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.

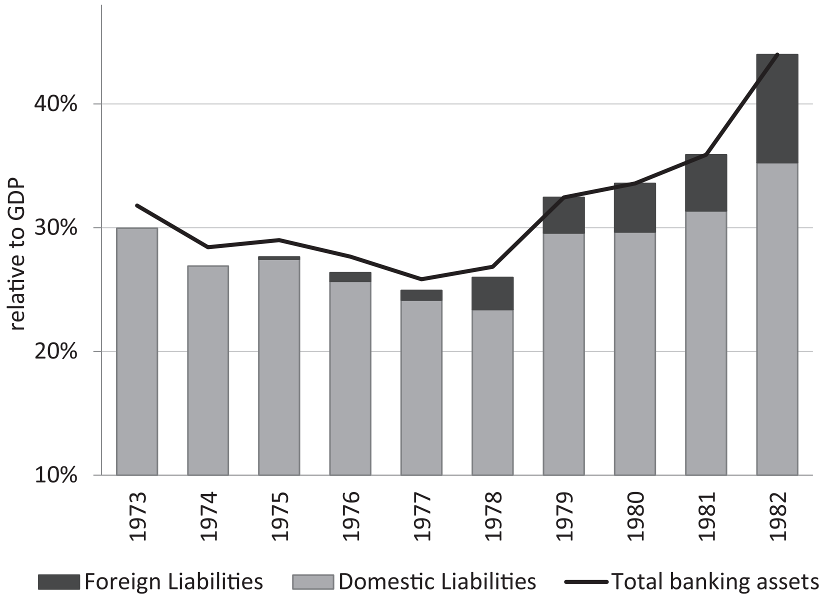

Fig. 3.1 Domestic and foreign funding in Mexican banking, 1973–1982 (*Source* Banco de Mexico's Annual Reports [several issues])

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.

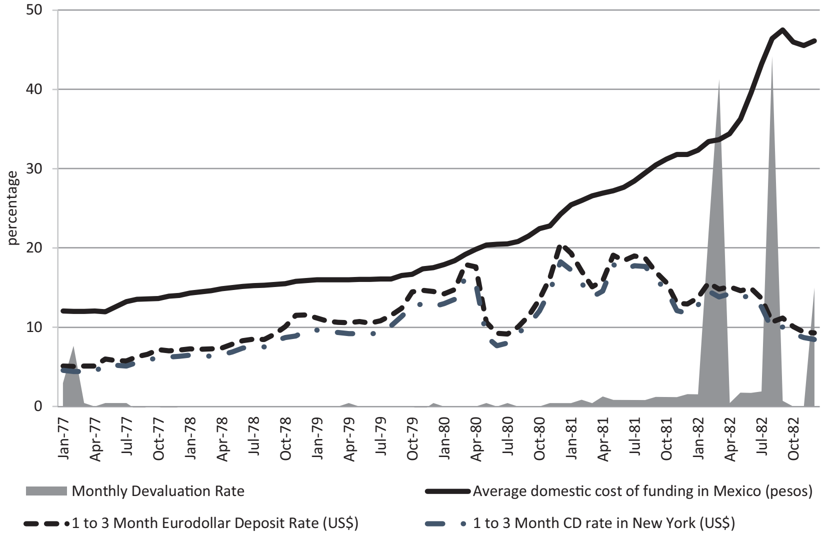

Fig. 3.2 Domestic and international cost of borrowing for Mexican banks, 1977–1982 (*Source* Banco de Mexico, Series Financieras Históricas)

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.

