of banking activities did not bring major changes in the performance of the asset side of the balance sheets. In 1977, credits to the government and private financial and non-financial sector accounted for about half of the claims of the Mexican banking system and oscillated around that level over the years leading to the 1982 debt crisis. Cash and balances with depository institutions were the other major accounts, representing between 38 and 43% of total banking assets, of which about nine-tenths were the legal reserve requirement held in Banco de Mexico. Taken together, they represented over 90% of the assets of the banking system, while investment in public bonds and private securities was usually below 5% and the remainder were other types of resources.

Figure 4.12 shows the evolution of the share of the loan portfolio on assets for the group of internationally and domestic-oriented banks. After a period of similar trends and levels between 1979 and 1980, the ratios began to diverge in 1981. While the share of loans to assets for the group of banks operating only at a domestic level falls, it increases for Mexico's international banks and starts to decrease in the first quarter of 1982 without reaching the low levels of its domestic-oriented counterparts. In the early 1980s, financial authorities increased the legal reserve requirements, and the funds that were previously available for lending had to be deposited in the central bank.[20] In terms of total assets, government securities and deposits in Banco de Mexico grew from 36.5 to 48.6% between mid-1979 and mid-1982 for domestic-oriented banks, while the loan portfolio dropped from 49.7 to 38.6% over the same period. Unlike them, internationally oriented banks had access to foreign funding that was not subject to reserve requirement, and this could be used to maintain their lending portfolio, which only started to decline after the currency crisis of early 1982.

[20] The legal reserve requirement raised from 37.5% in December 1979 to 40.9% by June 1980.

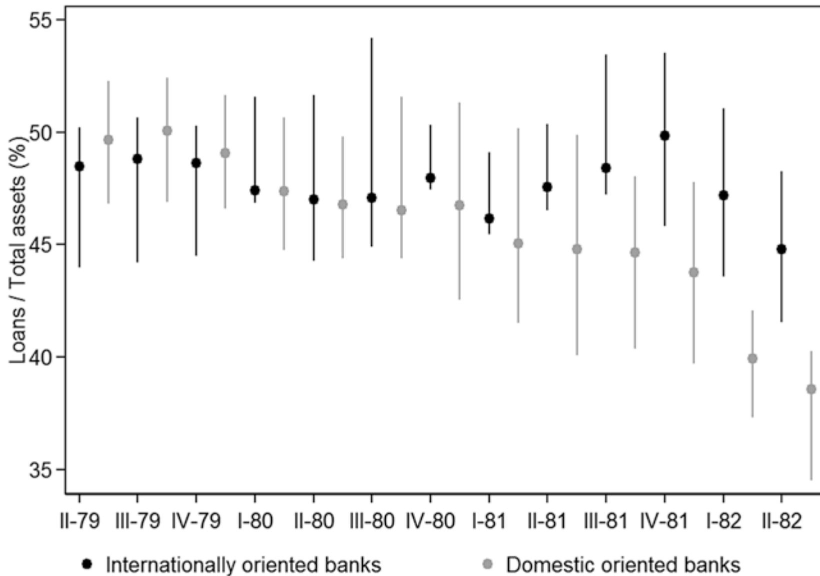

Fig. 4.12 Loan portfolio to total assets of international vs. domestic-oriented banks, 1979–1982 (*Source* CNBS Multibank Bulletin [several issues])

The involvement with foreign finance did not necessarily imply a deterioration in the asset side of bank's balance sheet. Figure 4.13 plots the ratio of non-performing loans to total loans for the six Mexican banks operating abroad and the group of domestic-oriented banks from March 1979, the first quarter for which information on non-performing loans is available, until June 1982. At the aggregate level, the share stands at around 3% in average over most of the period, slightly increasing to 3.8% by June 1982. The group of internationally oriented banks, which were engaged in dollar lending and external businesses, do not display particularly worrisome values, and the portion of non-performing loans was indeed lower than the sector average. Notably, the group of domestic-oriented banks experienced a deterioration, with the ratio increasing from an average of 3.2% during 1981 to 4.5% in March 1982 and 5.4% by June 1982. As described in the previous chapter, the economic

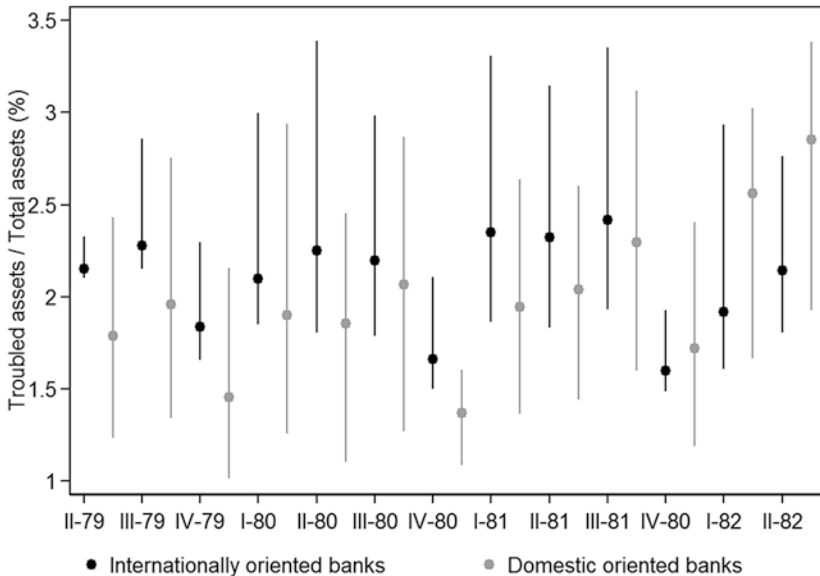

Fig. 4.13 Troubled loans to total loans of international vs. domestic-oriented banks, 1979–1982 (*Source* CNBS Multibank Bulletin [several issues])

crisis that followed the devaluation of February 1982 created some serious debt repayment problems among private sector borrowers and this affected the banking sector as a whole.

Archival evidence from Banamex shows that the Executive Committee was closely monitoring the evolution of the non-performing loan portfolio in the aftermath of the devaluation. As of June 1982, Banamex's General Director Agustin Legorreta reported to the Committee that the past-due portfolio has so far performed within the forecast. He notified that the ratio of non-performing loans to the loan portfolio for the banking system had been 3.43% in 1981 and 3.41% for Banamex, and that as of April 1982 the correspondent values had increased to 3.92 and 3.66%, respectively. He also explained that, given the abnormal situation the country was going through, it has been decided to increase bank's reserves above what has been originally planned, and that he did not expect potential losses to affect the projected outcomes for 1982. However, as a precautionary measure and in anticipation of possible

difficult cases, the bank had contacted law firms for debt collection management and created a special unit in charge of dealing with non-performing loans.[21]

The situation of the Alfa Industrial Group was given special consideration by Banamex. As of June 1982, according to the records of the bank's management team, the company's total liabilities reached US$2369 million, of which US$1669 million or 70% was owed to a total of 23 Mexican banks and 80 foreign creditor banks. The claims of Banamex with Alfa stood at around US$762 million, an amount representing 0.69% of the total debt of the group and 5.6% of outstanding loans with Mexican banks. As much as 90% of the Alfa's indebtedness was denominated in dollars, which explains why the devaluation created serious debt payment problems for the group. According to Banamex official Juan Elek, between January and April 1982 the cash flow deficit of the Alfa Group reached 10 billion pesos (about US$266 million) and interest payments US$55 million per month. For Legorreta, the "real state of Alfa was bankruptcy" and the solution would require the liquidation of some firms and the takeover of others by the government and the private sector. Had this been confirmed, in the eyes of Juan Elek, the situation of Banamex would not be seriously compromised because its "credits [had been] granted to the best firms of the Group, such as Hylsa, Fitón, La Marina, Redes, Textiles Industriales, among others."[22] In the particular case of Hylsa, which was Mexico's largest steel company and the best performing sector of the group, its financial health and productivity based profits were widely recognized, and it was therefore difficult to believe it would go bankrupt.

Compañía Vinícola del Vergel of the Garza Sada Group provides another example of the rise in debt payment difficulties post-devaluation and the preoccupations of Mexican creditor banks. This firm, which according to Banamex's records started to confront some financial problems in 1981 due to some speculative operation with Brandy, was seriously affected by the currency crisis of early 1982. At that moment, the company had bank liabilities of US$70 million, which resulted in foreign exchange losses of 1260 million pesos, an amount representing 26.4%

[21] See Banamex archive, Libro No. 14 de Actas de la Comisión Ejecutiva, June 9, 1982 Meeting.

[22] Ibid.

of its assets as of end-1981. The devaluation and short-term structure of its debt had brought the firm into the brink of failure. Banamex had US$14.3 million of outstanding claims with Vergel, US$6 million of which were overdue and the remaining US$8.5 million were coming due in the next months. The situation concerned other creditor banks as well, such as Comermex, Banco Internacional, Serfin, Bancomer, Citibank and Chase Manhattan, with which Banamex was meeting in order to arrange financial assistance and avoid the liquidation of the firm. To protect the bank of whatever outcome may occur, Alejandro Legorreta informed the members of the Banamex's committee that "all kinds of legal actions [had been filed] in order to ensure its interests in the best possible way within the difficult situation."[23]

Although debt payment problems were looming in 1982, it does not seem that banks involved with foreign capital had financed more, or were more exposed to, risky loans than domestic-oriented banks. It was the devaluation rather than the increased leverage on foreign borrowing what deteriorated the quality and riskiness of bank's assets. To the extent that the quality of the asset portfolio of financial institutions depends on the financial health and profitability of its clients, the problems confronted by the non-financial sector in the aftermath of the devaluation came to affect the balance sheet of the banks. An indicator of asset quality elaborated in previous work, which is based on the ratios of troubled assets to total assets and return on assets, along with other balance sheet indicators, shows virtually no deterioration prior to the currency crisis of 1982.[24] Moreover, unlike in the case of capital adequacy, liquidity position and funding maturity, no major differences are observed in the quality of the assets, and the risks associated with them, of internationally and domestic-oriented banks. The devaluation seems to be the landmark behind the weakening of bank's asset quality in 1982, and it concerned all Mexican banks and not just those involved in foreign finance and international lending.

As part of larger economic conglomerates, it is possible that the focus of the banks was on extracting a premium from their existing relationships with other firms from the group rather than shifting to riskier

[23] Ibid.

[24] Alvarez, 'Venturing Abroad', 547.

assets. Although there is no information available on financial terms or the composition of the loan portfolio at the bank level, the importance of insider lending within Mexican financial institutions has been largely documented in the national historiography. For instance, Gustavo del Angel has argued that, in a context where rights of ownership were uncertain in Mexico, related lending served as a way of overcoming the problems of asymmetric information such as adverse selection, monitoring, repayment and the establishment of new contracts.[25] He finds that during the post-war period Mexican banks did not present significant exposure to credit risk as a result of this practice, and that only a few institutions experienced financial problems connected to lending opportunism. Notably, in the 40 years that preceded the debt crisis of 1982 the ratio of non-performing loans to total loans was relatively stable and the banks that suffered financial troubles were mostly small local banks and not the leading ones.

Banks in the Stock Exchange

Multiple banks were *sociedades anónimas,* or joint stock-limited liability corporations, and they were listed on the Mexican Stock Exchange. Their paid-in capital consisted of shares issued in the stock market and purchased by shareholders, which then became publicly tradeable although most banks maintained a locked corporate control on them.[26] In 1982, for instance, the capital stock (*capital social pagado*) of Banamex was 5375.7 million pesos according to the records of the Mexican Stock Exchange and was made up of 107,494,400 shares with a nominal value of 50 pesos.[27] This amount of paid-in share capital represented 26% of the total capital or equity of Banamex, with the remainder consisting of legal and voluntary reserves as well as non-distributed profits. By end-1982, a total of 26 multiple banks were listed in the Financial

[25] Del Angel, 'Paradoxes', 202–40. See also Jorge Basave Basave, Carlos Morera, and Carlos Strassburger, *Propiedad y control en los grupos financieros empresariales en México*, 1974–1988 (Mexico City, 1994) and Nora Hamilton, *México: los límites de la autonomía del Estado* (Mexico City, 1983).

[26] See Leonor Ludlow (Ed.), *200 Emprendedores mexicanos: la construcción de una nación* (Mexico City, 2010).

[27] Bolsa Mexicana de Valores, *Anuario financieo y bursatil 1982*, 520.

and Stock Market Yearbook—including the 23 multiple banks analyzed in this chapter—along with a number of other deposit banks, *financieras*, investment firms or trust funds, insurance companies and other specialized financial institutions.

Although registered in the stock exchange, the shares of the banks were not necessarily all highly traded. In fact, operations in the Mexican security markets have been historically dominated by government papers and commercial banks' financial bonds, while the trading of stocks, from either corporations or the banks themselves, had a much smaller role in the activity of the exchange. According to data collected by Gustavo del Angel, the volume of stock transactions never exceeded 10% of the value of securities traded in the market.[28] After 1978, with the creation of an open market for government bonds—the Mexican treasury bills called Cetes, these securities came to account for a large majority of Mexican stock market activity. Among banks, those with regular monthly stock transactions were the largest four, Bancomer, Banamex, Banca Serfin and Multibanco Comermex, and to a lesser extent Banca BCH, Banca Cremi and Banca Confia, while the other banks had operations on a much more irregular basis and only during some months of the year.

Figure 4.14 plots the evolution of the Mexican Stock Exchange index along with the shares of Bancomer, Banamex and Serfin between 1977 and 1982. It shows the stock market boom experienced by Mexico in this period, with the average price per share increasing from 353 pesos in November 1977 to a peak of 1614 pesos by May 1979, an average growth rate of 8.8% per month. The enactment of the *Ley del Mercado de Valores* (Security Market Law) in 1975, which entailed the fusion of regional stock exchanges and their consolidation into a national entity called Bolsa Mexicana de Valores, set the institutional framework to reorganize and develop the market. The subsequent administration of Lopez Portillo, as María Elena Cardero and José Manuel Quijano explain, adopted a series of new measures, namely tax incentives and a legal requirement on banks to invest part of their saving resources in securities, with the intention to promote stock market activity.[29] The expansion of the market, which

[28] Del Angel, 'Paradoxes', 124–39.

[29] María E. Cardero and José M. Quijano, 'Expansión y estrangulamiento financiero: 1978–1981', in José M. Quijano (Ed.), *La banca: pasado y presente* (Mexico City, 1983), 221–304.

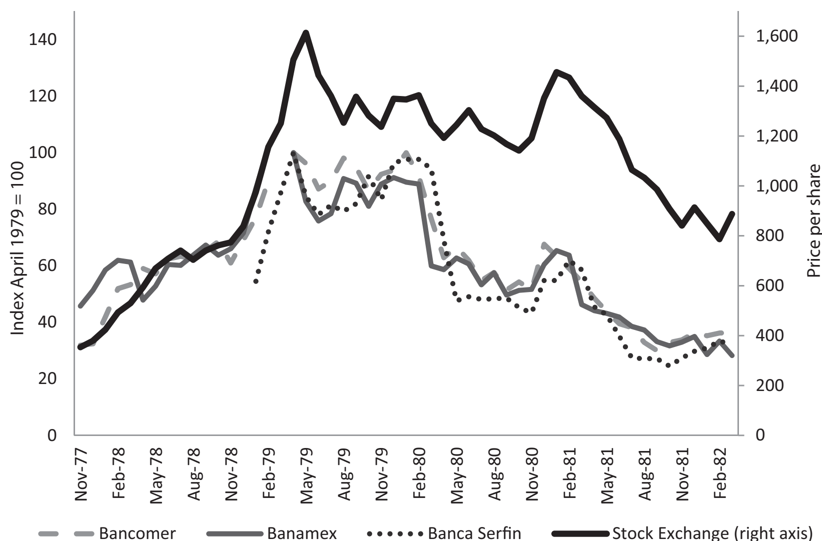

Fig. 4.14 Monthly share prices for international banks and Mexican Stock Exchange, 1977–1982 (*Source* Bolsa Mexicana de Valores, Anuario Financiero y Bursátil [several issues])

reflected speculative buying and selling of securities rather than primary stock issues, came to a halt by mid-1979, stagnated for the next two years and began to fall in early 1981.

During the late 1970s and early 1980s, the share prices of Banamex, Bancomer and Serfin coincided with the general trend observed in the stock market. They expanded at dizzying rates between November 1977 and May 1979, stagnating thereafter. However, as observed in Fig. 4.14, in the spring of 1980, one year prior to the bust of the stock market and well before the debt payment problems of 1982, the share prices of these three large Mexican banks collapsed. By June 1980, and in just six months, their stock prices had plummeted to almost half their January values, with Serfin exhibiting the most dramatic fall. From there on, banks' share prices continued a downward trend along similar lines that the Mexican Stock Exchange index until August 1982 when they reached the lower levels of the period. With the nationalization of the banking system of September 1, 1982, the Mexican state took the stocks out of the market, and their prices were thereby no longer listed.

The performance of share prices of Mexico's three largest banks, and of internationally oriented banks more generally, shows important differences with respect to those of other banking institutions. In the case of Banca BCH, for instance, stock prices quoted at 20–22 pesos per share in 1979, they dropped to 13.3 pesos in April 1970 and maintained around that value until January 1981, when prices climbed up again to oscillate between 20 and 30 pesos during the next period until August 1982. For Banca Cremi and Banca Confia, the other two banks for which a relatively complete series of monthly prices exist, the trend is a progressive and continuous decline all throughout the period. In May 1979, these banks quoted at 26.3 and 274 pesos per share, respectively, but they lost about half and a third of their value one year later and about 70 and 30% by the beginning of 1982. During 1982, Banca Cremi's share prices oscillated around 7.6 pesos on average until their exclusion from the stock market with the nationalization, as in the case of Banca Confia with an average price of 117 pesos.

Figure 4.15 plots the weighed mean and 50% inclusion ranges for the market-to-book values for the group of internationally and domestic-oriented banks between 1978 and 1982. Book value is the amount of paid-in capital and the market value is calculated as the product between the number of outstanding shares and the lower price reached by the shares during the year as reported in the 1982 Annual Yearbook of the Mexican Stock Exchange. The chart shows both types of banks as distinct groups, with international banks increasing the market-to-book value ratios during the stock exchange boom, declining then from an average of 3.5 in 1979 to about the unity in 1982. Some of them, such as Multibanco Comermex and specially Banca Serfin, reached situations where the market values of stocks were significantly lower than the book value, namely a ratio less than unity. On the contrary, the ratio for domestic-oriented banks was more stable, with average values of the market-to-book ratio between 1.6 and 2.1, and no fall toward the end of the period. It would seem, therefore, that the higher risks of internationally oriented banks were also represented in the stock market prices.

Noteworthy, Manuel Espinosa Yglesias, President and major shareholder of Bancomer, tried to sell the bank around this time. By the beginning of 1982, when Bancomer stock prices were at 35% of their January 1980 value, José Carral, the representative of Bank of America in Mexico, was approached by Banamex officials with a letter by Espinosa Yglesias to Bank of America's President Tom Clausen offering

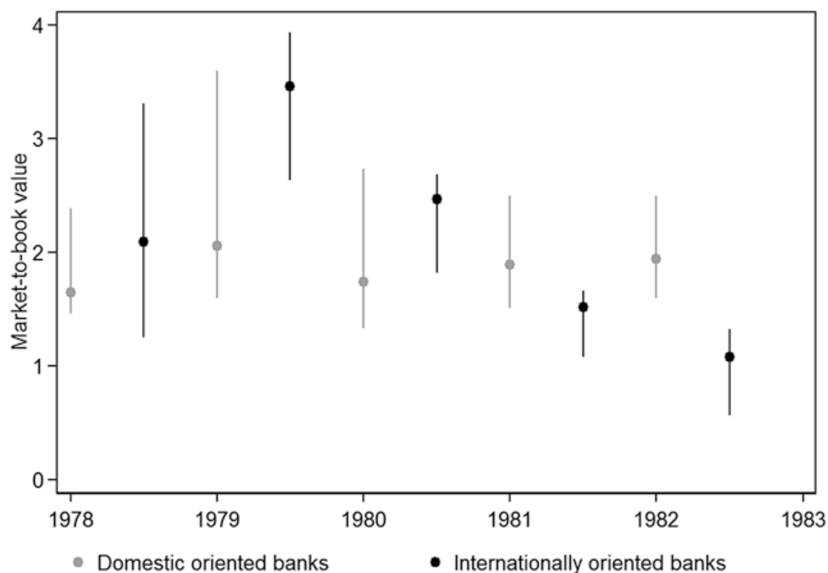

Fig. 4.15 Market-to-book values of international vs. domestic-oriented banks, 1978–1982 (*Source* Bolsa Mexicana de Valores, Anuario Financiero y Bursátil [several issues])

the majority of the shares and the control of the bank. The offer, which in Carral's words was "attractive in terms of cost per share," was analyzed in an extraordinary meeting of the Board of Bank of America in San Francisco.[30] One month before, Espinosa Yglesias had already contacted Citibank and discussed a similar proposal. According to Carral, Espinosa Yglesias was in touch with the authorities of the SHCP and Banco de Mexico regarding the operation, and they were in apparent agreement to allow a foreign bank taking the ownership and control of one of the two biggest banks in Mexico. In the end, neither Citibank nor Bank of America accepted the offer, and Banamex remained in the hands of Espinosa Yglesias and other Mexican private shareholders until its nationalization.

[30] José Carral, 'La banca extranjera y la estatización de la banca', in Amparo Espinosa Rugarcía and Enrique Cárdenas Sánchez (Eds.), *La nacionalización bancaria, 25 años después. Tomo II* (Mexico City, 2010), 117–37, esp. 128–30.

