THE GLOBAL STRUCTURE OF FINANCIAL MARKETS

An overview

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LIBERALIZATION AND DEREGULATION OF THE MEXICAN STOCK MARKET

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INTRODUCTION

"Financial repression" has usually been the dominant characteristic of financial systems from the developing countries. Its high cost was magnified by the debt crisis of the 1980s, and its inadequacy to promote economic development became more evident with increasing world patterns of financial globalization. As a result, to overcome their low savings and investments rates, lower their high dependency on foreign loans, foster a solid link with international markets to attract international flows, and above all to promote higher rates of economic growth, developing countries have enforced important financial liberalization and deregulation processes, which have transformed their financial systems significantly. Although high benefits are expected, the timing and sequencing of financial liberalization and deregulation have been open to debate. Controversy also exists in relation to the conditions that must first be met to implement financial liberalization, and on the degree of participation that securities markets should play in an economy.

Moreover, several financial liberalization processes from developing countries have failed, leading to costly state rescue plans of troubled financial institutions. For this reason it is necessary to identify the nature of financial liberalization and deregulation processes that have been taking place recently in the developing countries.

This chapter is a contribution in this direction. It analyzes the processes of financial liberalization enforced in Mexico during the 1988-94 period. Mexico is an excellent showcase from which many lessons can be drawn for other developing nations, not only because of profound financial liberalization and deregulation policies undertaken during that period but also because it is now undergoing a severe crisis which has often, been associated with financial Liberalization and deregulation.

The chapter is organized as follows. The section following this introduction briefly reviews the importance of financial liberalization to economic development in a globalized economy. Next, the goals of Mexico's financial liberalization and deregulation, as well as the reforms Induced by them in the financial sector during the 1988-94 period, are examined. The institutional and legal changes in the financial sector are then described and analyzed in detail, emphasizing changes promoted in the securities markets. The section which follows analyzes the performance of the securities markets, attempting to determine whether or not financial liberalization and financial deregulation can be associated with the peso crisis that has affected Mexico since December 1994. A short conclusion follows, stressing the macroeconomic conditions necessary to enforce financial liberalization and deregulation policies successfully.

FINANCIAL LIBERALIZATION AND ECONOMIC DEVELOPMENT

The link between financial development and economic development has long been established. Indeed, due to its importance, the financial sector has been identified as the superstructure of a nation's production and real assets, the infrastructure of the economy (Ortiz, 1993), However, in the developing nations over-regulation and the excessive intervention of the state in the economy, known as "financial repression (FR)," have limited the contribution of the financial sector to economic growth. Financial repression has included, among other things, ceilings on savings and lending interest rates, quotes for preferential loans to "priority sectors," excess supervision and regulation of financial markets and institutions, and excess participation of the state on financial intermediation activities through the ownership of commercial banks, developing banks and other financial institutions (McKinnon, 1973).

Financial repression has eventually led to the existence of relatively underdeveloped financial markets and institutions, incapable of promoting adequate levels of savings and investments. Furthermore, it has led to higher costs of credits, inflationary government financing, limited financial Innovation, excessive government borrowing - particularly from foreign sources - and an inefficient allocation of resources in the economy. As a result, economic growth has been low and the economy of financially repressed countries has been characterized by regional segmentation and inequities, and sharp income distribution differences (Araya Gomez, 1994).

However, as Edwards and Patrick (1992) correctly point out, we are on the threshold of a new age of global financial markets. A strong market- driven dynamic of international integration of banking, securities, and derivatives markets is bringing about a profound transformation in the structure of local and international financial institutions and markets. Taking into account prevailing Lrends in world trade and investments, the new era seems to be destined to bring about many opportunities to support business activity. These opportunities will not be available to nations who favor protectionism. Thus, to promote their own savings and investments processes and a more dynamic and efficient international mobilization of international financial flows to finance their economic growth, developing countries need to liberalize and deregulate their financial markets and built up stronger and more efficient financial institutions.[1] Financial repression must be replaced by fully liberalized financial systems.