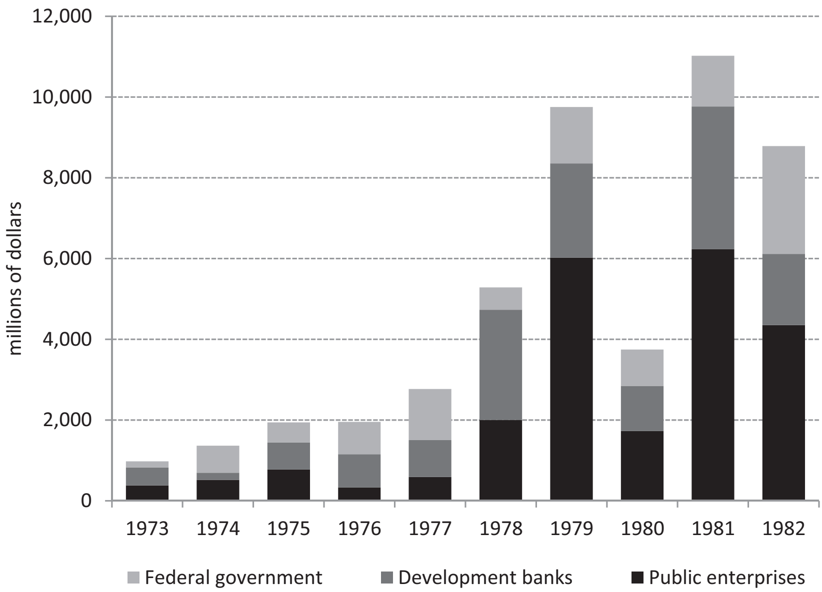

Fig. 3.3 Eurocurrency syndicated borrowing by the Mexican public sector, 1973–1982 (*Source* Negrete Cárdenas, "Mexican Debt Crises," Table B14, 361–86)

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

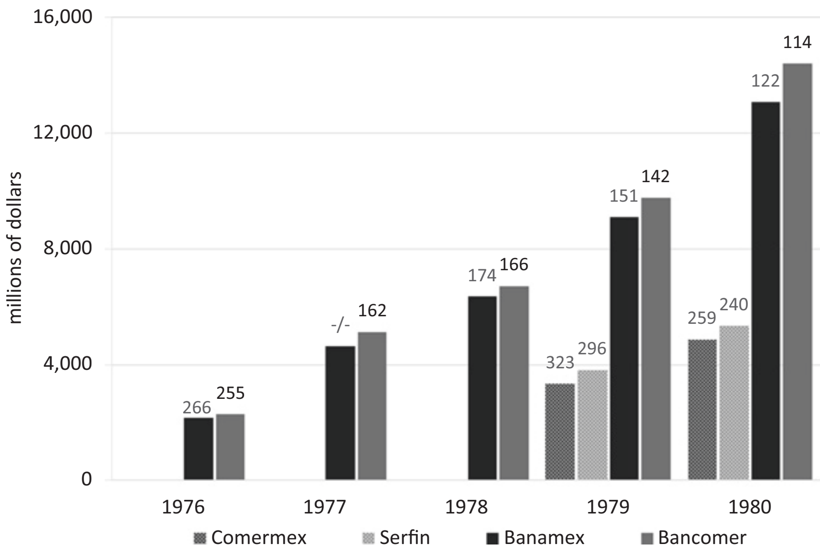

Fig. 3.4 Assets and ranking position of Mexican banks at an international level (*Note* Bars indicate the volume of total assets and the number on top of the bar is the corresponding position in The Banker's ranking of the world's biggest banks. *Source* The Banker magazine [several issues])

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.

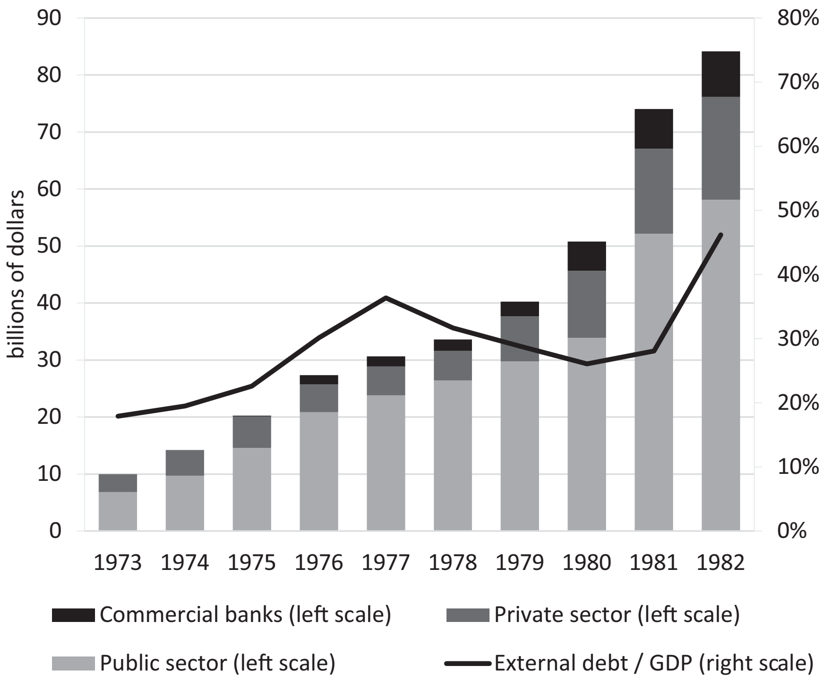

Fig. 3.5 Evolution of Mexico's external indebtedness by borrower, 1973–1982 (*Source* Solís y Zedillo, "The Foreign Debt of Mexico," 260)

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.