CHAPTER 5

International Business Risks

By 1982, a decade after the first steps with foreign finance and the Euromarkets were given, Mexican banks had considerably expanded abroad and developed a strong international presence. Through their agencies and branches in the main world financial centers, the six largest banks of the country were managing assets for US$7.7 billion, an amount representing about one quarter of their balance sheets. The international activities of the foreign banking offices included some trade finance and the provision of financial services to Mexican clients abroad, but the lion's share of the business was sovereign lending. As of end-1982, about 60% of the assets of the foreign agencies and branches consisted of international loans, of which as much as 91.2% was owed by Mexican borrowers. To finance these loans, the agencies relied almost entirely on the funds they could raise in the US wholesale money markets or through international Eurocurrency interbank transactions.

This chapter analyzes the risks and vulnerabilities of the international business model of Mexican banks and the severe financial problems that they confronted in the wake of the crisis. The use of wholesale liquidity, which consisted essentially of short-term fundraising instruments with maturity ranging from overnight up to six months, to finance long-term sovereign loans was not a very prudent strategy. It was also careless to grant most of the credits at predetermined fixed interest rates, while the interbank lines used to fund such lending were arranged at variables or floating rates. Another worrisome practice behind the

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intermediating activities of the overseas agencies and branches related to foreign exchange, since their liabilities were in dollars, but the bulk of the loans were granted to Mexican borrowers that operated mainly in pesos. Although not currency mismatched in their cross-border operations, their borrowers were and, consequently, the agencies were still exposed to foreign exchange risk and the balance sheet effects associated with a potential devaluation.

The dangers of the international activities of Mexican banks and their network of agencies and branches overseas came into sharp focus during the wake of the crisis. With the moratorium declaration of the Mexican government in August 1982, the fundraising activities that Mexican banks were undertaking in the international wholesale markets came under severe strains. As the perception of risk increased, international banks became reluctant to operate with their Mexican counterparts and they started to retrench the credit lines with them. Interbank funding became more expensive and available at shorter term, which aggravated the interest rate and maturity mismatches that the agencies had accumulated in their books. The drain of interbank funding created significant liquidity pressures on Mexican foreign agencies and compromised the external position of their parent banks, leading to the intervention of Banco de Mexico as well as the financial authorities of the host countries, namely the US Federal Reserve and the Bank of England, to secure their financial situation.

The liquidity problems encountered by the Mexican banks abroad revealed the existence of important loopholes in international financial regulation and misunderstandings about lending of last resort policies in the Euromarkets. In a context in which Banco de Mexico's international reserves were largely insufficient to meet the foreign exchange needs of Mexican banks, the possibility that they failed to reimburse their interbank obligations went beyond national borders and became a matter of international concern. The repercussions of a payment disruption in the international money markets and the possibility of a liquidity crisis were major worries for developed countries financial authorities, and it was not clear who, if anybody, was to assist foreign banking institutions in the case financial support from their home countries was not to come. Significant differences and conflicting positions existed between the US Fed and the Bank of England, the institutions behind the two largest money markets in the world, as to their lender of last resort responsibilities.

Mexican International Banking Network

In the early 1980s, the Mexican banking sector reached the peak of international presence and culminated the process of foreign expansion initiated during the previous decade. By 1982, the network of foreign banking offices of Mexican banks operating overseas—without considering representative offices—was made up of 21 agencies and 6 branches in six different cities: Banamex, Bancomer and Banca Serfin with 4 each, Multibanco Comermex with 5 and Banco Mexicano Somex and Banco Internacional with two each.[1] In addition, Banamex was leading the consortium bank Intermex, which counted also with Nafinsa and Banco Nacional del Comercio Exterior among its shareholders since 1979, and Bancomer and Banca Serfin had participation in the ownership of the Libra Bank and Eulabank respectively. It was, however, through their network of foreign agencies and branches rather than the affiliated consortium banks, as described in previous chapters, that Mexican banks got a direct involvement with, and exposure to, the international capital markets.

Table 5.1 shows the volume of activity of the foreign agencies and branches of the six large Mexican banks operating in the world capital markets. As of June 1982, their consolidated balance sheets totaled about US$7.7 billion, of which Banamex and Bancomer accounted for US$4.2 billion or 54.5%. These two largest Mexican banks, which were also among the major ten Latin American banking institutions, had been the first to start their international expansion process and to operate in the Euromarkets. Multibanco Comermex and Banco International were at the third and fourth place with about US$1.1 billion in assets and liabilities each, followed by Banca Serfin and Banco Mexicano Somex with US$772.7 and 480.4 million respectively. Except for Banca Serfin, the other three banks, and especially Banco Mexicano Somex, opened their foreign offices much later during the early 1980s, and thereby by 1982 the volume of their operations was relatively less developed.

The USA, which was the main destination for Mexican banks, was also the place where the bulk of their foreign balance sheets were concentrated. By 1982, the six Mexican international banks had agencies in New York and, with the exception of Banco Internacional and Somex,

[1] CIEN-A13/E-68/Agosto de 1982, 18–20.

Table 5.1 Asset and liabilities of Mexican foreign agencies and branches (US$ million in June 1982)

	Foreign agencies and branches					
	New York	*Los Angeles*	*London*	*Cayman Islands*	*Nassau*	*Total*
Banamex	580.0	159.2	887.7	0.0	420.1	2047.0
Bancomer	1004.6	376.6	523.3	260.7	0.0	2165.2
Banca Serfin	33.1	228.2	310.0	0.0	201.3	772.7
Multibanco Comermex	204.9	215.6	400.9	280.0	25.0	1126.4
Banco Mexicano Somex	1.1	0.0	0.0	479.3	0.0	480.4
Banco Internacional	105.8	0.0	0.0	1015.4	0.0	1121.2
Total	**1929.6**	**979.5**	**2122.0**	**2035.4**	**646.4**	**7712.9**

Source FFIEC 002 Report and Bank of England, Task Force, 13A195/2

there was also strong presence in Los Angeles, which were the two major money market centers in the USA. In June of that year, the ten US agencies of Mexican banks accounted for US$2.9 billion or 37.7% of the consolidated balance sheets of the network of foreign banking offices in major international financial centers, with two-thirds located in New York and the remaining third in Los Angeles. London was the other major destination of the banks with four banking offices—Banamex, Bancomer, Serfin and Comermex—and US$2.1 billion of assets and liabilities. The Cayman Island offshore financial center had also four agencies with a similar aggregate volume of business, half of which belong to Banco International, which had 90% of their operations there and only 10% in New York. Finally, Banamex, Banca Serfin and Comermex had US$646.4 million booked in Nassau, an amount representing 8.3% of the balance sheet of all foreign agencies and branches.

To operate in the USA, Mexican banking institutions had to adopt a legal form as established in US regulation. At that time, there were three main organization structures available to foreign banking corporations willing to engage in the US banking market, and agencies and branches were the two most common ones.[2] According to US banking legislation,

[2] See Betsy B. White, 'Foreign Banking in the United States: A Regulatory and Supervisory Perspective', *FRBNY Quarterly Review* 7 (1982), 48–58.

agency banks were extensions of the parent banks in the country of origin and integral part of its capital base. They were allowed to lend and transfer funds and accept credit balances incidental to their customers' banking transactions—essentially clearing and compensating balances, but not to take domestic deposits. Their main activity, therefore, consisted on wholesale banking, trade financing and money market operations. Branches, on the other hand, were virtually identical to agencies, but they could offer a larger range of banking services that included the accepting of deposits from domestic and foreign residents. The fact that all ten offices of Mexican banks in the USA were legally licensed as agencies and not branches reveals the interest in accessing the money markets rather than conducting retail banking businesses. In the case of the UK, legislation did not contemplate a figure directly equivalent to the US agency, and the four London banking offices of Mexican banks adopted the statute of full service branches with authorization to develop both wholesale and retail banking activities.

A third organizational structure used by foreign banks to conduct businesses in both the USA and the UK—apart from consortium banks—were the subsidiaries. Unlike agencies and branches, which acted essentially as wholesale banking offices, subsidiaries were separately capitalized banking entities subject to the same regulation than any other local bank. Thus, foreign banks willing to develop full consumer business activities, which often required having a bank with its own branch network and local identity, could directly charter a subsidiary or, as it was usually the case, buy an existing one with a retail branch network already established. In the case of Mexican banks, Banamex and Bancomer acquired two US subsidiary banks. Between 1979 and 1980, as part of its internationalization program, Banamex bought the Community Bank of San José and the Mexican-American National Bank of San Diego and merged them into the California Commerce Bank, which had seven branches in total. Likewise, in the spring of 1982 Bancomer purchased Grossmont Bank of San Diego, which had five branches in the state of California.

The balance sheet structure of these two Mexican subsidiary banks illustrates the different type of business that they developed when compared to agencies. As of June 1982, the total assets of the California Commerce and Grossmont Bank reached US$307 and 141 million, and their equity US$12 and 21 million respectively. Data compiled by the Federal Reserve Bank of New York (FRBNY) at the time of the

Mexican crisis show that these subsidiary banks were largely focused on local retail banking. In both cases, the loan portfolio represented about 60% of their assets, 40–45% of which had been granted to commercial and industrial corporations, between a fourth and a third was real estate credit, and the remainder were loans to individuals for household, family and other personal expenditures (basically consumer-oriented advances).[3] On the liability side, deposits were their main fundraising instrument. In the case of the California Commerce Bank, for instance, deposits accounted for about 93% of the funding base, 14% of which were demand deposits and the balance of 86% were time deposits. There were no substantial transactions with federal funds or borrowing from other financial institutions in the money or interbank markets. Through these banks, Banamex and Bancomer looked to participate in the financing of the rapid growth of trade between the USA and Mexico and the provision of banking services to the Mexican clientele in California.

These subsidiary banks were the first incursion of Mexican banks into retail banking in the USA and they represented only a small part of their businesses there. In mid-1982, for instance, the assets of the California Commerce Bank represented about 15% of the balance sheet of the Banamex's US agencies, and the Grossmont Bank only 6.5% of Bancomer's. While the US subsidiaries were small banks conducting retail activities at a regional level, the agencies were involved in wholesale banking and sovereign lending, and thereby the scale and scope of the operations were substantially different. By that time, the US agencies along with the branches in London and the Caribbean offshore financial centers had become important extensions of Banamex and Bancomer overseas and they were at the heart of their international businesses. At an aggregated level for the six Mexican banks operating abroad, the assets managed by their international branches and agencies accounted for as much as one-fourth of the consolidated balance sheets in Mexico.

An Interbank-Based Business Model

The business model of the foreign agencies and branches of Mexican banks and the role that they had in the international activities of parent banks can be depicted through a balance sheet analysis. In this

[3] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

regard, the most systematic and complete source of information available on Mexican banking offices abroad is the *Report of Assets and Liabilities of US Branches and Agencies of Foreign Banks* of the Federal Financial Institution Examination Council (FFIEC 002), available online in the historical commercial bank database of the Federal Reserve Bank of Chicago. With the approval of the International Banking Act (IBA) by the US Congress in 1978, which resulted from a rising controversy about the increasing expansion in the number and assets of foreign banks in the USA and the lack of federal regulation and supervision of their activities, Mexican banks as well as other foreign banking offices operating in the USA had to complete a detailed regulatory form and submit it to supervisory agencies quarterly, with the first report on condition filed in June 1980.[4]

An examination of the asset and liability structure of the US agencies serves to illustrate the business pattern behind the international activities of Mexican banks. As shown in the previous section, the USA was the only country where all Mexican banks involved with foreign finance had direct presence and the US agencies represented over a third of the volume of business of all the banking offices abroad. Figure 5.1 represents the liability composition of the six Mexican banking agencies in New York and the four in Los Angeles at a consolidated level as of end-June 1982. Borrowed money, which consisted of funding lines from other banking institutions in the form of interbank certificates of deposits or due bills, was their main fundraising instrument and accounted for about US$1.1 billion or 36.7% of the US$2.9 billion liabilities of the agencies. Excluding Banco Internacional and Banco Mexicano Somex, which opened their US agencies very late in the period and thereby had not a well-developed balance sheet structure as of mid-1982, the share of borrowed money as source of funding ranged between 30.7% for Bancomer and 57.4% for Banca Serfin.

Federal funds along with deposits and credit balances were the second largest sources of funding of the agencies. The federal funds, which consisted of overnight borrowing or purchases between banks and other entities in managing their reserves, accounted for 22.1% of agencies' liabilities on average, ranging from 10.6% for Banca Serfin and 26.1% for Bancomer. On the other hand, deposits and credit balances had a similar

[4] White, 'Foreign Banking in the United States', 52–56.

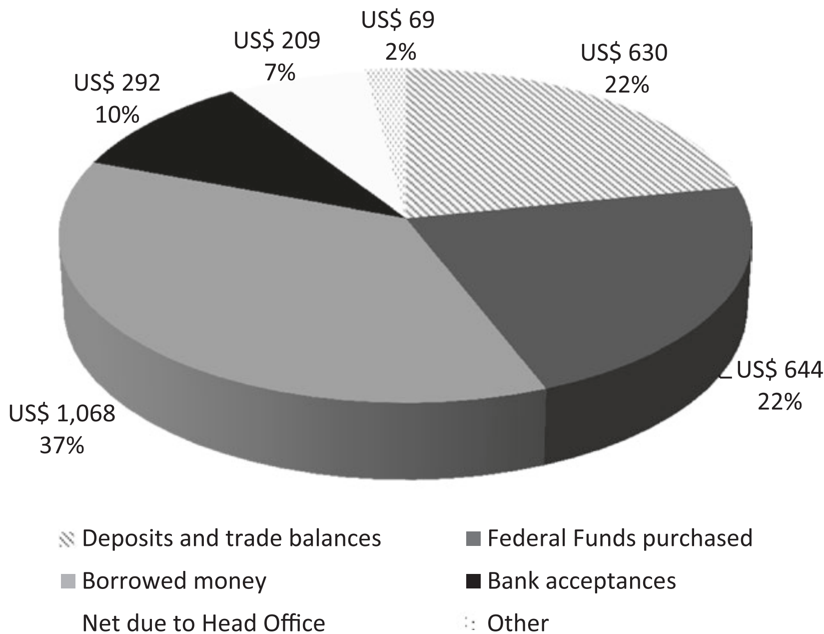

Fig. 5.1 Liability composition of the US agencies of Mexican banks (June 1982 in US$ million and %) (*Source* FFIEC 002 Call Report)

share of 21.9%, of which 65.5 and 32.3% were deposits from banks in foreign countries and commercial banks in the USA respectively, while the remaining 2.2% consisted of credit balances or deposits from individuals, partnerships or corporations. Finally, bank acceptances represented 10% of the total liabilities of the agencies, obligations to the head offices in Mexico 7.2%, and the remainder of 2% were miscellaneous liabilities.

The liability structure just described highlights the wholesale, interbank bias of the funding base of the agencies. The clear majority of the financial instruments that they used to raise funds were interbank transactions or money market facilities. In fact, at an aggregate level, only US$10.9 million or 0.5% of their liabilities was due to creditors other than banks, which shows the prominent role of financial institutions and wholesale liquidity as virtually the only source of funds for Mexican agencies. Through these agencies, parent banks had a direct line to access dollar funding in the US money markets, but also

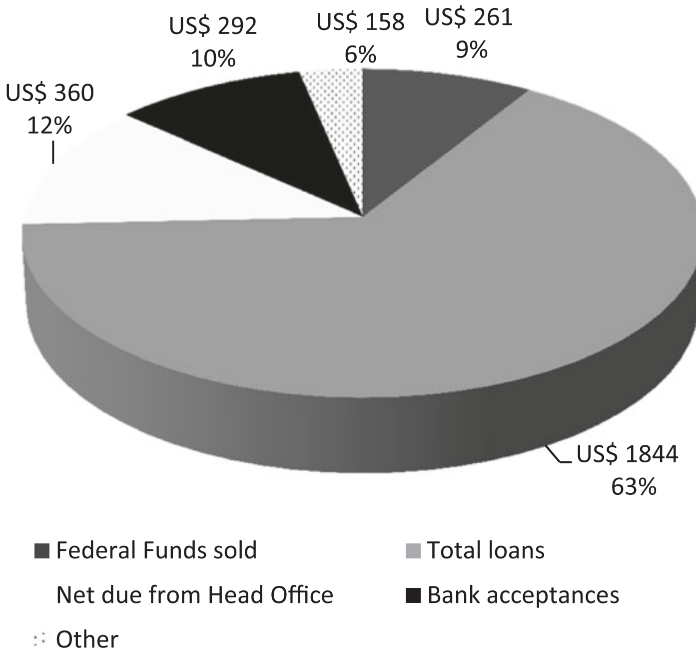

Fig. 5.2 Asset composition of the US agencies of Mexican banks (June 1982 in US$ million and %) (*Source* FFIEC 002 Call Report)

Eurocurrency wholesale liquidity because they could undertake cross-border transactions with banks in London. In fact, from the USA, the agencies could engage in operations with banks and other financial institutions not only there but also in other countries or international financial centers. Thus, interbank borrowing from the domestic and Eurodollar markets provided the US agencies of Mexican banks with a major source of the funding that they could use to conduct businesses in and outside the USA.

Figure 5.2 exhibits the asset structure of the agencies, which shows where they had been allocating these funds. As much as US$1.9 billion or 65.4% of the assets at a consolidated level were loans, of which 73.9% were commercial and industrial credits, 15.4% was lending to financial institutions and the balance has been mainly granted to foreign governments and official institutions. With a value of 81.7%, Banca Serfin was

the bank with the higher ratio of loan portfolio to total assets, while Bancomer was on the opposite extreme with a share of 66.9% and in all cases commercial and industrial credits accounted for over two-thirds of the agencies' loan portfolio. Lending was the main activity of the agencies and they were using the money raised in the international wholesale interbank markets to fund their credits. The asset and liability composition of the agencies makes clear a business model that essentially consisted in borrowing from banks operating in major international financial centers to relend these funds, notably to the industry and commercial sector, but also to foreign governments and other financial institutions.

This business model based on international wholesale funding and foreign lending was a salient feature of Mexican and developing countries banks participating in the Euromarkets. In a study on the development of the interbank market commissioned by the Institute of International Finance in 1985, the former French Executive Director of the International Monetary Fund (IMF) and Work Bank Paul Mentré makes direct reference to this pattern. Unlike the conventional use of interbank transactions to adjust the volume of assets and liabilities and to manage interest and exchange risk, "LDC commercial banks typically borrowed on the US domestic market or on the London dollar market to relend directly, or through offshore centers, to final borrowers." Moreover, as he adds, "during the years immediately preceding 1982, excess short-term borrowing by LDC banks, using their subsidiaries in industrial countries to channel long-term funds to their domestic borrowers, has been one of the catalysts of the 1982 crisis."[5] In the case of Mexican banks, it was not through the subsidiaries but rather the international network of agencies and branches in main financial centers that they were managing to do that.

The strategy employed by Mexican banks to raise funds in the international money markets is explicitly outlined in the minutes of Banamex's Executive Committee. During a meeting in May 1976, after highlighting the importance of the bank's agencies in New York and Los Angeles to support its corporate banking clients through the funds in dollars they were capturing abroad, Medina Mora asked the Committee for an authorization to make deposits with main international banks. As he explained to his colleagues, for these agencies to be able to raise funds

[5] FRBNY archive, Box 108403, The International Interbank Market and International Banking Lending, June 28, 1985.

"it was necessary a permanent presence in the international money markets, which impl[ied] (…) an active participation as buyers and sellers in the money market through the mechanics of interbank deposits." These interbank transactions were, in his words, "about a coming and going of money in which movement results a favorable [net] balance more or less permanent that [they] derive[d] to [their] clients, or that [they] used to buy money market instruments such as bank acceptances, certificates of deposits, commercial papers, etc."[6]

Thus, to access wholesale funding Mexican banks needed to participate on both sides of the money markets. This meant that "at the same time that [Banamex] receive[d] deposits from banks [Banamex] ha[d] to make [deposits] with them, otherwise [they] would be considered only as money takers, losing no only [their] image but also the possibility of continuing to operate."[7] From an operational perspective, the mechanism consisted in, as Director José Manuel Rivero would point up, "making placements with [lending banks], for example, placing $10 million with an institution that is providing $20 million to Banamex."[8] The relationship between federal funds purchased and sold by the US agencies of the Mexican banks illustrates this pattern at a money market financial instrument level. As of June 1982, their federal funds liabilities totaled US$645 million while the correspondent claims were US$261 million, leaving a favorable balance of US$378 million. By purchasing more than what they sold, Mexican agencies had a net borrowing position or were net takers of funds in that market.

It is also important to highlight the relationship between the assets and liabilities of the US agencies with their head offices represented in Figs. 5.2 and 5.1 respectively. These accounts capture the internal capital market transactions or transfer of funds between the US agencies and their parent banks in Mexico and thereby show the extent to which they lent to and borrowed from each other. The charts show that in June 1982, the US agencies had outstanding claims with the head offices in Mexico for US$360 million or 12.3% of their assets, while the corresponding obligations were US$210 or 7.2% of total liabilities. The

[6] Banamex archive, Libro No. 8 de Actas de la Comisión Ejecutiva, May 26, 1976 Meeting.

[7] Ibid.

[8] FRBNY archive, Central Records, BAC 1983: Office Memorandum, November 22, 1983.

US agencies had, therefore, a net creditor position *vis-à-vis* their head offices, meaning that they were channeling liquidity to their parent banks and providing them with part of the dollars that they raised in the international interbank market. Banamex was the only case in which the US agencies were net debtors to the head office, but during the previous quarters the situation was the other way around as it was also the case for the other Mexican banks. The higher proportion of inter-office claims relative to obligation illustrates the role assumed by the agencies in supplying foreign exchange and arbitraging domestic and international liquidity for their parent networks.