One important reform that must be taken is the promotion of the securities markets. Particularly, stock markets need to be fostered because they constitute the last stage in financial development, and in today's global economy they might constitute the additional force needed for a take-off into development (Ortiz, 1995). Traditionally, securities markets in the developing nations have remained thin and unimportant, and many developing countries do not even have that sort of market. Besides low economic activity, one important reason for the absence of securities markets in the developing countries has been the high intervention of the state in financial intermediation. Particularly, following World War II, state developing banks burgeoned beyond real needs and became highly bureaucratic and inefficient. This, along with interest rate ceilings, inflationary government financing through reserve requirements to the banking sector, and fixed quotas of loans to "priority" sectors, discouraged savings formation and an efficient allocation of financial resources through market mechanisms. Moreover, because firms enjoyed protected markets they limited their growth to the local market and did not seek significant external financing. Hence they offered small amounts of shares to be traded at the markets. Corporate property and management remained a family affair (Fischer, *et al.*, 1994).

Financial liberalization and deregulation (henceforth FLD) is therefore a challenge that must be undertaken by the developing nations to secure for themselves higher rates of growth and a smooth integration with the international financial markets. But FLD *per se* does not guarantee economic success. Its difficulties and successes can be best illustrated with the Mexican case.

FINANCIAL LIBERALIZATION AND DEREGULATION IN MEXICO
Challenges and strategies

During the last few years, Mexico's financial system has undergone profound transformations, many of these resulting from daring financial liberalization and deregulation policies aimed at adapting it to the emerging patterns of world trade, finance and investments. Reforms to Mexico's financial sector are not new. Indeed, they started as early as the 1970s in an effort to overcome the shortcomings of the model of '"stabilizing development[3]' applied since the 1950s. Failures in this inward-oriented model of growth led to fiscal laxness, which made it imperative to make the financial system more flexible in order to prevent capital flight and to avoid the need for inflationary financing.

Recently, Mexico's financial reforms have been aimed mainly at responding to the challenges and opportunities of financial globalization, both from the standpoint of short and medium term macroeconomic stability and the long run promotion mobilization of local and international savings to the local economy. The underlying forces behind these goals have been the deregulation of local markets, financial opening, promotion of financial innovations, and privatization of the banking system, nationalized in 1982.

An important part of this strategy was establishing adequate macroeconomic conditions for financial liberalization, so that no adverse results could take place as a result of its implementation. These conditions can be summed up in stability, re. emphasis on inflation control and discipline in public finance, and the development of efficient financial institutions through deregulation. Reforms have also sought to strengthen public financing in a search for non-inflationary sources. In this respect the emerging financial institutions were considered as pillars of economic stability, with the mobilization of local savings and international resources to local public and state enterprises and government agencies.

Three components of the financial liberalization carried out in Mexico are: (1) a new orientation in the role of financial institutions; (2) emphasis on savings formation; and (3) emphasis on investment and on the efficient allocation of resources. Mexican monetary authorities were convinced that changes in the financial sector could affect both the levels of financial intermediation and the overall volume of savings, which would further investment and growth (Aspe, 1993: 72). That is why savings have become the key variable to determine monetary policy. Indeed, in the aftermath of the debt crisis, the main challenge for the Mexican authorities was increasing local savings levels.[2] Consistent with the attainment of this goal were the pursuit of fiscal discipline; the promotion of innovative mechanisms to increase forced savings, among which must be mentioned Sistema de Ahorro para el Retiro (SAR: a retirement savings system),[3] and new regulations concerning financial intermediation supervision-Multiple diagnoses affirm that Mexico's challenge to its immediate future is increasing local savings, for their low level is also leading to low rates of investment. Indeed, compared with the successful economies from South-East Asia, Mexico's savings and investments are relatively low in relation to its GDP. In the Asian countries these variables account for 30 percent of GDP; in Mexico only for 16 percent (Mansell Carstens, 1995).

To understand the nature of the changes needed, it is important to identify four factors that have influenced the behavior of savings in modern Mexico:

1 Voluntary savings were not substituted with new forms of non- inflationary forced savings; the bulk of the population had no access to any mechanism to save for retirement or for the protection against risk.[4]

2 Financial innovations have promoted voluntary savings; but due to the lack of hedging instruments against inflation and exchange rate risks, people have preferred to purchase real estate and durable goods.

3 Income inequities have prevented growth in savings. Furthermore, it is worth mentioning that contrary to the Kaldorian view, increasing the participation of labor in national income has led to increases in voluntary savings.