Although the Bank of England did not produce systematic information on the operations of Mexican branches in London as the FFIEC, data collected after the outbreak of the debt crisis by a Task Force show a similar asset and liability structure that their US counterparts. As of June 1982, as much as US$1.87 billion or 88.2% of the US$2.12 billion of total liabilities of the four Mexican branches in London were owed to banking institutions. 62.8% of this amount were due to banks operating in the UK, 21.5% to other banks overseas and the balance of 13.7% to own offices. In terms of assets, loans and advances to non-bank final borrowers accounted for US$984 million or 46.3%, while the remaining US$1.13 billion or 53.7% were claims on banking institutions. Like in the case of the US agencies, the London branches of Mexican banks were net debtors to banking institutions in the UK and abroad, and net creditors of their parent banks and own offices. Therefore, the same business pattern emerges with the branches borrowing in the UK and international interbank market to deploy these resources in extending loans to the non-financial sector as well as transferring liquidity to their homes offices in Mexico.[9]

Asset and Liabilities Imbalances

Financial intermediation by Mexican foreign agencies and branches generated some new risks and vulnerabilities associated with asset and liability management. The engagement in wholesale banking activities implied a number of financial transformations between the borrowing of funds in the interbank market and the provision of loans to non-banking final

[9] Bank of England archive, Task Force, File 13A195/1.

users. There was usually a geographic transformation, since funds were typically borrowed in a marketplace and lent in a different country, but also in terms of the maturity, currency and interest rate of the obligations and the corresponding claims. A prudent management of wholesale banking operations would have normally required liabilities to be reasonably balanced by claims in amount, period and currency as to ensure adequate funds available from maturing assets to repay obligations when they were to come due. Thus, to the extent that the balance sheet was not managed with enough regard for matching, banking institutions became exposed to changes on market conditions and thereby their financial position more fragile.

A first type of imbalance that arose in wholesale banking when providing loans financed through interbank borrowing concerned maturity. On the one hand, interbank funding was made up of short-term money market transactions, with maturities normally ranging between overnight and six months, although placements up to a year and over could be also arranged.[10] On the other hand, the credits that were granted with these funds had much longer term. Borrowing short and lending long is the typical maturity transformation performed in traditional banking by taking deposits that must be available on short notice and lending out the money that will not be available for a long time, which implies that banks take the risk of continuing to generate deposits to replace withdrawals. This risk is, however, considerably more important in the case of wholesale funding because interbank deposits or credit lines usually have shorter maturities than retail deposits and they are much more volatile.

Table 5.2 shows the share of short-term funding and loans in the balance sheet of the US agencies of Mexican banks. As of June 1982, 22% of the agencies' total combined liabilities consisted of federal funds and borrowed money of immediately available funds with one-day maturity and 19.1% were deposits or credit balances—essentially from banks—for 30 days ending with call date. Banamex and Comermex had the lowest and largest concentration of the funding base on these two financial instruments with a 20.6 and 64% respectively. On the asset side, 73% of the commercial and industrial credits, which were the major component of US agencies assets and their loan portfolio, as the previous section has shown, were due within the following year and the remaining 27% had a

[10] See BIS, 'The International Interbank Market: A Descriptive Study', BIS Economic Papers No. 8 (1982).

Table 5.2 Maturity balance sheet structure of the US agencies of Mexican banks (US$ million in June 1982)

		Assets			*Liabilities*		
	Total Asset & Liability	*Loans due*		*Other assets*	*Borrowings due in a day*[a]	*TD & CB for 30 days*[b]	*Other liabilities*
		Within 1 year	*Over a year*				
Bancomer	1385	554	134	697	361	350	674
Banamex	741	198	64	480	136	17	588
M. Comermex	421	154	97	170	199	71	151
Banca Serfin	261	98	57	106	58	69	135
Banco Internacional	106	22	31	53	50	52	4
B. Mexicano Somex	1	0	0	1	0	0	1
Total US agencies	**2915**	**1026**	**382**	**1507**	**644**	**558**	**1553**

Source FFIEC 002 Call Report
[a]Federal Funds and borrowed funds of immediately available funds with one day maturity
[b]Total deposits and credit balances for 30 days (or month) ending with call date

maturity of over one year. These figures make very clear the considerable extent to which the agencies relied on very short-term interbank liquidity to finance their loans.

A second type of mismatch that the agencies accumulated in their balance sheets concerned interest rates. At that time, interbank funding lines were typically arranged at LIBOR plus a premium, which would depend on the risk associated with the borrowing bank, meaning that virtually all the liabilities of the Mexican banks' agencies in the USA, as well as the branches in London and other financial centers that borrowed in the interbank market, had variable interest rates. In contrast, data from the memoranda of the FFIEC 002 reports show that in the case of the US agencies an important part of their portfolio consisted of claims arranged at predetermined or fixed interest rates. Figure 5.3 exhibits the breakdown of commercial and industrial loans of the US agencies of Mexican banks by interest rate type, showing the predominant part of credits with fixed rates. At a consolidated level, only US$416 million or 30% of the agencies' commercial and industrial loans had a floating interest rate, while the remaining US$992 million or 70% had been arranged at fixed rates. In the case of Banca Serfin and Banco Internacional, at

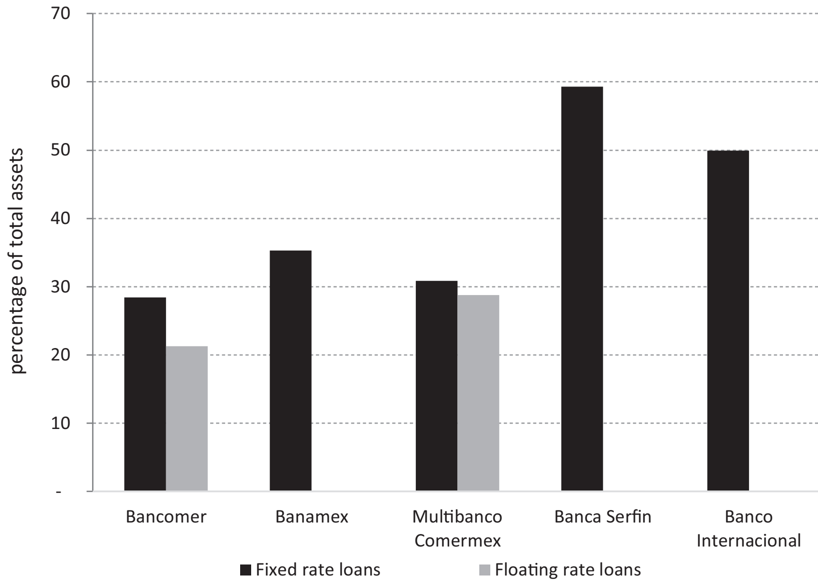

Fig. 5.3 Industrial and commercial loans of the US agencies of Mexican banks (June 1982) (*Source* FFIEC 002 Call Report)

least as much as 59.3 and 49.9% of their assets were loans with fixed rates respectively, while the correspondent shares for Bancomer, Banamex and Comermex stood between 28.4 and 35.3%. For its part, Banco Mexicano Somex, which had opened the New York agency in the early 1982, had not granted any loan by that time.

A final mismatch concerns the geographic scope of the foreign agencies and branches' activities. The data filed in the FFIEC 002 report distinguish between claims with and obligations to US addressees and non-US addressees, which allows to assess the extent of cross-border transactions and the pattern behind them. Table 5.3 shows the part of the assets and liabilities of the US agencies in and outside the USA. While average obligations to creditors domiciled in the USA accounted for 67.6% of the agencies' total liabilities, 73.3% of their claims were due to clients abroad. Apart from the new Somex agency, Banamex had the

Table 5.3 Cross-border balance sheet structure of the US agencies of Mexican banks (US$ million in June 1982)

	Assets				*Liabilities*			
	In the US		*Outside the US*		*In the US*		*Outside the US*	
	US$ m	*%*	*US$ m*	*%*	*US$ m*	*%*	*US$ m*	*%*
Bancomer	366	26.4	1019	73.6	975	70.4	410	29.6
Banamex	170	22.9	572	77.1	362	48.8	380	51.2
M. Comermex	129	30.6	292	69.4	341	81.1	80	18.9
Banca Serfin	88	33.5	174	66.5	206	78.7	56	21.3
Banco Internacional	26	24.6	80	75.4	89	83.9	17	16.1
Banco M. Somex	1	95.1	0	4.9	0	0.0	1	100.0
Total US Agencies	**779**	**26.7**	**2136**	**73.3**	**1972**	**67.6**	**943**	**32.4**

Source FFIEC 002 Call Report

lowest share of liabilities to US lenders, which represented about half of its funding base, but the bulk of the non-US borrowing that was not due to the head office but coming from London or another international financial center where the bank was operating. Such cross-border structure is in line with the business model analyzed in the previous section, meaning that the Mexican agencies funded themselves in the US money markets or from US bank lenders to make international loans outside the USA or to non-US borrowers.

The cross-border imbalance of the asset and liability structure of the agencies is important because it speaks about the implicit currency risks behind their operations. Although the FFIEC 002 report does not provide information on the location of non-US claims, an internal memorandum elaborated by the staff of the FRBNY estimated that of the US$2.9 billion in assets of the US agencies of Mexican banks in June 1982, about 80–90% represented dollar claims with Mexican borrowers, and 60% were owed by the Mexican government or public sector.[11] These agencies, as well as the ones in London and the Caribbean offshore centers, were the operating arm of parent banks in the Euromarkets and intermediated foreign capital with final borrowers in their homes countries. Lending was made in dollars, but to borrowers with businesses mainly in pesos and not necessarily

[11] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

to exporting firms with access to dollars. This means that, while the agencies might not have been currency mismatched in their cross-border operations, their borrowers were. They were consequently exposed to currency risk and to the balance sheet effects associated with a potential devaluation of the Mexican peso.[12]

The dangers of the mismatches incurred by Mexican banks when conducting their international activities worsened during the run-up to the debt crisis of 1982. On the one hand, after the arrival of Paul Volcker to the US Fed in 1979 and its decision to fight inflation through restrictive monetary policy, international interest rates experienced a sharp increase. Federal funds and prime rates, which averaged 11.2 and 12.6% respectively in 1979, climbed to a historic peak of over 20% during 1981, and the LIBOR and Eurodollar rates in London followed the same path.[13] With most of their assets arranged at fixed rates, the rise of the cost of funding could not be matched with an equivalent increase in interest income, creating thereby some financial pressures for the agencies. On the other hand, the devaluation of February 1982 and the subsequent payment problems of some private external debtors translated into increasing difficulties for Mexican banks to raise dollars in Mexico and service their foreign creditors. However, it was the outbreak of the debt crisis in August 1982 what brought the imbalances and weak financial position of the agencies and branches into sharp focus, delivering indeed a final blow to the international activities of Mexican banks.

The Impact of the Moratorium

On August 20, 1982, the Mexican government approached the international financial community and announced a temporary suspension of principal payments on external debt. The moratorium declaration did not only bring Mexico into default, but it also unleashed sovereign debt payment problems at an international level. In the next few months, a

[12] On the balance sheet effects of devaluations, see Paul R. Krugman, 'Balance Sheets, the Transfer Problem, and Financial Crises', in Peter Isard, Assaf Razin, and Andrew K. Rose (Eds.), *International Finance and Financial Crises: Essays in Honor of Robert P. Flood* (Boston, 1999), 31–56.

[13] Timothy Q. Cook and Thomas A. Lawler, 'The Behavior of the Spread Between Treasury Bill Rates and Private Money Market Rates Since 1978', *Federal Reserve Bank of Richmond Economic Review* November/December (1983), 3–15.

number of other heavily indebted developing countries with similar economic and financial difficulties pursued the same path, spreading the crisis regionally and all over the world. This marked the outbreak of the international debt crisis of the 1980s, which put a definitive end to the international bank lending boom and the petrodollar recycling process that had developed within the Euromarkets after the oil shock of 1973, launching a new phase of rescheduling and conditional lending as part of the negotiations of debtor countries with the group of international creditor banks, developed countries' governments and the IMF.[14]

The shrink in the flow of syndicated and direct Eurocredits to governments and the private and public companies from debtor countries was a salient implication of the crisis, but it also affected the international activities of their domestic banks. In the case of Mexico, the ability of the foreign agencies and branches to attract new funds from the world capital markets was seriously undermined. The international wholesale interbank market, which was the center of their funding operations, became highly sensitive about lending to Mexicans as the perception of risk increased. The policy of creditor banks in placing and lending in the interbank market was based on the creditworthiness of the borrower, which mainly relied on a country risk analysis. When assessing this risk, banks looked primarily to the nationality of the ownership but they also considered the location of the borrowing branch, treating with more caution those outside major financial centers.[15] Under this policy, as the BIS Interbank Market Study Group recognized, "it might be, for example, that the market comes to regard all banks of a certain nationality (e.g., Mexican) with some suspicion, perceiving the interbank operations with them more risky and therefore want to reduce their involvement with them."[16]

It was not a surprise therefore that when the country came into default, the confidence and credit standing of Mexican banks plunged, increasing their market risk and damaging their funding lines. Unlike in tranquil times when interbank placements were regarded as risk-free and trading volumes were large and automated within and across international financial centers, significant tensions and liquidity strains

[14] See, for instance, William R. Cline, *International Debt Reexamined* (Washington, DC, 1995).

[15] BIS, 'International Interbank Market', 35.

[16] BIS archive, File I/3A(3)M vol. 1: Policy Issue Paper, Draft of December 25, 1982.

could appear in the market when bad times emerged. Prior to the crisis, Mexican agencies and branches would typically roll over their interbank deposits when they came due, either by renewing them directly with the creditor bank or by borrowing from some other bank and refunding the first. However, when the crisis hit and concerns about banks from countries having debt-servicing problems raised, interbank credit lines became only available at shorter maturities and a higher price. Moreover, as lending banks began to implement and apply credit limits, in some cases Mexican banks became confronted with refusals on the rollover of deposits as they felt due.

Table 5.4 exhibits the net position of the Mexican branches in London as the percentage of total claims in different maturity bands and equivalent data for their interbank businesses. For the purpose of interpretation, a negative sign means that liabilities are larger than the correspondent assets, and therefore the branch is a net debtor or taker of funds at the given maturity band. Conversely, if there is a positive sign, the branch is a net creditor or lender. The net position of the branches highlights the great degree of maturity transformation performed by borrowing short and lending long, and how substantially the mismatch increased between August and November 1982. Lending in the three years and over band increased from 29.5 to 37% of total claims, while the sources of funding became shorter. On August 17, three days before the moratorium declaration, the share of liabilities with a maturity in excess of three months amounted to 36%, and by mid-November this proportion had fallen to 17%.

Regarding the interbank businesses, there was also a dramatic change in the maturity schedule. In the archival source, interbank is defined as the positions with UK banks and with bank overseas including the transactions with their own offices, which accounted for about 19% of their interbank liabilities and 73% of their interbank claims. The net position is given as a proportion of both total interbank liabilities and claims, since the former were significantly larger than the latter. The data in Table 5.4 show that the branches came to rely more on placements up to three months and less on six-month liabilities than before the outbreak of the crisis. The proportion of interbank liabilities with maturity of less than three months doubled from 30 to 59.8% of total interbank liabilities between August and November 1982, an increment that is even higher when considered as a percentage of interbank claims. Overall, the table illustrates the extent that the Mexican branches in London were relying

Table 5.4 Maturity analysis of the Mexican branches in London in 1982

	Net position		*Interbank business*			
	% of total claims		*% of total interbank liabilities*		*% of total interbank claims*	
	18-Aug	*17-Nov*	*18-Aug*	*17-Nov*	*18-Aug*	*17-Nov*
Less than 8 days	−5.8	+0.6	−6.3	−1.7	−11.8	−3.6
8 days–1 month	+2.1	−13.5	−1.6	−24.2	−2.9	−51.6
1 month–3 months	−14.2	−27.8	−22.1	−33.9	−41.1	−72.2
3 months–6 months	−14.1	+1.1	−21.6	+0.1	−40.1	+0.3
6 months–1 year	+2.0	−0.1	−0.1	−1.0	−0.2	−2.0
1 year–3 years	+7.0	+7.1	+1.1	+2.1	+2.0	+4.6
Over 3 years	+23.6	+30.4	+4.5	+5.5	+10.8	+11.8

Source Bank of England Archive, Task Force, 13A195/1

on the interbank market to fund longer-term lending to non-banks and how dramatically their funding sources shortened in the aftermath of the moratorium declaration.

The deterioration of the funding base of the Mexican foreign offices was also reflected on the price they had to pay for wholesale liquidity. The Mexican default, as next section explains in further detail, represented a major shock to the Eurocurrency interbank market and created tiering among banks and banking systems. The presence of tiering meant that instead of having uniform interest rates for all market participants, significant differentiation in spreads appeared according to creditworthiness and the assessment of the quality of the borrowing bank. While under normal market conditions, according to the Bank of England's International Division, the range of spreads was about 1/4 percent above LIBOR, it could extend to 1 or 2% in times of uncertainty and financial distress.[17] As for Mexican banks, though normally charged spreads of 1/8 percent or 1/2 percent at most prior to the crisis, by September–October 1982 they came pay rate premiums of 3/4 or 1% depending on the individual bank and its creditors. Lending banks began also to ask an extra fee or commission of 1/8 to 1/4 percent, which added to the greater spreads and arose premia up to 2% in some cases.

[17] John G. Ellis, 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin* September (1981), 351–64.

Furthermore, along with shorter maturities and higher spreads, Mexican branches and agencies suffered also from a shrinkage of wholesale funding lines. FRBNY's office memorandums on the meetings and calls held among Mexican authorities, US officials and international bankers refer to withdrawals by creditor banks and the drain of interbank deposits that followed the outbreak of the crisis. According to these records, large outflows of funds were indeed observed before the nationalization of Mexican banks in September 1, 1982, and the IMF-World Bank Annual Meetings in Toronto during the following week.[18] Between June and mid-November 1982, Mexican banks lost about US$500 million through their foreign banking offices and additional US$300 million up to the end of the year.[19] This amount represented an erosion of between 10 and 15 of the US$6.5 billion of interbank liabilities that their agencies and branches had as of mid-1982. Against the deposits that were paid off, the creditor banks responsible for the other 90% of interbank claims accepted to renew them, but at higher costs in terms of interest rate and with shorter maturity.

The dire funding conditions that Mexican banks faced in the international interbank markets created strong financial pressures in the foreign agencies and branches' balance sheets, calling into question their liquidity, and indeed solvency, position. Because the bulk of the assets were long-term loans to Mexican borrowers in debt payment difficulties or illiquid claims, their capacity to reduce the portfolio and adjust their position was very limited. Data submitted in August 1982 by Mexican banks to their national authorities show that the foreign agencies and branches were about US$6–6.5 billion mismatched in terms of their dollar assets and liabilities at a consolidated level. Of this amount, an estimated of US$1.25 billion was exclusively owed to the wholesale interbank market and was coming due by mid-September, while the remaining of US$4.75–5.25 billion were due to mature in the following months until the end of December 1982.[20] In the view of William Rhodes, the Citibank negotiator and chairman of the Bank Advisory

[18] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office Memorandum, October 19, 1982.

[19] FRBNY archive, Central Records, Bank Advisory Group November–December 1982: Office Memorandum, November 18, 1982.

[20] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

Group for Mexico, the US$6–6.5 billion mismatch in the dollar balance sheets of the Mexican agencies and branches was a potential "real bomb."[21]

Dealing with Liquidity Strains

Mexican banks confronted a series of difficulties and important challenges when looking to secure the financial position of their international agencies and branches during the aftermath of the debt crisis. On August 25, 1982, few days after the Mexican government declared the temporary moratorium on its external debt principal payments, Robert T. Falconer and Robert C. Flows from the FRBNY held "extensive conversations" (sic) with Mexican bankers about the situation of the agencies in the USA.[22] Both of them interviewed with representatives of four of the six Mexican banks operating in the country, namely Bancomer, Banamex, Banco Mexicano Somex and Banco Internacional, with the specific goal to learn about their liquidity position. They also asked about the availability of alternative sources to meet their funding needs given the new atmosphere of uncertainty and tensions that reined in the Eurocurrency wholesale and US interbank money markets as a consequence of the crisis.

Mexican bankers informed that they were still able to purchase overnight and term money in the Federal funds and Eurodollar markets, but that they were nevertheless working out credit lines with correspondent or partner banks in the USA and Europe. Marquis Gilmore, agent and senior vice president of Banco International's agency in New York, indicated, for instance, that they were capable to obtain the needed funds through its international banks correspondents and that they counted on continuing to draw upon them to make the payment that were coming due in the following months. In a similar vein, Manuel Farina, senior manager-finance of Bancomer's New York agency, reported that they had standby backup lines with several European banks, and that they could draw on these lines when no other sources of funds were available. Clifton Hudgins from Banamex said that the New York agency had confirmed term lines of credits for US$40 million with Bank of America,

[21] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office Memorandum, August 25, 1982.

[22] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 25, 1982.

Chase Manhattan, Manufacturers Hanover and Security Pacific, and that they had an additional "overdraft" line with Manufacturers Hanover of US$120 million which had also been confirmed. Banamex also arranged "advance" lines with a number of other foreign banks, ranging in size from US$2 to 30 million that could be drawn down at the price of higher cost of borrowing and shorter maturity.[23]

Noteworthy, in addition to the credit lines worked out with correspondent banks, the US agencies of Mexican banks were receiving financial support from their home country. In the conversation with Falconer and Flows, Clifton Hudgins indicated that during the previous week Banamex' US agencies had received a shipment of currency for US$31 million from Mexico and that he was expecting more money to arrive in the upcoming days. As he explained to the FRBNY officials, these transfers represented dollars gathered by the head office through foreign exchange conversions in Mexico, but there was also financial assistance directly provided by the Mexican central bank. As a matter of facts, although there are no systematic or complete records of these transactions, data compiled in a FRBNY note of a Group of Ten (G10) governors' meeting at the BIS show that between Tuesday the 7th and Wednesday the 22th of September 1982, Banco de Mexico assisted the foreign agencies and branches of Mexican banks with at least US$311.3 million.[24] This amount represented about a quarter of the US$1.25 billion of their interbank liabilities that were coming due within that time, and 14.6% of the international reserves of Banco de Mexico, which totaled US$2.1 billion as of end August 1982.

Table 5.5 presents the breakdown of Banco de Mexico's "known" funding (sic) of Mexican agencies per day in the period September 7–22, 1982, as reported in the FRBNY archival source. Banamex was the main beneficiary of these funds, receiving US$118.5 million or 38.1% of the total amount, followed by Multibanco Comermex and Bancomer with about US$63 million or 20% each. Banco Internacional and Banco Mexicano Somex accounted for the balance with US$22.8 and 17.5 million respectively.[25] It is interesting to note the fact that those flows of funding are labeled in the document as "known," which would suggest

[23] Ibid.

[24] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[25] Ibid.

that there may have also been transfers in unknown amounts. If that is the case, as it probably was, the figures of the table would be underestimating the true extent of the financial assistance provided by Banco de Mexico to the international network of agencies and branches of Mexican banks at a time when they were increasingly confronted with liquidity problems and difficulties to raise dollars in the international wholesale interbank market.

However, the ability of Banco de Mexico to assist its banks with foreign exchange was very limited. In the midst of a major balance of payment crisis and dwelling international reserves, Banco de Mexico simply did not have enough resources to support the potential financial needs of the foreign agencies. Figure 5.4 plots the evolution at the dawn of the crisis of Banco de Mexico's total reserves against the estimated dollar liabilities of the London branches and US agencies of Mexican banks. The chart makes explicit the limited availability of the international reserves in relation to the external obligations of these agencies, which becomes more acute in the aftermath of the devaluation of the peso in February 1982.[26] In particular, the US$6–6.5 billion mismatch on the dollar balance sheet of the total network of foreign banking offices represented about 3 to 3.5 times the volume of international reserves of Banco de Mexico between August and December 1982. Furthermore, the interbank obligations of Mexican banks were just a portion of the amount of foreign exchange that the country was required to service from its US$84.1 billion of total external indebtedness by that time.

In fact, a considerable part of the dollars that Banco de Mexico used to assist the agencies were not own resources but external borrowing. According to the FRBNY records reported in Table 5.5, as much as US$218.3 million, or 70% of the US$311.3 million sent by Banco de Mexico to the foreign banking offices during September 1982, came from Federal Reserve swap lines. In addition, IMF historian James Boughton states that a "substantial portion" (sic) of the US$1.85 billion BIS bridge-loan approved in August 1982 was parceled out to repay a part of the outstanding claims during the interbank panic that broke out against Mexican banks on Tuesday, September 7.[27] In this respect,

[26]As of mid-1982, London and the USA accounted for about 65.2% of the total liabilities of Mexican foreign agencies (37.7 and 27.5% respectively), while the remaining 34.8% was in Nassau and the Cayman Islands.

[27]James Boughton, *Silent Revolution: The International Monetary Fund, 1979–1989* (Washington, DC, 2001), 301.

Table 5.5 Banco de Mexico's known funding of Mexican agencies (US$ million)

	September 1982							
	Tuesday 7	*Friday 10*	*Tuesday 14*	*Wednesday 15*	*Thursday 16*	*Friday 17*	*Monday 20*	*Wednesday 22*
Bancomer	40.0			4.6			17.0	
Banamex	36.0	52.0		6.5	13.0	11.0		
Banca Serfin		14.0		13.9				
Banco M. Somex	2.0	9.4		6.1				
M. Comermex				4.0		4.0	30.0	25.0
Banco Internacional		8.7	5.0	4.0				5.1
Daily total	78.0	84.1	5.0	39.1	13.0	15.0	47.0	30.1
Cumulative total	78.0	162.1	167.1	206.2	219.2	234.2	281.2	311.3
Of which swaps								*218.3*
Other								*93.0*

Source FRBNY Archive, Box 108406 (see text)

when reviewing the Mexican situation with its G10 counterparts, Bank of England Governor Gordon Richardson reported that indeed "most of the BIS-U.S. swap drawings have been for the purpose of providing funds for the Mexican offshore agencies and branches," while "the use of the swaps, other than for the Mexican banks' agencies, has been very modest." This funding was part of a financial package put in place by creditor countries to rescue Mexico, but, as Richardson pointed out, its use for assisting Mexican foreign agencies was not "what the facility was designed for."[28]

The reliance of Mexican authorities on foreign capital and international creditors for securing the external position of its banks is also evident from the other funding sources they intended to draw upon. Although US agencies of Mexican banks did not have access to lender of last resort facilities from the Federal Reserve, after the outbreak of the crisis, as Falconer and Flows reported, they "were all acting to make sure that they [were] in a position to borrow from the discount window."[29] In a discussion with Sam Cross from the FRBNY,

[28] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[29] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 25, 1982.

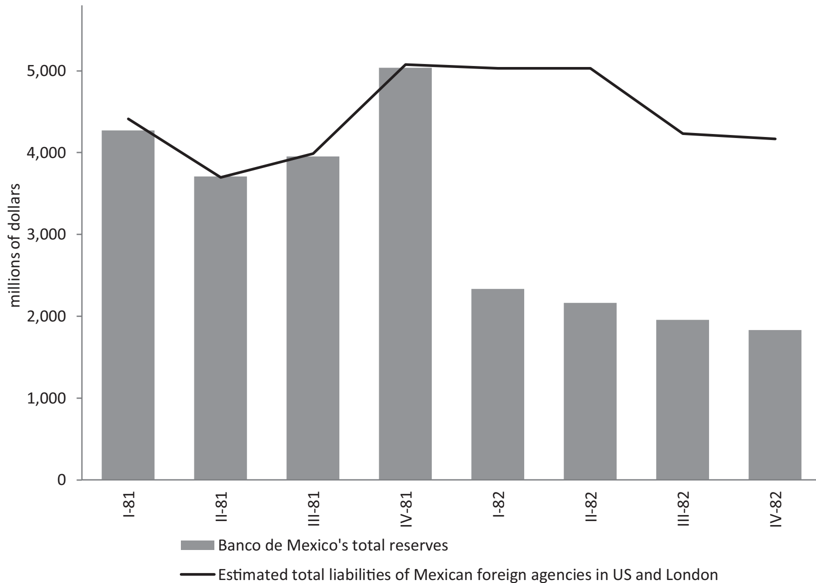

Fig. 5.4 Mexico's international reserves and banks' foreign liabilities (*Source* Banco de Mexico's 1983 Annual Report, FFIEC 002 Call Reports and Bank of England Archive, Task Force, 13A195/1)

Angel Gurría, Mexico's Director of Public Credit and leading external debt negotiator, explicitly stated that Mexican authorities were counting on Federal Reserve discount facilities to handle the possible dollar needs of these agencies. Raising doubts about the availability of such funding, Cross said that it "might be wise to consider how best to deal with any problem with [Mexico's] own resources," to which Gurría replied that "they would be happy to support Mexican banks," but "[they] were a 'little' [sic] short of cash."[30]

[30] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

Mexican consortium banks, which were also highly reliant on the interbank market for funding and exposed to defaulting countries, also confronted funding difficulties after the outbreak of the crisis, but they did not create the same worries among financial authorities. Unlike the foreign agencies and branches of Mexican banks, their consortium banks could benefit from financial support that the shareholder banks had committed to provide in case of emergency. In fact, after the liquidity crisis and the troubles experienced in the Eurocurrency markets with the German Herstatt Bank failure in June 1974, the Bank of England began to require firm assurances from shareholding banks that they will stand behind their London offspring in case of liquidity needs. The affirmation of support was done through a formal letter that the banks could couched in rather general terms with freedom to choose their own phrasing, but with explicit commitment to the provision of standby facilities. Although not legally binding, the fulfilling of undertakings by shareholders was regarded by the Bank of England as a solid moral commitment by parent institutions to support their respective affiliates.[31]

The case of Intermex illustrates how the financial problems confronted by Mexican consortium banks were dealt with. In early 1983, its Managing Director Gerard Legrain, as the Banking Supervision Division of the Bank of England reported, "described himself as a swimmer who is just about managing to keep his head above water." His bank was in troubles since it "[could not] get enough six-month money to fund [its] roll-over assets which [meant] that [it] ha[d] a fairly large interest mis-match position," and "will have to continue to rely on shareholder funds to keep them going."[32] By that time Intermex had received about half a billion dollars form their shareholders, of which the Mexican partners, which were the majority shareholders, contributed with only US$30 million or 6%, although, according to the note, they "ha[d] apparently guaranteed their [non-Mexican] partners for the proportion they have provided on their behalf."[33] What this example shows is that, unlike the agencies or

[31] Richard Roberts, *Take Your Partners: Orion, the Consortium Banks and the Transformation of the Euromarkets* (London, 2001), 85–6; Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997* (Cambridge, 2011), 96–100.

[32] Bank of England Archive, Task Force, File 13A195/1: Note for Record, February 3, 1983.

[33] Ibid.

branches, the problems of the consortium banks did not bring about the intervention of Banco de Mexico and the funding that the Mexican banks were not able to provide was covered by the other shareholder banks before financial assistance from central banks might be required.

A Regulation Loophole on International Banking

The issue of a lender of last resort for international banking and the Euromarkets had been debated among G10 central bankers for some time prior to the 1982 crisis. The lacunae about responsibilities for securing financial support for foreign banking offices in case of emergency was a major problem during the banking failures of the mid-1970s, of which the Herstatt crisis is the most prominent example. On June 26, 1974, the Bankhaus I. D. Herstatt, a relatively minor German banking institution, went bankrupt because of losses arising from short positions in forward operations with short-term maturity schedules. The bank was heavily engaged in interbank foreign currency trading and its failure affected international creditor banks, especially in New York and London, which had outstanding deposits and forward foreign exchange contracts with it.[34] The collapse of the bank damaged interbank market confidence and, as Catherine Schenk observes, "prompted withdrawals from commercial banks in Germany, a sharp increase in Eurodollar market interest rates, and a contraction in international banking activities."[35] Figure 5.5 shows the impact of the crisis on the external and local interbank positions in foreign currency of BIS reporting banks, which dropped by 7% in the third quarter of 1974, marking an inflection point in the evolution of the Eurocurrency market during the 1970s.

The way German financial authorities managed the failure of the Herstatt Bank generated some controversies with their counterparts in the other countries affected by the crisis. On the one hand, the Bundesbank decided to close the bank in the middle of the business day, with many spot transactions with banks operating in different time zone

[34] Emmanuel Mourlon-Druol, '"Trust Is Good, Control Is Better": The 1974 Herstatt Bank Crisis and Its Implications for International Regulatory Reform', *Business History* 57 (2015), 311–34, esp. 326–8.

[35] Catherine R. Schenk, 'Summer in the City: Banking Failures of 1974 and the Development of International Banking Supervision', *The English Historical Review* 129 (2014), 1129–56, 1136.

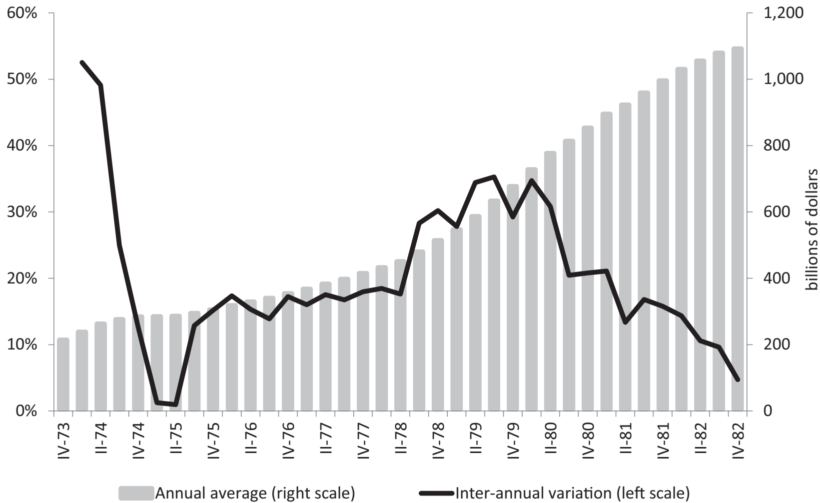

Fig. 5.5 Interbank position in foreign currency of BIS reporting banks, 1973–1982 (*Source* John G. Ellis, 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin* September [1981], 351–64)

still in course, thereby interrupting transfers and leaving the correspondent payments unsettled. On the other hand, unlike the policy adopted by the US Federal Reserve when dealing with the collapse of the Franklin National Bank of New York earlier that year, the Bundesbank looked only to compensate local depositors.[36] While the Fed assisted Franklin's head office in the USA with the liquidity needed to meet the foreign obligations of its London branch, the liquidator of Herstatt refused to make payments to the bank's international creditors. Similar policy discrepancies arose with the liquidity problems of the Israel-British Bank's London subsidiary in the aftermath of the Herstatt failure, which confronted British and Israeli financial authorities. In this case, the Bank of England sought to bear responsibility on the Bank of Israel, which had quickly intervened to guarantee the deposits of the Israel-British Bank in Tel Aviv, but was not willing to take over the London subsidiary.[37]

[36] Joan E. Spero, *The Failure of the Franklin National Bank: Challenge to the International Banking System* (Washington, DC, 1980).

[37] Schenk, 'Summer in the City', 1150–3.

The reassessment of risks behind international finance after these events, along with the lack of understanding regarding lender of last resort responsibilities in the Euromarkets, led central bankers to discuss and coordinate their actions during their BIS meetings. In late 1974, G10 governors issued a communiqué confirming the availability of funds to be used in the event of a liquidity crisis and formed the Basel Committee on Banking Supervision (BCBS) to address the question of how to bear responsibility about foreign banking affiliates or international banks. The outcome of these conversations was the Concordat of September 26, 1975, which set out some basic principles and collaborative guidelines over banks' overseas operations and provided a framework for the allocation of certain duties between home and host countries.[38] A main point of the agreement was that, while host authorities were chiefly responsible for the supervision of foreign establishments' liquidity in the domestic currency, the parent financial authority should have primary responsibility for all other currencies. The Concordat was, however, an arrangement on supervisory duties and, as it would become clear in 1982, it did not necessarily embody or govern the allocation of support or bailing out operations of foreign banking establishments to prevent crisis.[39]

Archival evidence shows indeed important ambiguities among financial authorities with respect to lending of last resort functions in international banking as of the early 1980s. By that time, at the initiative of the Bank of England, G10 central bankers have been discussing a study about the potential implications of a major shock to the international capital markets, namely a default by a large borrowing country, on the banking system and individual banks. They recognized that a "main threat to the stability of the international banking system [was] likely to be lack of liquidity," which could generate funding problems for some banks or group of banks that may quickly turn into a solvency crisis if not properly managed.[40] In response to such diagnosis, the Basel Eurocurrency Standing Committee (BESC) prepared a questionnaire to review the

[38] James C. Baker, *The Bank for International Settlements: Evolution and Evaluation* (Wesport, 2002), 45–50.

[39] Anthony Saunders, 'The Inter-Bank Market, Contagion Effects and International Financial Crises', in Richard Portes and Alexander K. Swoboda (Eds.), *Threats to International Financial Stability* (New York, 1987), 196–238, esp. 237.

[40] Bank of England archive, Apocalypse Now, 3A143/1: Paper Draft, June 1980.

measures at the disposal of financial authorities for dealing with financial crises, and in particular the availability of liquidity support arrangement for international banking. The purpose was to assess the extent to which foreign banks operating in BIS member countries and the overseas establishments of the domestic banks could benefit from central banks' emergency lending facilities in domestic and foreign currencies.

The replies to the questionnaire demonstrated that, regardless of the legal authority that central banks had to operate on these matters, the views and positions of financial authorities were highly conflicting. The draft of the briefing note prepared by the International Division of Bank of England for the BESC points out two main outcomes. First, it stressed that all eleven central banks (G10 and Switzerland) had the ability to grant liquidity support indirectly for foreign establishments of their own domestic banks by providing support to the relevant head office, with some caveats in the case of Bank of France. Second, it underlines the fact that central banks had powers that enable them to provide liquidity support to branches and subsidiaries that operated in their countries, except for Canada where foreign banks had no access to central bank facilities and Sweden where there were no foreign banks operating.[41] However, while there were no immediately apparent gaps in the legal ability of the authorities to provide lender of last resort assistance to foreign subsidiaries and branches experiencing liquidity difficulties, important holes might exist in practice.

The response provided by the USA illustrates the extent of the misunderstandings and ambivalences among financial authorities on these important policy issues. In the reply document to the BIS questionnaire, the US position with respect to the overseas branches and subsidiaries of American banks was that the authorities of the country in which these establishments were located should deal with their liquidity problems when associated with developments affecting financial institutions in that country more generally. However, as far as branches and subsidiaries of foreign banks operating in the USA were concerned, it advocated that these institutions were first expected to make use of other "reasonably available" (sic) source of credit, including the resources of host authorities, before turning to the Fed and its discount window.[42] Such answers

[41] Bank of England archive, Apocalypse Now, 3A143/5: Note, July 8, 1981.

[42] Bank of England archive, Apocalypse Now, 3A143/5: Answers to BIS Questionnaires, United States.

generated controversies about potential distortions in the stance of US authorities and raised the question of whether the US Fed was prepared to offer the same facilities to foreign banking establishments located in the USA as it expected other host authorities to provide to their US counterparts abroad.

The incongruities underlying the US response to the questionnaire did not go unnoticed to the British financial authorities. In the words of J. W. Drage, the Bank of England's International Division official that prepared the first draft of the briefing note reporting the results of the survey to the BIS, "reading a little between the lines (…) and stating the position a little crudely the Fed appear[ed] to be arguing that if an American branch or subsidiaries of a British bank (for example) [was] experiencing liquidity difficulties then it [was the Bank of England's] job to provide support via the parent banks and if it [was] a British branch or subsidiary of an American bank in difficulties it [was] also [the Bank of England's] job as host authority to provide support."[43] Drage also pointed out similar inconsistencies in the responses of the Japanese central bank, which stated that it could only support local branches of foreign banks on their yen business in Japan, while foreign agencies and subsidiaries of Japanese banks were expected to seek liquidity support from the relevant host authority.

A main concern behind such contentious statements was the vacuums they left in the arrangements to provide liquidity as to what host and home authorities expected from each other. In light of the responses to the questionnaire, the presence of gaps in one central bank hoping that another one would take the lead in providing support seemed considerable. Moreover, as pointed out in the note, "the responses indicate[d] that in advance of knowing the circumstances of a particular crisis most respondents [were] not prepared to commit themselves as to whether liquidity should be provided by parental or host authorities."[44] The words of a Bank of England official make the dichotomy that central bankers faced very clear: "if [the necessary support for a foreign bank in London] was not forthcoming would [the Bank of England] be prepared to stand by and watch foreign banks become insolvent or would [it] find [it] necessary to act to protect London's reputation as an

[43] Bank of England archive, Apocalypse Now, 3A143/5: Note, July 8, 1981.

[44] Ibid.

international center?"[45] Such uncertainties about the respective roles of central banks prior to a liquidity crisis arising were problematic because authorities needed to move very fast to provide financial assistance and prevent funding problems from rippling through the banking system as had happened in 1974.

The lack of understanding and coordination among G10 governors was clearly worrisome, but what generated even more concern was the question of who, if anyone, would support banks from developing countries in the major international centers if they were to run into liquidity difficulties. Unlike industrial countries, no clear safeguard existed for them, since central banks from developing countries confronting debt problems were struggling to build up their international reserve and could only provide token support in foreign currency as the previous discussion on the Mexican case has shown. Moreover, these banks had not subscribed to the Concordat of 1975 nor had they participated in the subsequent discussions at the BIS, and were thereby not necessarily well aware of, nor committed to, the allocation of lender of last resort responsibilities in international banking and the Euromarkets as their G10 counterparts. In such a context, the liquidity problems that the foreign agencies and branches of Mexican and other developing country banks encountered in the wake of the crisis created major challenges as the following chapter will demonstrate.

[45] Bank of England archive, Apocalypse Now, 3A143/1: Paper Draft, June 1980.

CHAPTER 6

Banks and Debt Negotiations

The vulnerability of the international financial system to the potential impact of defaults or serious debt payment failures was a salient feature and one of the biggest challenges of the international debt crisis of the 1980s. The strains steamed largely from the fact that much of the Mexican and broader Latin American debt was in the hands of the world largest banks, and the amount of the claims was large relatively to their capital base.[1] The exposure of banks and banking systems was indeed a major concern for governments and financial authorities from industrial countries and a main reason why they became forcefully involved in the management of the crisis. With the international capital markets closed to Mexico, negotiations started as to reschedule bank external debt and provide financial assistance conditioned on the implementation of IMF-adjustment programs.[2] Securing payments by Mexico, as well as other heavily indebted countries, was important because of the precarious capacity of creditor banks to take losses without compromising their solvency position.

Aside from direct exposure to Mexican debt, an additional source of vulnerability came from the money markets and interbank transactions.