4 Negative interest rates have diminished the levels of voluntary savings.[5]

In order to overcome the shortcomings inhibiting savings and investments, Mexican authorities have implemented a complex set of financial reforms since 1988. Furthermore, besides overcoming those restrictions to savings and investments, deregulation and liberalization have aimed at modernizing domestic financial intermediaries to make them internationally competitive, capable of pooling resources at international markets, and to channel them efficiently to the local economy.

Financial reforms have been focused on the financial opening and deregulation of financial markets; financial innovation; the strengthening of financial intermediaries; privatization of the commercial banking sector; and financing government déficit without recurring compulsory reserve requirements, but thorough non-inflationary instruments. Privatization and strengthening market activity had high priority because *de facto* nationalization of credit was identified as the main reason for a loss of capacity in the banking sector for credit analysis and its efficient allocation. Similarly, over-regulation was reducing flexibility to financial institutions and leading to the creation of innumerable subsidies which made credits more expensive (Aspe, 1994; 1044).

Financial liberalization and deregulation policies

Post-World War If quantitative controls

Following World War II, Mexico's financial system was characterized by financial repression. During the period between the early 1950s and the early 1980s quantitative measures prevailed to regulate and control financial intermediaries. Among these measures must be mentioned the imposition of reserve requirements, selective credit quotas, borrowing at interest rates predetermined by Banco de Mexico. Nevertheless, departure from this rigid system began in 1976 with the creation of multiservices banking *(banco, multiple)*. Further, in 1978 Certificates of the Treasury (CETES) were created. This marked the beginning of the development of a domestic money market. Originally, yields for CETES were fixed by the authorities; by the fast quarter of 1982 auctions became formalized and participants could bid for both yield and amounts (Aspc, 1993; 74). During that period an effort was also made to enhance the role of the securities markets.

Responses to the debt crisis

However, financial liberalization really started as a response to the debt crisis in the early 1980s. Mexico underwent a drastic adjustment process. The banking system was nationalized at the beginning of the debt crisis, but authorities restructured its oversized and inefficient structure, merging some banks and liquidating the smallest and least efficient ones. The goals were to promote economies of scale and eliminate inefficiencies. Similarly, investment banks and brokerage houses, which were part of the nationalized banks, were soon returned to their owners. These measures, along with reforms in the Mexican Stock Market law, led to a remarkable growth in the capital market during this period. In addition efforts were made to curb the impacts of the crisis, giving high priority to the control of inflation and favoring high real interest rates. These policies helped to prevent capital flight, and above all developed monetary discipline.

End of financial repression

This phase of FED began in 1988 and ended in 1989. Initially, a gradual elimination of quantitative controls were enforced. First, credit quotas to high priority sectors were eliminated. Beginning Octobcr 1988, only a bank's resources coming from checking and savings deposits remained subject to the high priority sectors' credit allocations and reserve requirements. Compulsory reserves were revoked for banking liabilities collected through non-traditional bank instruments. But reserve requirements for these instruments were replaced by a "liquidity coefficient requirement" consistent in the obligation of maintaining 30 percent of the portfolio of assets in interest bearing government paper. Eater, this reform was extended to traditional time deposits in April 1989, and to checking accounts in August of the same year (Aspe, 1993": 77). Finally, in 1989 the compulsory liquidity coefficient requirement was eliminated and instead the authorities issued a ten-year variable-rate government note, to be used and traded among banks to meet their voluntary reserve needs. This ended the transition from a repressed financial system to one based on the market

Full fledged financial liberalization

Early reforms[6]

Transition from financial repression to a freer financial system was supported with significant reforms to the monetary law. On December 1989,, a set of financial reforms submitted earlier by President Salinas de Gortari were approved by the Congress. Those laws aimed at reforming existing regulation for financial intermediaries. Their main purpose was to advance the institutional development of the Mexican financial system, above all redefining its structure, diminishing excess regulation and improving supervision, regulating possible excesses from financial intermediaries, strengthening their capital, promoting economies of scale and scope, and promoting a wider market coverage, and greater competition,