[1] William R. Cline, *International Debt: Systemic Risk and Policy Response* (Washington, DC, 1984).

[2] William R. Cline, *International Debt Reexamined* (Washington, DC, 1995); James Boughton, *Silent Revolution: The International Monetary Fund, 1979–1989* (Washington, DC, 2001).

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The funding problems of the Mexican agencies and branches in the international financial centers, as this chapter demonstrates, were a major concern among G10 central bankers, and their external interbank obligations played an important role within the renegotiating process and rescheduling approach. Within a context of great misunderstandings about lender of last resort responsibilities in the Eurocurrency markets, the failure by Mexican banks to reimburse its interbank debts could generate a liquidity crisis with considerable potential systemic implications. An agreement was eventually reached between the Mexican government and international creditor banks to maintain the interbank credit lines with the foreign agencies and branches of Mexican banks at the level they had before the moratorium declaration in August 1982.

The risk of developed countries' banks and banking systems in the face of the international debt crisis was apparent, but the corresponding exposure of their counterparts in Mexico was much more worrisome. While foreign outstanding claims in Mexico accounted for about a third of the capital base of the US banking system—the country with the largest participation in foreign lending to Latin America, the amount in the books of Mexican banks represented several times the capital base of the domestic banking system. In terms of their assets, foreign loans to Mexico accounted for about a third of the total bank loan portfolio of the large Mexican banks involved with foreign finance, but less than five percent of the most exposed and systematically important US creditor banks. Therefore, it appears evident that Mexico's external debt payment problems posed substantial risks not only for US and other developed countries' banks, but more importantly for the domestic banking sector itself.

The exposure of Mexican banks to funding risks in the international interbank markets was also a major threat to their financial position. Since the bulk of their external assets were long-term troubled loans to Mexican borrowers or illiquid claims, the capacity to reduce their portfolio and adjust their balance sheets to the loss of interbank funding of the foreign agencies and branches was very limited. With virtually no access to alternative non-interbank wholesale dollars, the stability of the external position of the banks was largely dependent on the rollover of short-term funding lines by creditor banks. The large exposure of the domestic banking system to its own debt crisis and the heightened reliance of Mexican government on funding lines under the control of international creditors are crucial for understanding Mexico's international negotiating position and debt rescheduling deals.

The Mexican Agency Situation

The financial problems affecting the foreign agencies and branches of Mexican banks were largely debated by G10 central bankers in Basel. In the aftermath of the moratorium declaration, during the meetings where financial assistance programs for Mexico were discussed and the implications for the international banking system examined, "the Mexican agency situation" (sic) received special consideration. Among the financial authorities of industrial countries, the liquidity strains experienced by Mexican banks in the interbank market were of especial concern to Bank of England Governor Gordon Richardson, who would regularly bring the issue to the fore during the BIS meetings. While in his eyes the extent and scale of the problem were clear-cut, he had the impression "that the others [governors] in the G-10 [were] not sufficiently aware of the potential dangers." As he pointed out in front of his colleagues, "the Mexican situation involved more than 1,000 banks" and it "did not affect just a few financial centers in the U.S., U.K., Switzerland, etc., but concerned everyone."[3]

There were good reasons to worry about the Mexican agencies since their problems did not only entailed liquidity or funding risk, but they threated to turn into insolvency. Mexican banks had no liquidity cushion and, as discussed in the previous chapter, they had very limited access to alternative non-interbank dollar funding. They were not under the protection of the Federal Reserve System or the Bank of England, and the financial support provided by Banco de Mexico had been scarce and largely insufficient. Given the far-reaching interconnection among banks through mutual claims and obligations, and the extent of maturity transformations performed along the chain of international interbank transactions, a payment disruption by the Mexican agencies could easily propagate through the banking system within and across financial centers. The outbreak of crisis and the uncertainty and fears that it rose among banks had indeed prompted, as BIS official Alexandre Lamfalussy reported to the Eurocurrency Standing Committee, a more general "shrinkage of interbank positions and a halt in the cross-border interbank market," with "increasing tiering among banks and banking systems."[4]

[3] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[4] Ibid. 'Tiering' occurs when, instead of having uniform interest rates applicable to all participants, there is a differentiation in the spread according to the nature and the nationality of the borrowing bank.

In effect, several other foreign banking institutions seemed also to have been confronting difficulties to fund maturing Eurocurrency interbank liabilities in the market. A review of international financial developments between 1982 and 1983 prepared by the Bank of England highlights the problems experienced by the London branches of banks from various debtor countries in the wake of the crisis. Along with the Mexican agencies, Brazilian banks were also suffering a loss of interbank placements both from banks in London and abroad; during the second half of 1982, the Brazilian agencies worldwide lost US$3.5–4 billion in the interbank market, an amount representing a 35–40% drop.[5] According to this report, South Korean and Portuguese branches had also gone through some complicated months during the last quarter of 1982, but while the former experienced a modest recovery during early 1983, the balance sheet of the latter continued to contract in 1983 due to reduced interbank activity. The overall situation was, as Anthony Solomon from the FRBNY put it during a BIS meeting, a "widening problem of branches and agencies, not only involv[ing] Mexican banks but also Brazilian, Argentinian and Korean, and others, whose liabilities were owed to the interbank market and whose assets were not liquid."[6]

The participation of Mexican agencies and other troubled banks in the international money markets was modest, but the potential systemic implications were not to be neglected. The collapse of the Herstatt Bank in 1974 had made very clear to central bankers that the failure of small active banks could transmit large losses to solid institutions and spread to the rest of the banking system through the interbank market at a domestic and international level, with significant contractionary effects on the Euromarkets and interbank transactions. In a comparative perspective, while the outstanding interbank foreign exposure of the Herstatt Bank was estimated at US$200 million or less than 0.1% of the Eurocurrency market, the interbank short-term mismatched liabilities of Mexican and Brazilian foreign agencies alone accounted for about US$16 billion or 1.5% of the market.[7] Thus, considering the Herstatt experience, there

[5] Bank of England archive, Task Force, 13A195/1: Review of International Financial Developments 1982–1983.

[6] FRBNY archives, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[7] On the Herstatt exposure, see Michael Moffitt, *World's Money: International Banking from Bretton Woods to the Brink of Insolvency* (New York, 1984), 90; On Latin American

were good enough reasons to think that a default by these agencies on their interbank obligations could also trigger a dangerous domino or knock-on effect, raising the prospect of a systemic collapse in London as well as in other financial centers.

Although the tensions and liquidity pressures developed in the interbank market after the Mexican crisis were worrisome for developed countries' financial authorities, they were hardly a surprise. G10 central banks have been debating for some time in the BESC about the problems related to the foreign lending activities of international banks and evaluating the potential reactions that the market could have if subject to a large shock such as a default. Those discussions were based and framed on a paper entitled "*Possible consequences of a default by a major borrowing country*" prepared by the Bank of England, which considered different scenarios under which a massive loan default could happen and the complications that it would create for the world economy and international finance. In its sixth section, the paper analyzed the impact of such a default on the international banking system, with special attention to the consequences for the interbank markets and wholesale liquidity. To the Bank of England, given the precedent of the Herstatt crisis and its repercussions on the interbank markets, it was "not too far fetched to hypothesise that a default by a large borrower could be an event of sufficient importance to trigger off renewed tiering."[8]

As it turned out, the situation observed in the international interbank market after the Mexican default fitted well with the forecasts and expectations of the Bank of England. In fact, the study stressed that "the banks that could face liquidity problems the earliest would be banks without their own dollar base who primarily rely on the inter-bank market for their funds and have large amounts outstanding to the defaulting country or to countries felt to be in a similar position." Furthermore, it was envisaged that these banks could be very quickly "faced with tiering and funding losses" and that they may "go under if expeditious support from the authorities was not forthcoming."[9] By contrary, institutions

banks, see FRBNY archive, Box 108403, The International Interbank Market and International Banking Lending, June 28, 1985.

[8] Bank of England archive, Apocalypse Now, 3A143/1: Paper draft, June 1980.

[9] Ibid.

with large retail deposits and access to non-interbank dollar resources would find it easier to fund their outstanding portfolio and would most likely not be affected by liquidity difficulties in the same extent that their non-dollar-based wholesale counterparts. Mexican agencies, along with other developing countries banks, belonged to the first group of banks and the difficulties that they experienced were in line with the anticipations made by the report.

But the fact that the problems of Mexican banks and its effects on the interbank market may have not been entirely unexpected for G10 governors does not mean that they were prepared to manage them. The paper, which was confidentially circulated and referred to by the financial authorities as "Apocalype Now," was not only concerned with identifying the likely reactions of the markets, but also the policy response that government and central banks in creditor countries may undertake in the event of crisis. To the Bank of England, the past experiences in domestic markets, such as the secondary banking crisis of 1973–1975 in the UK and the failure of the First Pennsylvania in the USA in 1980, suggested that authorities would move very fast as to provide the necessary liquidity and prevent rippling effects. However, whether they would do so to head-off a funding crisis in the international banking system was far from clear. By that time, as saw at the end of the previous chapter, there were significant gaps in lender of last resort policies in international banking and important doubts existed about the intervening role and capacities of central banks from debtor countries that have not subscribed to the Concordat and were not part of the BIS discussions either.

Interbank Debt Within Renegotiations

The uncertainties surrounding Mexican agencies and lender of last resort responsibilities came quickly to light during the negotiations that followed the outbreak of the crisis. As early as August 20, 1982, at the meeting in the FRBNY where the moratorium was announced to the international financial community, creditor banks asked Mexican officials "about the short-term deposits with the Mexican banking system." The response of Angel Gurría, Mexico's Director of Public Credit and leading external debt negotiator, was "that the Mexican banking system was the backbone of the country's economic progress" and that the government expected that "Mexican banks would be supported [by creditor banks] for a return to normalcy." Furthermore, he appealed to

the understanding and collaboration of the banks in the room, arguing that "if other banks ha[d] the perception of difficulty in collecting from Mexican banks, if they withdraw deposits, they ma[de] that perceived problem a real problem."[10]

The conversations between Mexico's authorities and its international creditors about the management of the interbank market for Mexican banks continued during the following weeks. Given the concerns of creditor banks about the mismatches of the Mexican agencies in the USA and London and the potential troubles that they might confront in meeting their dollar funding needs, FRBNY official Sam Cross called Gurría on August 30, 1982 to learn about how they planned to deal with the situation. Gurría said that he intended to meet with 140 bankers in Mexico City that day and that he "would point out as emphatically as he could that no bank had ever been allowed to fail in Mexico, and that the Government and the Bank of Mexico stood strongly behind the banks." He planned also to request the Bank Advisory Committee, which was the group of 13 banks responsible for negotiating on behalf of all Mexico's bank creditors, "to send out a telex asking the banks to show understanding and cooperation in this matter, and not to create a problem by drawing down credit lines."[11]

Mexican authorities have been also discussing with the creditor countries counterparts the possibility of accessing to lending of last resort facilities from their central banks. In this respect, Gurría asked Cross if Mexican agencies could potentially borrow from the rediscount window, to which he replied that the issue of "any use of Federal discount facilities would have to be studied very carefully," and "if available, was very limited in nature."[12] The responses given by other central banks contacted by Mexican authorities on this matter were not promising either. In particular, the Bank of England, the home authority of the branches in London, said that "it would not provide discount facilities in this situation since the need was for dollar financing rather than sterling financing."[13] As for Banco de Mexico itself, its international reserves were dwindling and, as the previous chapter has shown, it has no enough resources to

[10] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office memorandum, August 23, 1982.

[11] Ibid.

[12] Ibid.

[13] Ibid.

assist Mexican banks with the dollars needed to meet a potential liquidity shortfall of the network of agencies and branches in the USA, London and the Caribbean.

With virtually no central bank willing or capable to assist Mexican banks in the event of a liquidity problem, the alternative was to stop the withdrawal of funds by creditor banks. In a note on the management of the interbank market for Mexican agencies, the Bank of England concluded that their "position [could] be held, but only if the lending banks carry on rolling over their deposits, the US/BIS facilities continue[d] to be available and the market [made] some adjustments of pricing and maturity."[14] In this vein, the Advisory Group set up a subcommittee under the responsibility of Larry Miller and Terry Canavan of Chemical Bank to handle the Mexican agency problem. The subcommittee was the vehicle through which the lending banks were to be encouraged to roll over, and it worked in close collaboration with central banks that were actively involved with this issue. The Bank of England, for instance, would occasionally do "some coaxing and hand holding of banks in London who either enquire[d] about their maturing deposits or who appear[ed] to be pulling back."[15] Moral suasion and arm-twisting were indeed salient features of the debt management strategy deployed by creditor governments and financial authorities to make international creditor banks cooperate with funding and participate in the rescheduling deals with Mexico and other developing countries as well.[16]

Yet, persuading creditor banks to maintain the level of interbank credit lines with Mexican banks and succeeding to stop the leakage of funds proved to be a difficult task. On October 15, 1982, Sam Cross reported to Paul Volcker and Anthony Solomon a call from Larry Miller saying that, despite the efforts of the Bank Advisory Group to secure the renewal of wholesale credit lines, "the situation with respect to the [Mexican] agencies [was] more and more uncertain." Although the rollover rate had been at around 90%, the banks responsible for the other 10% "continue[d] to demand to get paid off and [did] get paid off." The problem was, as Miller stated, that "every time one bank gets paid off, another is

[14] Bank of England archives, Task Force, 13A196/1: Management of Interbank Market for Mexican Banks, September 22, 1982.

[15] Ibid.

[16] Jérôme Sgard, 'How the IMF Did It—Sovereign Debt Restructurings Between 1970 and 1989', *Capital Market Law Journal* 11 (2016), 103–25.

encouraged to insist on it too," and this has raised questions among banks on the Advisory Group that have maintained their deposits, about the continuation of "a system in which they [saw] themselves disadvantaged."[17] In Miller's opinion, the willingness and commitment of lending banks to continue with this arrangement if such situation persisted could not be guarantee for much longer.

Two possible choices, none of which was finally implemented, were considered by the Advisory Group as alternative to the current arrangement. A first, more radical possibility was "to tell the Mexican agencies not to pay to those who demand payment." The Bank of England had already recognized the "good payer" behavior of the Mexicans as potentially counterproductive, stressing that "the branches of some [Mexican] banks in London [were] repaying maturing deposits without waiting to be asked" and that "the exercise might be more efficiently conducted if the central bank of both the lending and borrowing banks had a common approach to what was expected."[18] However, a refuse to pay a maturing deposit implied a default on the interbank claims, and this could cause even worse problems. As Sam Cross warned, not only would it lead some banks to "initiate legal proceeding and the game would be up," but there was also the acknowledged risk of triggering a dangerous knock-on effect.[19]

The other possibility envisaged to reschedule interbank obligations as was to be done with the rest of the country's external debt. During the early stages of the crisis, the Mexican government have indeed spoke to the Advisory Group about the alternative of folding the foreign liabilities of Mexican banks into the package of medium-term restructuring that was under negotiation. The unanimous view of the banks was, however, "don't try it." The bankers argued that no rescheduling had ever covered interbank deposits, and they felt "that the Mexico to try [sic], would not only fail, but would also cause problems for the proposed rollover."[20] A formal restructuring of these facilities represented

[17] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office memorandum, October 19, 1982.

[18] Bank of England archive, Task Force, 13A196/1: Management of Interbank Market for Mexican Banks, September 22, 1982.

[19] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office memorandum, October 19, 1982.

[20] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

a de facto default, which would also disappoint the expectations of the most reticent lending banks and was likely to shrink even more the interbank market for Mexican banks. For the Bank of England, the attempt to restructure these obligations generated also concerns about widespread negative implications for the interbank deposit market more generally since the line between manageable liquidity problems and solvency could be quickly crossed in the event of such a market disruption.

It seemed clear, therefore, among bankers and financial authorities that the Mexican agencies could not be allowed to default in their money market activities, but in order to avoid that from happening the hemorrhage of funds had to stop. Securing interbank funding was not only important for the stability of the domestic and international banking system but also, more generally, to allow Mexico to implement the stabilization program under negotiation with the Fund. In the eyes of IMF Managing Director Jacques de Larosière, one of the key actors and a fundamental person in the management of the Mexican crisis, international commercial banks' rollover operations could not be limited to medium- and long-term debt but also needed to integrate "the inter-bank element related to the euro-market operations of agency banks, which attract[ed] short-term euro-market deposits to re-lend to banks in their own countries at longer maturities." As he stressed to the staff of the Fund when discussing the financial program for Mexico in early 1983, "it could undermine the rest of the rescheduling operation if the base of the iceberg (the large interbank element) were to dissolve."[21]

Within the approach developed to deal with the Mexican crisis, interbank obligations appeared as a valve from where the financial assistance to be provided to the country could escape. The basic principle of the debt management strategy consisted of rescheduling the amortization of principal with commercial banks while extending new money facilities conditioned on IMF agreement. On the one hand, the Mexican government committed to adopting austerity measures and introducing economic reforms to address the economic imbalances and improve balance of payment performance. On the other hand, the group of creditors, which included commercial banks, governments of industrial countries and international organizations, were to jointly supply the financing and foreign exchange the country needed to implement the adjustment program and keep current on its

[21] IMF archive, OMDF Jacques de Larosière's chronological files, Box 3, File 4: Office Correspondence, February 23, 1983.

external debt. Under such scheme, there was a risk that the money given to the country was used to cover the funding needs of the Mexican foreign agencies, dissipating the proceeds in the interbank market, and compromising thereby the payment of rescheduled debt. The US$5 billion in new loans that international creditor banks have committed to provide as part of the rescheduling agreement with Mexico were after all about the same amount that the Mexican agencies owed them in the interbank market.

The Agreement on the Interbank Lines

A compromise solution was eventually reached between Mexico and international creditor banks on this interbank problem. As part of the rescheduling arrangement and Financial Package of 1982–1983, it was agreed that creditor banks would maintain their existing exposure to the foreign agencies and branches of the Mexican banks at the August 1982 pre-moratorium levels. The commitment consisted in not letting interbank credit lines fall below US$5.2 billion until the end-1986, which in practice meant that the banks would keep deposits rolling over every 90 days, whenever they were about to expire for the next three years. For their part, Mexican banks would continue to pay the market interest payments on their outstanding interbank debts when they came due, and the government and central bank committed to make the necessary foreign exchange available for those payments.

Although no specific formal document was signed on this regard, the agreement was included in the text of the general restructuring documents agreed on and subscribed by the two parts. The clause about interbank debt stated that an event of default would be triggered if ever the aggregate level of the interbank liabilities placed with the international agencies and branches of Mexican banks were to drop below US$5.2 billion. The solution adopted, as sovereign debt lawyer Lee Buchheit has explained, “did not of course convey any legal assurance that the deposits generally, nor any specific deposit in particular, would be maintained,” but it served to “raise the stakes for a bank seeking to withdraw its deposits.”[22] Had a bank sought to be repaid on its interbank deposit, it risked to jeopardize the whole rescheduling exercise by triggering the event of default.

[22] Lee C. Buchheit, ‘But What Do We Do About All Those Interbank Lines?’, *International Financial Law Review* X (1991), 15–16, 16.

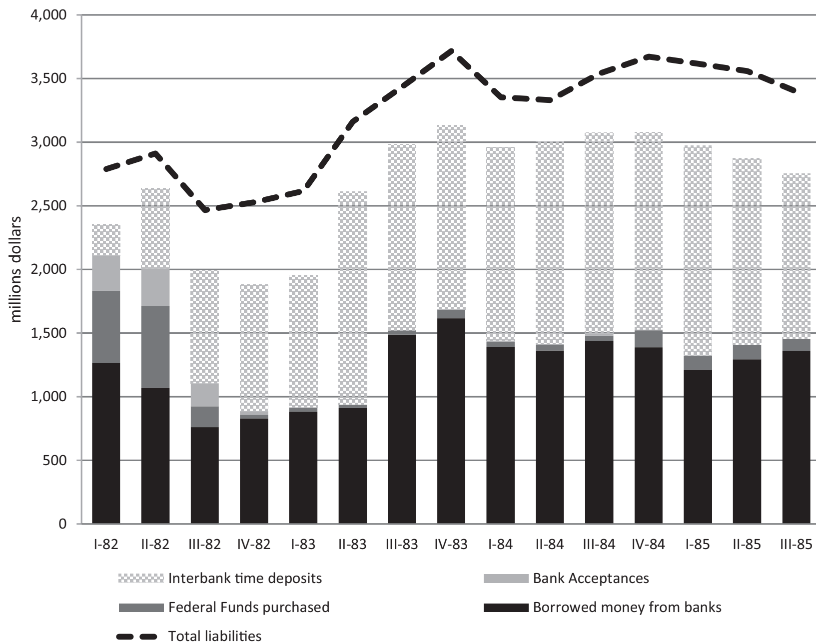

Fig. 6.1 Interbank funding structure of the US agencies of Mexican banks, 1982–1985 (*Source* FFIEC 002 Call Report)

Figure 6.1 shows the quarterly evolution of the liabilities of the US agencies of Mexican banks along with the breakdown by main interbank fundraising instruments between 1982 and 1985. The chart shows the contraction that followed the outbreak of the crisis in the third quarter of 1982 and the subsequent recovery since mid-1983 after the arrangement over interbank debt was reached. Borrowed money, the agencies' main fundraising instrument, fell progressively until September and it stagnated at that minimum level until the third quarters of 1983, when it returned to its previous values. As for federal funds and bank acceptances, which were their second major source of funding, abruptly shrank and they virtually disappeared among agencies' liabilities by the end of 1982, never recovering the pre-crisis levels. On the other hand, total deposits and credit balances from banking institutions, which

accounted for about 10% of agencies' funding in early 1982, increased their share up to 40% by the end of the year and will keep those levels afterward. The chart reflects the change in the fundraising structure of the agencies after the interbank debt arrangement, with deposits and credit lines from creditor banks overcoming the shortfall in more liquid and marketable money market instruments such as federal funds and bank acceptances.

The agreement on interbank debt was effective to stabilize the funding and liquidity position of the Mexican agencies, but it did not return their wholesale market activities back to normalcy. As of mid-1984, a FRBNY memorandum updating on the financial situation of Mexican banks reported that "the process of 'normalization' [had] been slow" and that "the banks [were] making clean ups of funding sources and several appear[ed] to be working hard to establish a 'business as usual' atmosphere." The memo also points out important gains reached in terms of the term structure of liabilities, with all Mexican bankers indicating a lengthening of maturities since late 1983, as "the average interbank maturity [was then] about three months, some four to six weeks longer than it was at year-end." Much less progress was observed regarding access to new interbank funding lines, since "only the two largest banks (Banamex and Bancomer) [had] gained new money and the amounts [were] relatively small," while none of the "smaller banks reported gaining any new money." On the contrary, the small banks had "left the general impression that no new sources of funding were available to them, nor were they likely to occur in the near term."[23]

A moderate improvement was also observed in terms of the cost of funding and the rate premiums that Mexican banks were charged on those interbank lines. A Bancomer official, for instance, informed that while some banks, namely Chase Manhattan and Citibank, have dropped the fee requirement on their interbank deposits, there were others, such as Morgan, that continued to charge commissions of about 1/8 percent. For Banamex, the cost of interbank borrowing was reported to have fallen about 1/8 percent, although significant differences were observed between London and New York as well as across lending banks. While National Westminster, as well as other German, Spanish and Italian banks, continued to require a high spread over LIBOR—about 7/8

[23] FRBNY archive, Box 142529, 1980–1984 Solomon Anthony Material: Office memorandum, July 25, 1984.

percent, "three of the United Kingdom clearing banks had reduced their premium charge by about 3/8 percent to a spread of ½ or 3/8 percent." As for the smaller banks, they characterized their spreads as having declined an average of 10–15 basis points and they were also "aiming to pay 1/2 percent over LIBOR, although some continue[d] to pay substantially higher depending on the individual bank and its creditors."[24]

The situation of the agencies became, however, more problematic as the Mexican government entered into the second renegotiating round that led to the multi-year rescheduling agreement (MyRA) of 1984–1985. A main problem was that the new restructuring lengthened the maturity of a significant portion of the agencies' dollar-denominated assets, while, as Banamex officials declared in a conversation with its FRBNY counterparts, it did "nothing to lengthen the maturity of their inter-bank dollar deposits," worsening thereby the maturity mismatch. Banamex officials also reported that "they [were] being caught in a squeeze on their profit margins as a result of the recent restructuring of certain Mexican public and private debt."[25] While the interest rate on the restructured loans has been reduced, interbank deposits with the Mexican agencies continued to pay roughly 3/4 to 1% over LIBOR. Additionally, there was also the fact that under the 1983 restructuring agreement, the Mexican agencies have been assured only that the US$5.2 billion of interbank deposits would be maintained up to December 1986, raising concerns about what would happen with the agencies' liquidity needs after that date, particularly with respect to the smaller banks.

Some attempts were developed with the purpose of improving the situation of the agencies. To alleviate the effects of the MyRA, Mexican banks proposed to: exclude them from the restructuring agreement, switch a portion of their dollar assets exposure into local currency or negotiate with major creditor banks the conversion of interbank deposits to a longer-term basis, but none of them was accepted by the Bank Advisory Group.[26] In 1985, Banamex worked in a new proposal to find

[24] Ibid.

[25] FRBNY archives, Box 142529, 1980–1984 Solomon Anthony Material: Office memorandum, September 18, 1984.

[26] Ibid.

a longer-term solution to the interbank problem. The idea, as described in a FRBNY internal memorandum, was to "establish a special purpose company – Park Capital Corporation – which would issue commercial paper and pass the proceeds to Banamex."[27] The proceeds would then be used to repay Banamex's outstanding interbank obligations to certain major creditor banks, which, in turn, would provide standby letters to an insurance company, the National Union Fire Insurance Company, that would have provided the guarantee to back the issuance of the commercial papers. According to the archival source, an agreement between Banamex, the insurance company and the participating banks was signed on July 30, 1985, and the private placement of the commercial paper scheduled for mid-August, but there are no more traces of the operation, and, whatever happened, it was not the final solution to the interbank issue.

As time passed and no viable alternative option emerged, Mexican government officials eventually asked to extend the expiration date of the covenant beyond the deadline of December 1986. They argued that "Mexican banks needed the placements as a long term source of funding for their loans to Mexican public sector borrowers governed by the Restructure Agreements" and raised the concerns "about the possibility of large demands for repayments."[28] After all, although inconvenient in many respects, the arrangement has proven successful in avoiding large scale leakages of funding while allowing creditors to maintain the flexibility of working directly with their original clients. In the end, during the negotiations of the 1986–1987 Financial Package, Mexico and international creditors agreed to extend the expiration date to June 1989. This time, a mechanism was included to permit reduction of the US$5.2 threshold through the transaction of the interbank liabilities for other Mexican restructuring facilities. But this did not turn out to be an attractive solution to the creditor banks because the secondary market value of interbank placements was approximately 20 percentage points higher than restructured debt, so they preferred to keep them.[29]

[27] FRBNY archives, Box 142529, 1980–1984 Solomon Anthony Material: Office memorandum, August 1, 1985.

[28] FRBNY archive, Box 108401, Report 'United Mexican States', December 19, 1988.

[29] Ibid.

In the late 1980s, some new unsuccessful attempts were developed as to find a definitive solution to the interbank problem. Lee Buchheit mentions, for instance, a transaction arranged between Banamex and First Interstate Capital Markets Limited in which US$200 million of short-term interbank deposits were transformed into a 20-year subordinated obligation of the bank, which could be counted as bank capital for Mexican bank regulatory purposes. According to him, this innovative operation became the model for several similar deals in Mexico and elsewhere and there were also a separate series of transactions involving the exchange of interbank deposits for medium-term floating rate notes that had greater secondary market liquidity, but these initiatives did not gain in scale for resolving the interbank issue.[30] Like in 1986, as the freezing agreement approached to the end, Mexico and its commercial bank creditors agreed within the 1989–1992 Financial Package of the Brady Plan to extend the special arrangement relating to interbank deposits for another three years.

The final solution came in June 1991 as part of the bank privatization process initiated by the Mexican government during the previous year. Up to that date, interbank deposits remained the only portion of Mexico's external debt that had not been dealt with on a permanent, market-oriented basis. The project proposed "all holder of interbank deposits the opportunity to exchange these deposits for new readily marketable instruments that may be used to purchase shares of any Mexican bank being privatized."[31] An auction was to be organized, and creditor banks would bid for a Floating Rate Privatization Note issued by the United Mexican States to be paid with their interbank claims, which could then be used at full face value for the acquisition of any of the 18 Mexican banks in process of privatization. The initiative was well received by international banks, and the auction was held on July 3, 1992 with the participation of 32 lending banks and 67 bids recorded for a total of US$1170 million in interbank facilities. According to Angel Gurría, the universe of interbank obligations was reduced by about 31%, which corresponded to the most volatile and unstable part of such liabilities.[32]

[30] Buchheit, 'What Do We Do', 16.

[31] FRBNY archive, Box 111386, Mexico: Telex, June 4, 1991.

[32] José A. Gurría and Sergio Fadl, 'Mexico's Strategy for Reducing Financial Transfer Abroad', in Robert Grosse (Ed.), *Government Responses to the Latin American Debt Problem* (Miami, 1995), 121–58, esp. 146.

Excluded Debts

Along with the interbank placements of foreign banks in Mexican agencies, there were two other main categories of Mexican external indebtedness with private creditors that were not subject to the general rescheduling principles. These were short-term trade facilities, essentially letters of credits and banks acceptances, and tradable instruments, such as publicly issued bonds and floating rate certificates of deposits or notes. In 1983, as exhibited in Table 6.1, these three categories of so-called excluded debt accounted for as much as US$15 billion or 17% of Mexico's foreign obligations with private creditors. Loans made by official multilateral agencies, namely the World Bank, the IMF and the Inter-American Development Bank (IADB), which represented about US$4.4 billion as of end-1983, were also excluded from the rescheduling deals. On the other hand, the debt with official bilateral creditors, mainly developed countries' governments, represented US$3.4 billion and was renegotiated with the "Paris Club" following similar principles than other rescheduled credits.[33]

The outstanding feature of excluded debts was that, contrary to restructured debt, they never felt into arrears all through the crisis. "Even after 23 August 1982," as Angel Gurría emphasized, "Mexico's public sector entities continued to pay promptly the amortization and interest when due on facilities excluded from the restructuring agreement."[34] The decision to keep current on these obligations reflects, to some extent, a sense of determination to avoid the consequences that a restructuring or debt payment failure could otherwise generate. Within a rescheduling process, the main objective of any debtor government is debt relief, and to that end, it would seek to restructure as much debt as possible, though it may "forbear to do so in respect to a particular category," as Lee Buchheit explains, "if it is persuaded that the attempted restructuring of that category will result in a disproportionate injury or inconvenience to the debtor country's economy or longer-term financial interests."[35]

[33] On Mexico's rescheduling agreements, see José A. Gurría, 'Debt Restructuring: Mexico as a Case Study', in Stephany Griffith-Jones (Ed.), *Managing World Debt* (New York, 1988), 64–112.

[34] Ibid., 76.

[35] Lee C. Buchheit, 'Of Creditors, Preferred and Otherwise', *International Financial Law Review* X (1991), 12–13.

Table 6.1 Composition of Mexico external indebtedness in 1983 (US$ million)

Total external debt	*92,831*
Private creditors	**84,993**
Commercial Banks	75,174
Public sector	48,544
Private sector	26,630
Long-term	16,490
Publicly guaranteed	1690
Non-guaranteed	14,800
of which rescheduled under FICORCA	*12,000*
short-term	10,140
Trade-related debt	4164
Interbank deposits	5976
Publicly-issued bonds	4589
Others public sector creditors	5230
Official creditors	**7838**
Multilateral agencies	4432
Bilateral	3406

Source World Bank's World Debt Tables (several issues) and Gurría and Fadl, "Mexico's Strategy"

The position of Mexican policymakers with respect to trade finance provides an illustrative example of the rationale behind excluded debt. By the time of the crisis outbreak, the claims of creditor banks with Mexico did not only concern long-term sovereign loans, but there were also short-term financial instruments that had been used to finance international trade. From the very beginning of the negotiations with international creditors, the stance of Mexican officials was targeted at having foreign banks and official export agencies keeping trade credit lines open and avoid lack of import and export financing.[36] Indeed, at the August 20, 1982 meeting where the moratorium was announced, Angel Gurría communicated that trade-related debt was to be excluded from the rescheduling process. When asked about the reasons for excepting trade-related financing, Gurría argued that "that was the bloodline of trade relationship, and otherwise the structure of trade would become very difficult" since "trade-related financing was largely self-liquidating and self-renewing."[37]

[36] Sebastian Alvarez and Juan H. Flores, Alvarez, 'Trade Finance and Latin America's Lost Decade: The Forgotten Link', *Investigaciones de Historia Económica—Economic History Research* 10 (2014), 127–39, esp. 130.

[37] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office memorandum, August 23, 1982.

The worries about the potential negative consequences of the country's debt payment problems on international trade were very important among some Mexican policymakers. The words of Secretary of Finance Jesús Silva-Herzog, in persuading President Lopez Portillo not to declare a unilateral default at a time of strong domestic pressures and political issues against international creditors in Mexico, make clear the extent to which a disruption of trade was a source of preoccupation for Mexican officials: "Mexico import[ed] more than half of its corn consumption from the United States; if we had no money, as we didn't have, and if we had no credit, as we wouldn't had if we declared a [unilateral] moratorium, in two months the Mexican people would have run out of tortillas."[38] In the eyes of Silva-Herzog, a production shortage of *tortillas*, a thin round of unleavened cornmeal that is an essential part of the consumption habits in Mexico, "would have probably caused a social explosion of unimaginable magnitudes."[39]

A shortfall in the supply of corn or other consumption goods might have indeed entailed some problems in terms of social harmony, but the lack of production inputs risked inflicting more serious economic damage. By the time of the crisis, a substantial portion of the demand for raw materials and capital goods in Mexico was met through imports from creditor countries, and those imports were heavily dependent on the availability of foreign trade financing. In 1982, according to the Instituto Mexicano de Investigaciones Tecnólogicas (IMIT), the Mexican private manufacturing sector imported about US$1.5 billion in capital equipment and would need to import about US$1 billion for replacement and spares in 1983, an amount estimated to represent at least 35% of the sector's capital requirements.[40] Within such a production system, a cutback in financing for those imports represented a serious threat to industrial production capacity with potential broader negative domestic economic effects.

Although also excluded from the moratorium, the position of Mexican policymakers about outstanding capital market instruments was much less determined. According to Joseph Kraft, there were conflicting views with respect to the treatment of Mexican bonds issued by the government and public agencies, but it concerned only a group of

[38] Jesús Silva-Herzog, '1982: The President's Decision', documentary directed by Diego Delgado and Luciana Kaplan, 2008.

[39] Ibid.

[40] FRBNY archive, Box 111377, Mexico Trip—February 21–4, 1984: Internal report, June 13, 1983.

creditors.[41] While some European banks argued that these securities should be excluded from the restructuring agreement, their American counterparts were more favorable to fold them, and the Mexican government had no apparent clear preference on this matter. A salient feature of Mexico's outstanding bond debt was that it was not in the portfolio of the banks but in the hand of individual investors or bondholders, which were large in number and dispersed all over the world, thereby making coordination and restructuring more difficult than commercial bank debt. Preserving Mexico's credit standing in that market was also a way of keeping a gateway to foreign finance, which proved useful for the conversion of troubled loans into securities with the Brady Plan of 1989 and the ensuing return of the country to the international capital markets.

As for interbank debt, the position of the Mexican government was to secure the external situation of its banks and protect the access of their foreign agencies and branches to the wholesale funding lines. As the previous chapter has shown, Mexican policymaker had not only assisted their banks to cover their foreign financial needs after the outbreak of the crisis, but they were using foreign capital to do so and had explicitly asked creditor banks not to withdraw their interbank deposits. On the other hand, the financial authorities of creditor countries were also concerned about potential systemic liquidity problems and the IMF was worried with possible negative effects on the broader restructuring exercise. It was under such circumstances that the decision to warrant special treatment to interbank deposits and to exclude them from the generalized restructuring was conceived. As Angel Gurría explained in the early 1990s, it reflected "a consensus among the Mexican banks, the Mexican government, the central banks and monetary authorities in the principal money centers worldwide and the interbank creditors themselves as to the overriding importance to all concerned of safeguarding the integrity of the interbank markets."[42]

What would have happened if interbank debt had been listed along with other rescheduled debt is a contrafactual question that can only have speculative answers. For policymakers and financial authorities, the full effects on the international money markets and the attitudes of the banks participating in it were difficult to predict given the absence

[41] Joseph Kraft, *The Mexican Rescue* (New York, 1984), 43–44.

[42] FRBNY archive, Box 111386, Mexico: Telex, June 4, 1991.

of similar operations in the past. Perhaps an early fold-in could have also removed the urgency generated between lending banks and Mexico by the leakages of wholesale funding, and the interbank market might have resisted the shock and adapted to the new conditions after all. But what seems clear, as the Task Force of the Bank of England acknowledged in an internal report of early 1983, was that "no-one – banks, borrowing authorities, Fund or central banks – wanted to run the risk of paralysing this market." Indeed, to the Task Force, the immediate threat to the banking system continued so long as the "liquidity trap" remained loose, and the interbank area represented "an undetonated mine" even under the freezing agreement had been reached.[43]

Direct Exposure to Sovereign Debt

The situation of the money markets and interbank transactions represented a risk for banks and banking systems, but the most notorious source of vulnerability back then came from the direct exposure in Mexico. In fact, one of the defining and most salient features of the crisis, and perhaps its biggest challenge, was that major international commercial banks held significant amounts of Mexican and broader Latin American debt in their balance sheets. As of June 1982, commercial banks from the BIS reporting countries had outstanding loans in Latin America for about US$191.4 billion and Mexico, which accounted for US$62.4 billion or 32.6% of that amount, was the country where the concentration was the largest. The vulnerability steamed from the fact that these claims were large relative to the capital base of creditor banks, and therefore, a potential default or serious debt payment disruption by Mexico, as well as other large borrowing countries encountering sovereign debt problems such as Brazil or Argentina, could seriously undermine their solvency position.

In the case of the USA, the country with the largest participation in foreign bank lending to Latin America, Mexico was the place where the bulk of their claims were located. By the end of 1982, Mexican debt in the hands of US banks reached a total of US$24.3 billion, an amount

[43] Bank of England archive, Task Force, 13A1951/1: The International Financial Situation, February 3, 1983.

equivalent to a third of the capital base of the entire banking system. Although relatively large for the industry, the exposure of individual banks could be very different from the average level exhibited by this aggregate computation. Table 6.2 shows that debt exposure was significantly greater for the biggest, most systematically important institutions in US banking. According to data compiled by Salomon Brothers, outstanding loans to the Mexican public and private sector made from Citibank and Bank of America, the two largest US commercial banks, accounted for over half of their respective capital bases. In the case of Manufacturer Hanover and the Chemical Bank, which ranked in the top six of the US biggest banks, outstanding loans made up as much as two-thirds of their capital. When other developing countries coming into debt payment problems are considered, the exposure of these banks, and to a lesser extent of the US banking system, was significantly higher than capital levels.

The exposure of the banking system to Mexican debt was a major concern for US policymakers. Since the very beginning of the crisis, the US Federal Reserve and Treasury Department became forcefully engaged in providing emergency funding to Mexico and promoting international cooperation and medium-term financial assistance from the BIS and commercial banks to keep the country afloat.[44] According to US banking regulation, if interest payments came into arrears for longer than 90 days, banks had to classify the loans as non-performing and write down the value of their loan portfolio. Although the capital and reserve levels of most banks may have withstood the impact of the loan loss provision, the resulting reduction of banks' capital could lead to further curtail the size of their assets and affect the confidence of depositors. US banking supervisory authorities adopted, however, a lax attitude and declared that the cooperation of the banks in making new funds available to Mexico was not subject to regulatory criticism.[45] Similar policies were also endorsed by banking regulators in Japan, the country with the second highest exposure to Mexican debt after the USA, and in the UK where the exposure was the largest among European countries.[46]

[44] See United States General Accounting Office, Financial Crisis Management: Four Financial Crises in the 1980s, May 1997, Chapter 2, 19–34.

[45] This was announced by Paul Volcker in Boston on November 18, 1982. Kraft, *The Mexican rescue*, 44–6.

[46] Boughton, *Silent revolution*, 293–94.

Table 6.2 Exposure of the six largest Mexican and US banks to Mexico as of December 1982

	Values (US$ million)				*Ratios (%)*		
					Foreign loans to Mexico relative to		
	Foreign loans to Mexico	*Loan portfolio*	*Total assets*	*Total capital*	*Loan portfolio*	*Total assets*	*Total capital*
Mexican banks							
Banamex	1135	3178	7767	280	35.7	14.6	404.7
Bancomer	1200	3167	8006	260	37.9	15.0	462.3
Banca Serfin	428	1807	4351	114	23.7	9.8	375.0
Multibanco Comermex	624	1651	3074	52	37.8	20.3	1202.5
Banco Internacional	266	1475	2004	42	18.1	13.3	641.1
Banco Mexicano Somex	621	2399	3520	73	25.9	17.7	855.0
Total Mexican banks	*4275*	*13,676*	*28,723*	*820*	*31.3*	*14.9*	*521.1*
US banks							
Citicorp	2725	79,224	121,482	5495	3.4	2.2	49.6
Bank of America	2500	72,523	119,869	5247	3.4	2.1	47.6
Chase Manhattan	1687	52,057	77,230	3844	3.2	2.2	43.9
JP Morgan & Co	1082	30,376	56,766	3306	3.6	1.9	32.7
Manufacturers Hanover	1730	42,222	59,195	2945	4.1	2.9	58.7
Chemical Bank	1500	29,740	45,011	2413	5.0	3.3	62.2
Total US banks	*11,224*	*306,142*	*479,553*	*23,250*	*3.7*	*2.3*	*48.3*

Note Foreign loans to Mexico for Mexican banks are the loans granted from their foreign agencies and branches to Mexican borrowers
Source US banks: Salomon Brothers, A Review of Bank Performance, 1982; Mexican banks: CNBS Multibank Bulletin, FRBNY and Bank of England archives

While the risk of the Mexican debt crisis for US and other industrial countries' banks was apparent, the situation of their banking counterparts in Mexico was considerably more delicate. As a result of the involvement of the country's major banks in the Euromarkets and international lending, the Mexican domestic banking system had also become directly exposed to the debt crisis. Historical records of Banco de Mexico show that by the time of the crisis, the international network of Mexican banking offices had important amounts of troubled loans in their balance sheets. By the end of 1982, their international loan portfolio totaled US$4.68 billion, of which US$4.27 billion or 91.3% were direct or syndicated credits to the Mexican government or private sector, while the remaining US$210 million or 8.7% were claims with borrowers from

other countries, mainly in Latin America.[47] This level of total outstanding loans in the hands of the foreign agencies and branches of Mexican banks represented over four times the capital base of the domestic banking sector.

Table 6.2 exhibits the amount of Mexican external debt held by the foreign agencies and branches of the six domestic banks involved in foreign finance as of end-1982. Bancomer and Banamex were the largest creditors among Mexican banks with foreign outstanding claims in Mexico for US$1.2 and 1.13 billion, respectively, an amount not so different in absolute terms from the correspondent claims of large US creditor banks such as the Chemical Bank or Manufacturers Hanover. Evidence of their importance as holders of Mexican debt is the fact that the Advisory Group for Mexico, which, in the words of its co-chairman William Rhodes, "assembled representatives of 12 to 15 major banks (…) with membership based on the size of [the banks'] exposure and geographic representation," had one of them among its original members. Banamex, along with the Chemical Bank, Manufacturer Hanover and another 11 foreign creditor banks, was part of the Bank Advisory Group announced by Silva-Herzog at the FRBNY meeting of August 20, 1982, but it was removed after the bank nationalization.[48] As for Serfin, Comermex, Banco Internacional and Somex, they accounted together for the balance of US$1.9 billion or 45.3% of the foreign loans extended by the Mexican foreign agencies and branches to Mexico.

Although important in absolute terms, the amount of foreign loans to Mexico was relatively more significant when compared to the capital base of parent banks. As explained in previous chapters, Mexican overseas agencies and branches were not independently capitalized, but rather integrated in the balance sheet of their head offices in Mexico. In the case of Bancomer and Banamex, the ratio of foreign loans to Mexico to capital was 462.3 and 404.7%, respectively. For some of the four smaller Mexican banks involved in international lending, the relative exposure was even higher: 6.4 times the capital base for Banco Internacional and 8.5 and 12 times for Somex and Comermex, respectively. Banca Serfin

[47] Banco de Mexico archive, C3147Exp.4, Oficina de evaluación y control de la información bancaria, Crédito otorgado por agencias y sucursales de bancos mexicanos en el exterior.

[48] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office memorandum, August 23, 1982.

was the bank with the lower relative exposure, but even in this case, the foreign claims with Mexican borrowers represented several times its capital level. In fact, as can be observed in Table 6.2, the size of the exposure of the six major Mexican commercial banks to their own country's external debt was considerably much larger than that of their US counterparts.

Furthermore, Mexican banks' exposure to home country's external debt was high not only relative to capital, but also as a share of total bank loans. While, for instance, foreign loans to Mexico represented between 3.2 and 5% of the total foreign loan portfolio value of the six largest US creditor banks, the average for Mexican creditor banks was 31.3%—and 14.9% in terms of total bank assets. Banco Internacional was the Mexican bank where the concentration of loan exposure was the lowest with a ratio of 18.1%, while Bancomer and Comermex were on the other extreme with corresponding values of loan exposure of 37.9 and 37.8%, respectively. Additionally, the international loan portfolio itself was substantially less diversified: Lending to Mexican borrowers represented about 6.9% of the total foreign loan portfolio of all US banks at an aggregate level, but as much as 76% for Mexican banks.[49] It seems clear therefore that the external debt payment problems of the country posed substantial risks not only for US and other industrial creditor banks, but even more importantly for the Mexican banking sector as well.

These figures give a sense of the damage that a debt servicing failure by the Mexican government and private sector could inflict on the domestic banking system. If the country was to default and the government refused to agree to orderly rescheduling, then all banks with outstanding external loans in Mexico would have to make loan loss provisions. However, the potential losses represented a significant proportion of the loan portfolio of the country's biggest banks, and their capital and reserve levels were largely inadequate to withstand the impact of such loan loss provisions. Most of these foreign loans included cross-default clauses, meaning that if creditor banks declared a technical default on one of the borrower's obligations it would have automatically affected its other obligations. In other words, a failure by Mexico to service its external debt to any particular foreign creditor bank would have triggered a default on the international claims of Mexican banks as well.

[49] Based on data from FFIEC's Country Exposure Lending Survey for December 1982 and Banco de Mexico's Historical Financial Statistics.

In the particular case of syndicated loans, for instance, non-repayment had a direct impact on all lending banks that had taken part of the operation, including the Mexicans. This implied that a partial or selective default to exclude Mexican banks was virtually impossible and also that protecting the domestic banking system from the effects of default required the Mexican government to service all its foreign bank loans.

Mexico's International Negotiating Position

It should be clear by now that the Mexican banking system was not only in bad shape at the time of the moratorium declaration, but that the debt crisis put in serious jeopardy the financial position of its most prominent financial institutions. When the crisis hit, the country's six largest domestic banks displayed sizable amount of Mexican external debt relatively to both their capital base and loan portfolio, and they came to face serious liquidity strains in the operations of the network of foreign agencies and branches in the international interbank markets.

These findings imply that, along with the sovereign debt and balance of payment problems, Mexican policymakers had also to manage a banking system under serious threat of bankruptcy. Since the beginning of the crisis, as previously demonstrated, Mexican authorities looked very hard to protect the banking sector and made every effort to secure the external financial position of the banks operating abroad. To this end, it was necessary that they continued to service its outstanding external loans (of which Mexican banks were creditors) as well as meeting the interbank funding needs of the foreign agencies and branches, but the government and central bank were in lack of resources and had to rely on foreign creditors to raise the foreign exchange required to do that. In the middle of a severe economic and financial meltdown, securing the stability of the banking system was important because the collapse of the country's major banks would have exacerbated the domestic economic damages of the crisis and that was a price that Mexican policymakers could hardly afford to pay.

President Lopez Portillo's dramatic nationalization of commercial banks on September 1, 1982 can also be interpreted as a demonstration of support to the banking system. The expropriation of the banks meant the transfer of ownership to the state but also that, as the President of the Association of Mexican Bankers Carlos Abedrop Dávila acknowledged, the Federal government became responsible of "the high dollar

indebtedness of the private banks."[50] Hence, the measure was arguably beneficial for securing the much-needed interbank credit lines with the foreign agencies and branches because it was perceived by foreign creditor banks, in the words of the SHCP, "as a way to ensure that the external debt of the Mexican banking sector would be paid."[51] In a similar vein, American banking and finance journalist Robert A. Bennett wrote in his The New York Times column covering the news that "it [was] expected that, as a result of the nationalization, international banks [would] be willing to place funds with Mexican banks because such investments would become obligations of the Government and not of private individuals."[52]

The dependence on foreign capital to secure the stability of the banking system brought the Mexican government into a weak negotiating position when confronting its international creditors. The money required to service the country' external debt and, in particular, to maintain the interbank obligations was under the control of foreign creditor banks, and this gave them with leverage to enforce some of their claims during the negotiations. The issue of the arrears on the external debt payments of the Mexican private companies, which was a source of major concern for international creditor banks, provides an illustrative example. By the time of the moratorium declaration, some big Mexican companies, such as the Alfa Industrial Group, the main economic conglomerate and the largest private international debtor of the country, had entered into default some months ago and creditor banks were not receiving any payment on their loans. The reimbursement of private loans, of which only a small part was publicly guaranteed (see Table 6.2), was important not only because of the amount involved—about US$18 billion as of end-1982, but because it could trigger off financial problems relative to regulatory considerations and non-performing debt condition as previously discussed.

Archival evidence shows that international creditor banks brought to the fore the issue of Mexican private debt when discussing the interbank funding problems of the Mexican banks. In a conversation with Sam Cross in October 19, 1982, Larry Miller, the official from Chemical Bank responsible for handling the foreign agency situation for the Advisory Group for Mexico, referred to "the fact that the banks were not getting

[50] Comercio Exterior, Vol. 32, No. 11, 1186.

[51] Secretaria de Hacienda y Crédito Público (1988), *Deuda Externa Pública Mexicana* (Mexico City, 1988), 82.

[52] 'Takeover Pleases U.S. Banks', *The New York Times*, September 2, 1982.

any payment to speak of on private debts was tending to make them more aggressive in trying to draw money out of the agencies."[53] Along the same lines, in a meeting between the IMF and commercial banks held at the FRBNY on November 16, 1982, the chairman of Mexico's Advisory Group William Rhodes of Citibank stressed that "partly as result of the small banks' frustration over the private interest problem, the Mexican banks (all state owned) have lost about $500 million in deposits through the agencies."[54] It has been a while since the Advisory Group had approached Mexican negotiators on the matter of private sector debt and made suggestions about potential solutions, but they had received no feedback or response from Mexico up to that moment.

Afterward, the banks took a stronger position and made the solution of the private sector debt problem a necessary condition for addressing any requirement from them. In November 19, 1982, in a meeting with the Fund, creditor banks made clear that "the Mexicans had to deal with the private sector interest situation as a matter of urgency as it was of paramount importance to many banks and up to [that] time they had pushed the matter into the background."[55] In response to de Larosière demand of new credit lines as part of the restructuring program for Mexico, the banks stated that this "certainly could not be achieved unless the private sector aspect was dealt with very quickly by pressure from the Fund, as many banks – and not just the small ones – would not be prepared to consider fresh money if the Mexican could not even find a solution to the interest element on the private sector, which meant such a lot to them," underlying that this "was a prerequisite to any further help from the banking system."[56] William Rhodes had this asserted to US Fed authorities two days before, during which time Paul Volcker conceded that "it was essential to solve the private sector interest problem but he doubted this could happen until after December 1, for political reasons."[57]

[53] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office Memorandum, October 19, 1982.

[54] FRBNY archive, Central Records, Bank Advisory Group November–December 1982: Office Memorandum, November 18, 1982.

[55] Lloyds Bank archive F/1/BD/LAT/1 9249, Memorandum on Mexico, November 19, 1982.

[56] Ibid.

[57] Lloyds Bank archive F/1/BD/LAT/1 9249, Memorandum on Mexico, November 17, 1982. Mexico's new elected President Miguel de la Madrid was taking office on December 1, 1982.

The threat of refusing to provide financial assistance to Mexico as a way to enforce the repayment of private debt could risk backfiring on foreign creditor banks. First, there were acknowledged fears that a refusal to maintain interbank deposits and stop the leakage of funds from Mexican banks could provoke a disruption in the world money markets, with important negative repercussions on creditor banks and the international financial system. Second, in pressing too hard on rescheduling conditions, creditor banks pushed Mexico to consider refusing to restructure and repudiate its debts, which put in jeopardy their solvency position. It is however difficult to think that the Mexican government would proceed in this way when its domestic banks and banking system were more seriously exposed to, and compromised by, their own debt crisis than their foreign creditor counterparts. Not only was their capacity to withstand the impact of the potential losses on international loans weaker, but they were in considerably worse shape when it came to facing funding strains and a potential liquidity crisis in the international wholesale markets. In terms of bargaining, the gun was therefore in the hand of foreign creditor banks and the Mexican government had little option but to concede their demands.

In the end, as part of the rescheduling agreement of 1982–1983 the Mexican government established a subsidized scheme for the settlement of private external debt. FICORCA, from Spanish *Fideicomiso para la Cobertura de Riesgo Cambiario*—Trust Fund for Covering Exchange Risk, was a foreign exchange mechanism that assisted private enterprises with both the pesos and the dollars they needed to serve their rescheduled foreign debt with international commercial banks, while transferring the currency risk to the public sector. The program, which was set with respect to the foreign currency debt incurred prior to December 20, 1982, gave good results, and the overwhelming majority of outstanding bank debt, approximately US$12 billion, was repaid under this scheme, with a similar mechanism relaunched in 1984 for the external debt contracted after the initial deadline.[58] Yet the conditions demanded by international creditors and agreed to by the Mexican government went beyond the socialization of private external debt, including also onerous financial terms on rescheduled and new debt as well as harsh IMF-adjustment programs and austerity measures that brought the country into its worst development crisis since the Great Depression.

[58] For an explanation of the program and how it worked, see Gurría, 'Debt Restructuring', 79–83.

Conclusion

International banking and foreign lending are salient features of the development of the world capital markets during the decade that preceded the debt crisis of 1982. After the oil shock of 1973 and the onset of big trade surpluses of OPEC countries to the Eurodollar markets, international commercial banks began to relend these funds to the developing world, particularly to Latin America, spawning a boom of external indebtedness that ended up with the Mexican moratorium declaration in August 1982. Although largely dominated by institutions from industrial countries, leading state-owned and private commercial banks from Latin American countries themselves also went international during those years and they became heavily involved in the petrodollar recycling process and sovereign lending to government and private sector borrowers at home as well as from other debtor countries.

This book has focused on the international expansion of Mexican banks in connection with the sovereign debt crisis of 1982. Between 1972 and 1974, as Chapter 2 developed, the top commercial banks of the country took their first steps into the international capital markets through the creation of London-based consortium banks in partnership with banking institutions from other developed and developing countries. To more fully engage in international businesses, the next move was to open their own branches and agencies in London and the USA, the major world financial centers at that time. From their associated consortium banks and the network of foreign offices, the largest Mexican banks took on an important role in international lending and became

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inextricably intertwined with external debt payment problems of the public and private sectors in Mexico.

A major concern of this book is about the factors that drove Mexican bank internationalization and its implications on the financial condition of the banking system. As discussed in Chapter 3, domestic funding problems linked to high inflation and negative real interest rates, coupled with increasing competition from foreign bank loans, were at the base of the decision of the banks to go abroad. Foreign finance offered new funding sources for lending and to secure their market share from foreign banks. Allowing the banks to reach the international capital markets proved helpful in supporting financing for the Mexican government's state-led development strategy and the fixed exchange rate policy of the central bank. The Mexican government was directly involved in this process through the partial ownership of Intermex, the biggest Mexican consortium bank, by Nafinsa as well as Banco International and Banca Somex, two of the six commercial banks involved in international lending.

The financial position of the Mexican domestic banking sector, as Chapter 4 demonstrated, increasingly weakened during the buildup to the debt crisis. Mexico's six largest commercial banks, Bancomer, Banamex, Banca Serfin, Comermex, Mexicano Somex and Banco Internacional, were among the most affected. Overall, they displayed considerable worse than average capital adequacy levels and a more instable funding base than the rest of the domestic banks. These problems were, to a large extent, related to their growing involvement in the international financial system, and, more specifically, to the heightened reliance on foreign borrowing for funding. The more dependent they were on external funding, the larger the exposure to currency risk and the more susceptible the banks became to international financial fluctuations. Mexico's international banks were much more aggressive in financing their growth with debt instead of shareholder equity than domestic banks with no access to foreign finance, and they were consequently more leveraged by the time the crisis hit.

The second concern of this book is the mechanism employed by the banks to intermediate foreign liquidity with domestic borrowers. Mexican banks could not easily access foreign liquidity from their headquarters in Mexico, so they opened their own agencies and branches in major international financial centers to do so. These foreign banking offices were not strictly defined as banks: They were not independently

capitalized nor subject to reserve requirements, and, although they were not allowed to take retail deposits, they could raise funds from the large international wholesale markets. The business model, as Chapter 5 explained, consisted in borrowing in the US dollar and Eurocurrency interbank markets to relending these funds in Mexico. In the context of fixed exchange rates, foreign liquidity allowed the banks to access loanable money that was cheaper than domestic deposits and to offer credit lines to their clients at interest rates that were competitive to those of foreign banks.

Such a business model was fragile by design and further aggravated by risky asset–liability management decisions of the banks. The use of very short-term interbank borrowing to fund longer-term loans led to the accumulation of important maturity mismatches on the balance sheets. Additionally, while these interbank credit lines were set at floating rates, namely LIBOR or US prime, a significant part of the loans were arranged at predetermined fixed rates. The third problem was linked to currency risk and the cross-border nature of the activities they undertook. While banks' dollar liabilities were owed to foreign bank creditors, their dollar claims were mainly with Mexican clients, which ran their businesses largely in pesos and were not necessarily exporting firms. The increase of international interest rates in the early 1980s, the devaluation of the peso in early-1982 and the ensuing external debt payment problems of Mexican debtors aggravated the interest rate, currency and maturity imbalances accumulated by the banks, and thus compromised their external financial position.

Finally, the last concern of the book relates to the situation of the domestic banking system in the wake of the crisis and how this affected the negotiation position of the Mexican government during the debt rescheduling process. The large exposure of the most systematic important banks of the nation to their own country's debt crisis is a major and crucial finding of this study. On the one hand, as documented in Chapter 6, international loans with home country final borrowers extended several times over the capital base of the six largest banking institutions of the country. On the other hand, in the aftermath of the moratorium, these banks found increasingly difficult to raise funds in the international wholesale markets and confronted liquidity problems. Lending banks came to regard their Mexican counterparts with suspicion, perceived interbank operations riskier and thereby reduced their involvement with them. The debt crisis put the solvency of the banks at serious risk.

The weak condition of the domestic banking system constrained the renegotiation strategy of the Mexican government *vis-à-vis* its international creditors. After the outbreak of crisis, Mexican policymakers came to rely upon foreign capital to assist their banks and they went to great lengths to protect interbank funding. The heavy dependence on funding lines under the control of international creditors to secure the stability of the banking system translated into a weak bargaining position when entering debt renegotiations. Moreover, because the exposure of Mexican banks was much larger than that of their US and European counterparts, a default or unsuccessful rescheduling threatened to inflict more damage on Mexico than on foreign creditors themselves. This helps to understand why Mexico did not unilaterally suspend debt payments and subscribed to restructuring deals that make the country borne the burden of the adjustment of the crisis.

Toward a New Understanding of the Crisis

A main contribution of this book is that the Mexican crisis of 1982 did not only involved balance of payment and sovereign debt problems, but it also embraced the banking sector. As a growing literature has shown, because financial institutions and governments are interconnected in several ways, distress in one sector tends to generate difficulties in the other and Mexico in 1982 was no exception. Moreover, the debt crisis and the banking problems overlapped with major devaluations of the peso after years of stability, drawing also the currency exchange market into the financial turmoil. However, despite the actual coexistence of triple banking, currency and debt problems, explanations for the crisis have largely focused on government indebtedness and have not taken into account the situation of the domestic banking sector nor its connection with the currency crisis.

This raises a number of revisionist questions in light of the current literature on financial crises. What is the causality relationship between the debt crisis and problems in the domestic banking sector? Does the Mexican case follow the Diaz-Alejandro's account of the Chilean crisis, where the massive use of central bank credit to bail out the banks seems to have been the cause of the government's fiscal problems and the sovereign default in 1983?[1] Or was it the debt crisis that brought on the

[1] Carlos F. Diaz-Alejandro, 'Good-Bye Financial Repression, Hello Financial Crash', *Journal of Development Economics* 19 (1985), 1–24.

banking sector's troubles? Through what channels did the banking and public sector affect each other? How does the devaluation fit into the story? Was the currency crisis the cause of the banking sector's problems? Or did causality work the other way around, as, according to Kaminsky and Reinhart, is usually is the case?[2] Although addressing causality issues is beyond the purposes and scope of this study, it is possible to outline the anatomy of the Mexican financial meltdown of 1982 by considering the sequence of events as they developed within the crisis and the foregoing stylized facts.

The central argument of the book is that a fundamental reason for the fragility of the Mexican banking system is to be found in foreign finance. More specifically, the asset–liability mismanagement along with the accumulation of interest rate, currency and maturity mismatches on the balance sheets of the banks was a consequence of their involvement in international lending and foreign borrowing. These imbalances exposed the banks to external shocks and shifts in the international capital markets, as well as to foreign exchange and debt payment problems in Mexico, but they do not explain by themselves how distress built up in the banking sector. The simultaneous presence of currency and debt crises along with the financial problems encountered by the banks begs the question, however, of the link between them. The book makes clear that the devaluation of the peso and the debt payment difficulties in both the public and private sectors affected the liquidity and solvency position of the banks, but it speaks little about the flip side of these implications.

Since there were no banking failures in Mexico, it is difficult to analyze the causality links between banking and the currency crisis based only on the chronological order of events. The explanations that point to financial sector problems as the root of currency collapses usually stress the presence of central bank bailouts or government guarantees that ultimately account for the currency crash by excessive money creation, as in the Chilean case of 1982–1983.[3] However, despite isolated episodes of liquidity provision through special auctions in 1980, the Annual reports of Banco de Mexico and the balance sheets of commercial banks show no sign of atypical or considerable use of the discount window or

[2]Graciela L. Kaminsky and Carmen M. Reinhart, 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems', *American Economic Review* 89 (1999), 473–500.

[3]Diaz-Alejandro, 'Good-Bye Financial Repression'.

other financial facilities from the central bank. If anything, the bailout was arguably the nationalization of the banking system, but it took place six months after the currency crisis of February 1982. This does not mean, however, that the banks had no influence in the foreign exchange markets since they were intermediating important flows of capital in and out of the country, and thereby directly affecting the supply of and demand for dollars as well as the monetary base.

Whether at the origin of the currency crisis or not, the February 1982 devaluation directly impacted the balance sheets of the banking sector by increasing the weight of foreign liabilities. Between 1975 and late 1981, foreign dollar interbank debt went from 0.7% of the total liabilities of the Mexican commercial banks to 13%, and then to 20% after the fixed exchange rate regime collapsed. The banks, however, had sought to hedge the currency risk of their cross-border operations by lending in the same currency that they borrowed in abroad. Hence, to the extent that the devaluation increased the share of dollar claims in the same proportion as the foreign liabilities, there was no visible amplification of the currency mismatch on their balance sheets. The problem was that the dollar loan portfolio was largely concentrated in Mexican borrowers that operated in pesos and had no direct access to foreign currency. If the devaluation affected the banks, it would have been through the worsening of the balance sheets and the repayment capacity of their clients.

Indeed, as private Mexican firms were the first to suffer the consequences of the devaluation, banks bore the brunt of this repercussion. Two months after the devaluation, Grupo Industrial Alfa, Mexico's biggest private sector conglomerate and international borrower, informed its national and foreign creditor banks that it was suspending the payments of all debts. Difficulties in reimbursing credits to the banking sector were not limited to Alfa, but rather a generalized phenomenon among private sector borrowers. Banks involved in international finance as well as those operating at only a national level experienced an increase of loans arrears and a deterioration of asset quality beginning in February 1982. The fact that there were no differences between both groups of banks in this regard makes it difficult to establish a clear link between loans financed by borrowing in foreign currency and the financial position of the banks. Or to put it differently, the cross-border foreign exchange exposure of leading commercial banks and the currency crash was not the totality, let alone the most lethal source or immediate cause, of the real problems experienced by the banking sector.

The outbreak of the debt crisis in August 1982 appears to have been even more damaging than the devaluation and repayment problems of the private sector. Like major creditor commercial banks from the industrialized world, the six largest domestic banks also had Mexican debt on their books, but their level of exposure was much larger. Individual and syndicated loans to the Mexican government and private sector borrowers accounted for about a quarter of the loan portfolio and between four and five times their capital base. Faced with such exposure levels, the problem for the banks concerned the potential net losses of troubled loans and the possibility of a run by depositors and, consequently, failure. A default or unsuccessful restructuring of Mexican debt that could lead to a write-down of assets would have ultimately made the banks insolvent. Because the banks at issue accounted for as much as three quarters of the general public's deposits, the debt crisis represented a major threat for the entire banking and domestic financial system.

The impact of the debt crisis on the banks was not limited to the deterioration of the assets but, more importantly, to the effects on the liability side. The increasing reliance on short-term foreign interbank liquidity as source of funding had raised the exposure of the banks to liquidity strains that could developed in the international wholesale markets. The government moratorium declaration curtailed the supply of interbank credit lines to Mexican banks. The heavy exposure to its own government's debt raised concerns about bank solvency and made creditor banks unwilling to roll over maturing interbank deposits with them. But the Mexican banks were ill-prepared to manage the funding risk and overcome foreign liquidity strains: They had no alternative genuine source of dollars and no lender of last resort coverage. Further erosion and leaks of interbank funding were prevented at a high cost in financial terms and the commitment from international creditor banks, as part of debt rescheduling agreements with the Mexican government, to keep funding at the pre-moratorium.

The fact that the external debt payment problems of the Mexican government brought down the countries' major banks does not mean that the banks themselves were not at the origin of the debt crisis. Access to international wholesale liquidity provided them with a new source of loanable resources that was not subject to reserve requirements, thereby its effects in expanding the supply of credit was stronger than domestic funding. Thus, while it does not appear that banks involved with

international finance had necessarily made bad loan decisions—at least compared to domestic banks with no access to foreign liquidity, they contributed to the creation of the crisis by fueling the growth of public and private sectors external debt along with the other foreign banks participating in international lending to Mexico. Moreover, the Mexican international banks were an endogenous and unstable force in the world financial markets that simultaneously pushed the demand and supply of foreign capital upwards, thereby exacerbating the borrowing and lending boom that came to a definitive end in August 1982.

Arguably, Mexican banks would have succumbed to the same fate anyway. The business model underlying international banking activities was highly risky: It led to a worsening in maturity and interest rate mismatches, and a poor capital structure that weakened the liquidity and solvency position of the banks. Presumably, the most dangerous flaw was its vulnerability to shifts in the international money and interbank markets and the related exposure to funding shocks. A default by another large international borrowing country, such as Brazil or Argentina, or the occurrence of any event likely to distress the wholesale market would have triggered similar liquidity strains on Mexican banks. Despite their exposure to home borrowers, since they were highly reliant on interbank funding and had no dollar retail deposit base, Mexican banks were inherently risky. Had liquidity strains developed in the international interbank markets for reasons other than the moratorium declaration by the Mexican government, these banks would have still been among the first candidates to face a curtailed funding supply and confront liquidity problems.

A Novel Perspective on Bank Nationalization

Such weakness and exposure of the commercial banking system raises the question of the program of bank nationalization. On September 1, 1982, the Mexican government decided by presidential decree to expropriate the possessions of all private credit institutions. Ranging from physical installations to financial assets and shares or participations in other enterprises, all the properties of the private banks, with the exception of those of Banco Nacional Obrero and Citibank, were transferred to the Mexican public sector. The nationalization encompassed the banking sector's Mexican assets and included the transfer of ownership, control and administration of the overseas branches and agencies of Mexican commercial banks and, consequently, of their foreign assets and liabilities.

The official justification for Lopez Portillo's nationalization measure was the need to deal with the large amounts of capital draining out of the country. In the eyes of the president, a state-controlled banking system would enable the government to stop the outward flight of dollars that was being operated through the banking system. The concomitant establishment of formal capital controls with the introduction of a two-tiered exchange rate was also part of the policy package that Carlos Tello, new General Director of Banco de Mexico, considered necessary to control capital flight. From an internal political perspective, the decision was embedded in a context of rising tension and conflicts between bankers and policymakers that had been building up over the previous decades. The idea of a potential nationalization of the banking system has indeed been present in left-wing parties' proposals since at least the 1960s and attracted growing support from them in the late 1970s.[4]

The traditional interpretation of the nationalization of the Mexican banking sector is that it was an opportunistic decision taken for political and ideological reasons. In the context of a severe crisis, the Mexican president accused the country's banks of encouraging, and providing mechanisms for, capital flight. In doing so, he may have been purportedly seeking to shift some of the blame for the country's economic problems from his administration in order to salvage the political image and power of a weakened government. More generally, the measure has been seen as resulting from a long-standing confrontation between two different factions within the Mexican government, neoliberals and structuralist economists, over the national development strategy and the role of the financial system within it.[5] Under this perspective, the seizure of the banks is understood as aiming to strengthen the position of the public sector and punish the private sector while providing nationalist policymakers with the control of the banking system they believed necessary to pursue economic restructuring.

The overwhelming focus placed on the political motives for bank nationalization has drawn attention away from the situation of the institutions that were the target of the program. The book "La nacionalización bancaria, 25 años después, la historia contada por sus protagonistas" [*The bank nationalization, 25 years later, the story told*

[4]Carlos Tello, *La nacionalizacián de la banca en México* (Mexico City, 1984).

[5]Rolando Cordera and Carlos Tello, *México: la disputa por la nación, perspectivas y opciones del desarrollo* (Mexico City, 1971).

by its protagonists], edited by Amparo Espinosa Rugarcía and Enrique Cárdenas Sánchez and published by the Centro de Estudios Espinosa Yglesias in 2008, is probably the most comprehensive study available on the program and provides a representative example of the classical account of the Mexican bank nationalization. This work revisits the episode, based on oral histories, and compiles in three volumes the testimonies of the main participants, including successive Mexican presidents and senior government officials, bankers, judges, private entrepreneurs and analysts, with the purpose of providing new insights into the hindsight of history. Yet, as in other important studies on the subject such as the book edited by Gustavo del Angel, Carlos Bazdresch and Francisco Suárez Dávila, there is little reference to the condition of the Mexican banking system at the time of the nationalization.[6]

A number of Mexican officials and prominent banking scholars have pointed out, however, the potential importance of financial and economic factors for explaining the nationalization. Gustavo del Angel himself, for instance, notes that "the expropriation was a controversial political move, but perhaps a mechanism to bail out a banking system on the edge of collapse."[7] Along the same lines, Carlos Marichal adduces that "possibly, the [nationalization] was unavoidable because after the devaluation [of 1982] many Mexican public and private banks had to be rescued."[8] Likewise, Angel Gurría, the leading Mexican external debt negotiator, while acknowledging that the process could have been managed differently and that the decision might have been taken for the wrong reasons, contends that the nationalization was a way of solving the financial difficulties of banks that would otherwise have had to declare themselves insolvent.[9] Certainly the weak liquidity and solvency position of leading domestic banks in the wake of the moratorium

[6]Gustavo del Angel, Carlos Bazdresch Parada, and Francisco Suárez Dávila (Eds.), *Cuando el estado se hizo banquero: consecuencias de la nacionalización bancaria en México* (Mexico City, 2005).

[7]Gustavo del Angel, 'Paradoxes of Financial Development: The Construction of the Mexican Banking System, 1941–1982', Unpublished PhD diss. (Stanford University, 2002), 229.

[8]Carlos Marichal, 'Crisis de deudas soberanas en México: empresas estatales, bancos y relaciones internacionales, 1970–1990', *Historia y Política* 26 (2011), 111–33, 124.

[9]Interview held on July 9, 2013.

constituted a veritable banking crisis as this book has demonstrated, and this provides strong support to these suggestions.

At an international level, the Mexican bank nationalization does not appear as an exceptional event but part of a trend of similar measures undertaken in other Latin American countries with troubled banking sectors. In Argentina, for instance, more than 70 institutions, which accounted for 16 and 35% of commercial bank's and financial companies' assets respectively, were liquidated or subject to intervention between 1980 and 1982.[10] In the case of Chile, its systemic banking crisis of 1981 led to a series of major interventions by the government and persuaded the central bank to inject massive amounts of capital into the banking system to avoid its collapse, thus constituting a de facto nationalization.[11] In Peru, a systemic banking crisis broke out in 1983 and in 1987 President Alan Garcia nationalized the banking system as a mean of preventing capital flight and financial speculation that adversely affected the balance of payments. Prior to these cases, there was the nationalization of much of the privately owned French banking sector by Mitterrand, which appears to have played an important role as inspiration for the decisions taken by Latin American governments.[12]

The position of the international financial community with respect to the nationalization was also more ambiguous that it might initially appear. Notwithstanding the fact that the measure conflicted with their commitment to private ownership, international creditor banks did not object to the Mexican government's decision to assume ownership of the banking sector. In line with the previous discussion, "some foreign bankers," as Euromoney reported, "[saw] the uncertain state of Mexican banks as one possible motive for nationalization, since they reason[ed] that the government would have had to prop up the shakier ones sooner or later."[13] Some US bankers applauded indeed the decision as necessary to bolster international confidence in the Mexican private banks, perceiving it, in the words of the spokesman for the Bank

[10]Luc Laeven and Fabian V. Valencia, 'Systemic Banking Crises: A New Database', IMF Working Paper 08/224 (2008), 32.

[11]José P. Arellano, 'El financiamiento del desarrollo', in CIEPLAN (Ed.), *Reconstrucción económica para la democracia* (Santiago de Chile, 1983), 188–236.

[12]Sylvia Maxfield, 'The International Political Economy of Bank Nationalization: Mexico in Comparative Perspective', *Latin American Research Review* 27 (1992), 75–103.

[13]"Portillo Pockets the Banks," *Euromoney*, October 1982, p. 51.

of America, as "a positive step in that it puts the Mexican Government clearly behind its banking system."[14] Whether the Mexican state would stand behind the debts of the private banks was a major concern for international creditor banks, which were refusing to roll over interbank deposits or to lend them money, raising the prospects of failure.

From a debt management perspective, the nationalization aligned with the broader strategy adopted by Mexican government to handle the external liabilities of the Mexican private sector. In addition to the US$6 billion of nationalized interbank debt, the SHCP estimated that the Mexican private sector's external indebtedness reached US$24 billion up to December 1982. Of the outstanding amount, approximately US$4 billion were credits from foreign suppliers and the remaining US$20 billion was owed by more than 1200 private enterprises to international commercial banks, most of which had no official guarantee.[15] However, through the subsidizing foreign exchange program FICORCA, the government and Banco de Mexico assisted the private enterprises with both the pesos and the dollars needed to serve their rescheduled foreign debt. As for the US$2000 million debt with foreign suppliers without official guarantee, the central bank created a mechanism by which the firm deposited their payment in pesos and paid off as foreign exchange were available. As in the case of the banks, these policies meant the takeover of private external debt by the public sector.

The discussion above makes clear the need for further work to revisit the nationalization program. The existence of underlying financial problems in the banking sector at the time of its expropriation, although suggestive, does not represent sufficiently solid evidence to constitute a new political economy interpretation of the measure. The fact that the nationalization affected the banking sector as a whole regardless of the situation of the individual banks suggests that there are other factors than financial considerations behind the decision. Economic and political reasons are unlikely mutually exclusive explanations, but more plausibly complementary ones and they should both be factored in the accounts of the program. What economic groups or sectors would have been the most severely affected by the failure of major commercial banks? Whose interests were protected and whose interests were sacrificed with the measure? These are still open questions that need to be addressed

[14]"Takeover Pleases U.S. Banks," *The New YorkTimes*, September 2, 1982.

[15]José A. Gurría, *La política de la deuda externa* (México City, 1993), 50.

to understand the rationale behind the dramatic nationalization of the Mexican banking system.

On the Reasons of Debt Repayment and Renegotiation

This study of the Mexican financial fallout of 1982 also provides insights into understanding the motives behind the repayment decisions of debtor countries and the outcome of sovereign debt negotiations. A salient feature of the debt crisis of the 1980s was that it did not bring about a unilateral suspension or repudiation of foreign debt, but rather an orderly restructuring with no major interruption in the service of outstanding bank loans. Indeed, "the continued servicing of the public external debt, even with delays and arrears, and the provision of extraordinary facilities for the servicing of private external debt," as Diaz-Alejandro put it, was "perhaps one of the most important decision adopted by Latin American countries since mid-1982."[16] Unlike in past episodes of sovereign debt crises, such as in the Great Depression of the 1930s or the wave of defaults of the early and late nineteenth century, during the 1980s Latin American governments made strong efforts to respect and renegotiate their external debts at a time when the region confronted a major development crisis—the well-known "lost decade," which raises the question of why they did not suspend payments.

In explaining the conforming behavior of Latin America to repayment and rescheduling deals in the 1980s, scholars have focused on factors such as the collective power of creditors and the policy setting of governments in debtor countries. Jeffrey Sachs, for instance, has argued that a main difference between the experiences of the 1930s and the 1980s is that, while during the Great Depression there was no "hegemonic" power acting as lender of last resort and enforcer of international contractual obligations, the USA assumed that responsibility in the 1980s and exerted strong pressure to force debtor countries repayment as to secure the stability of the international financial system.[17] In a similar

[16]Carlos F. Diaz-Alejandro, 'Latin American Debt: I Don't Think We Are in Kansas Anymore', *Brookings Papers on Economic Activity* 15 (1984), 335–403, 356.

[17]See Jeffrey D. Sachs, 'Managing the LDC Debt Crisis', *Brookings Papers on Economic Activity* 1986 (1986), 397–440 and 'The Debt Overhang of Developing Countries', in Guillermo A. Calvo, Ronald Findlay, Pentti Kouri, and Jorge Braga de Macedo (Eds.), *Debt, Stabilization and Development: Essays in the Memory of Carlos Díaz-Alejandro* (Oxford, 1989), 80–102.

vein, Carlos Marichal has also emphasized the intervening role of the USA and its powerful alliance with the IMF and international private banks in guaranteeing continued debt service payment during the crisis of the 1980s.[18] Other scholars, such as Sue Branford and Bernardo Kucinski, have looked at causes on the Latin American side, pointing to the connections between domestic socioeconomic and political elites and the international financial establishment, and the existence of a common policy approach based on a commitment to the respect of the market economy and international contracts.[19]

This book offers a different interpretation and argues that in the case of Mexico, a main reason why the government repaid its external debts was to protect its domestic banking system. By the time of the moratorium declaration, the nation's most important banks displayed sizable amounts of Mexican external debt in their balance sheets and a unilateral default or outright repudiation would have inflicted major damages to the banking system. If the country failed to repay its external bank obligations and the government refused to agree to orderly rescheduling, then the banks would have to make loss provisions and their capital and reserve levels seemed largely insufficient to withstand the impact of the potential losses. Because most loans were syndicated or included cross-default clauses, a technical default declared by one creditor bank would have triggered Mexico's default among their other obligations, thereby a partial or selective default that excluded the domestic banks was not a feasible option. The collapse of the country's major financial institutions and the possibility of a systemic banking meltdown that threatened with business ruin and the amplification of the ongoing economic crisis was a price that Mexican policymakers were not willing to pay.

Yet Mexico did not only repay its external bank obligations, but it also subscribed to a debt management strategy that sunk the country into a development crisis of historical proportions. Between 1982 and 1989, Mexico went through four debt restructuring agreements and hard austerity adjustment programs which deepened the recessionary effects of the crisis. By 1986, Mexico had already transferred a large amount of

[18]Carlos Marichal, 'The Finances of Hegemony in Latin America: Debt Negotiations and the Role of the U.S. Government, 1945–2005', in Fred Rosen (Ed.), *Empire and Dissent: The United States and Latin America* (Durham, 2008), 90–115.

[19]Sue Branford and Bernardo Kucinski, *The Debt Squads: The US, the Banks and Latin America* (London, 1988).

resources to creditor countries, but the weight of both debt and service payments on GDP and exports continued to rise while the economy remained depressed. By the end of the decade, Mexico's GDP per capita was still below than at the outbreak of the crisis, and unemployment, along with other economic indicators, had worsened considerably with important social costs.[20] As for Mexico's creditor banks, despite their great exposure to the country and other highly indebted economies, no major failures or collapses occurred. Indeed, interest receipts exceeded new lending, banks remained profitable, and suffered no reduction in the value of their loan portfolio until very late in the decade. As Robert Devlin and others have argued, the protracted debt management process was instrumental in helping the banks from industrial countries bolster their loan-loss reserves and build their equity bases through nearly seven years of healthy profits.[21]

Why did Mexican policymakers accept to subscribe to burdensome rescheduling agreements, when they proved to be so unsuccessful and costly for the domestic economy? In a context in which there were serious fears in the international financial community and the stability of the world's biggest banks and the banking and financial system of industrial countries depended on repayments from Mexico and other borrower countries, one could have expected the Mexican government to have some leverage to drive negotiation outcomes in its favor and impose a greater part of the cost of the adjustment of the crisis on creditors. It is difficult, however, to think that Mexican policymakers could push creditors into concessions when the exposure of its own banks was larger than that of its foreign counterparts and, more importantly, when the financial stability of the domestic banking system depended so crucially on funding lines under the control of those same international creditors. To obtain the foreign exchange required to reimburse its external debt and secure interbank funding lines with Mexican banks, the government had little option but to accept the conditions demanded of it.

Some of the same dynamics and forces seem to have been at work during the recent eurozone crisis. As in Mexico and Latin America in the 1980s, the strategy adopted by European authorities and the IMF

[20]Robert Devlin and Ricardo Ffrench-Davis, 'The Great Latin America Debt Crisis: A Decade of Asymmetric Adjustment', *Revista de Economía Política* 15 (1995), 117–42.

[21]Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton, 1989).

to deal with the sovereign debt problems of the countries in the region has been based on the provision of new lending and restructuring conditioned on austerity programs with deep recessionary effects on domestic economies. Nevertheless, following several negotiating rounds and restructuring agreements, the economic and debt difficulties of Southern European nations, particularly Greece but also Italy, Ireland, Portugal and Spain, have not subsided after nearly a decade since the first crisis started. Although the reasons why these countries subject themselves to harmful rescheduling conditions are still a matter of discussion, Martin Sandbu has argued that the chokehold by which international creditors made some countries accept their demands was indeed on the domestic banking system.[22] He claims that the European central bank succeeded on a threat of cutting financial assistance to domestic banks when Greek and Irish authorities refused to agree to rescheduling conditions, and that the dependence on such financing to secure the stability of a weak domestic banking system was a main factor underlying the decision to comply with creditors' rescheduling rules.

A similar argument is raised in Jerome Roos' recent book *Why Not Default? The Political Economy of Sovereign Debt*. As a number of scholars have observed, unlike past periods of major crisis where sovereign defaults were widespread and appeared largely unavoidable—v.gr. the Great Depression of the 1930s, the declaration of such unilateral moratoriums by debtor countries has become exceedingly rare in the postwar years, even in times of acute fiscal distress as during the Latin American debt crisis of the 1980s or the recent European crisis.[23] Roos claims that the enforcement mechanism of debtor compliance is to be found within the architecture of modern global finance, arguing that "what has driven the generalized trend away from unilateral default" is "the capacity [of private and official lenders] to withhold short-term credit lines on which economic actors in the borrowing countries—states, firms and households alike—depend for their reproduction."[24] He warns that, in

[22]Martin Sandbu, *Europe's Orphan: The Future of the Euro and the Politics of Debt* (Princeton, 2015), esp. 76–79.

[23]See Christian Suter and Hanspeter Stamm, 'Coping with Global Debt Crises Debt Settlements, 1820 to 1986', *Comparative Studies in Society and History* 34 (1992), 645–78.

[24]Jerome Roos, *Why Not Default? The Political Economy of Sovereign Debt* (Princeton, 2019), 4, 10.

a context of growing reliance on foreign credit, the possibility to pursue a unilateral suspension of payments, which has featured prominently in the policy toolkit available to heavily indebted countries during times of crisis in history, seems no longer to be an option seriously considered by debtor governments.

The dependence upon foreign capital to secure the stability of the domestic economy, particularly the financial system, is crucial to understanding why debtor countries may end up bearing the bulk of the adjustment of the crises. Debt renegotiations are, after all, a bargaining game between debtors who seek forbearance and creditors who want full value for their claims, and the outcome of this process reflects how the parts distribute among them the costs of the bad loans. To the extent that creditors manage to impose rescheduling conditions that allow for escaping losses and consequent devaluation of the assets, they obtain rents that could be captured by debtors if their bargaining power was greater. In this regard, the fact that the debtor economies prove vulnerable to the lack of foreign credit under the direct control of its international creditors brings their governments into a structurally weak negotiation position. With the money in their hands, creditors have the leverage to drive rescheduling conditions in their favor and set the debt management strategy that they find the most appropriate or convenient. As for debtor countries, in the absence of any other funding alternative on which to draw, there is meager ground for dissenting and they may have no option but to concede the demands of their most powerful counterparts.

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