Among the reforms undertaken must be mentioned the substantial changes to the Law for Credit Institutions, and the Law for the Securities Market. Although changes to the banking laws were more ample than those proposed for the securities exchange, interest for promoting its development was also clear. Other laws reformed included: the Law for Public Service in Banking and Credit; the Law for Insurance Companies; the Law for Bonding Institutions; The General Law for Auxiliary Credit Institutions and Activities, and the Law for Investment Funds. Moreover, it is worth noting that changes to the banking laws were tangled in a sharp debate due to implied changes to the Constitution, modifying its Articles 28 and 123 to allow private ownership of these institutions/ One important transitional aspect of these legal changes centered in giving greater autonomy to the management of state-owned banks. The new banking laws sought to strengthen the role of their administrative boards in the decision-making processes of their institutions. These boards were granted the right to name and remove their chief executive, which under the nationalized scheme of bank ownership was a right of the President, through a process carried out by the Ministry of Finance. In the new law it was also established that the Board should approve its own financial programs and investment and expenditure budgets, The Board was also given the right to approve the location or relocation of its institution's branches, agencies and representative offices throughout the country; the acquisition, leasing or sale of equipment; the initiation of expansion facilities, etc. However, these changes did not imply a total loss of control by the state, for it maintained a position of majority participation in the Boards of the banks (Ortiz Martinez, 1994: 59).

These reforms were also set forth in accord with the deregulation about the operations from banking institutions, as well as to promote a more active participation from the private sector in the capital and management of these institutions, privileging majority control by Mexican nationals.

The capital of multiple banking institutions was divided in three series of shares: Series A (remaining always at 51 percent) subscribed by the Federal government, development banks, holding companies of financial groups and the Banking Protection Fund; Series B (which could amount up to 49 percent) to be subscribed by Mexican nationals or legal Mexican corporations alone; and Series C (which could represent up to 30 percent of total capital), for any of the above plus foreign nationals, but not foreign governments and their entities.[s] Another important part of this strategy- was opening further development banks to private investment through Certificates of Capital Participation, which aimed at strengthening their capital. These shares are composed of Series A, owned by the government (66 percent), and Series B, owned by private individuals (34 percent), with an individual cap of 5 percent (before 1 percent).[9]

Finally, in relation to banking supervision, prudential regulation began to be emphasized, but Mexico's Banking Commission (Comision Nacional Bancaria) was granted attributes to sanction all those institutions which do not fulfill or violate the established norms.[10]

The most important changes concerning the Securities Market Law, which regulates investment banks, brokerage houses, and the management of investment funds, centered on promoting conditions that favor a greater participation of the capita! markets intermediaries in foreign markets; redefining the treatment of privileged information (promoting greater information and transparency); the deregulation of capital market operations to promote greater competitiveness and to make operations more flexible; and the legal creation of capital market specialists (*especialista bursátil).* In relation to foreign investments, the law was reformed to allow the participation of foreign investors with up to 30 percent of the capital of a brokerage house, with a cap of 10 percent on individual ownership.[1] Concerning investment funds, the law was modified to deregulate their operations and simplify their administration. Investment societies represent the most important vehicle for accessing the stock market by small and medium size investors. Thus, these reforms aimed at increasing local savings.

The law of the securities markets was also reformed in 1989-90 to allow the integration of financial intermediaries into financial groups. Stipulations were made to allow the creation of holding companies to administer these groups, and the participation of foreign investors in the common capital of a holding company was prohibited. Concretely, the law also mandates that the holding company must be at least conformed by three non-bank financial intermediaries, and the holding company must own at least 51 percent of the capital of each one. Similarly, it was mandated that the holding company maintains full responsibility on the losses of all its member institutions (Ortiz Martinez, 1994: 69).

In 1990 a new Law to Regulate Financial Groups appeared, allowing banking institutions to be part of this form of financial organization, i.e. creating universal banking as an alternative for the financial institution's organization and operation. The main objective of this reform was to allow sharing in costs and infrastructure, as well as offering better services to the clients (Aspe, 1993: 83).

In relation to supervision and monitoring, the role of the Comision Nacional de Valores (CNV), Mexico's Securities Exchange Commission, was also redefined. It was granted the right to impose those sanctions contemplated in the laws and to enforce operating rules without consent from the Ministry of Finance. Similarly, it was granted greater autonomy in the management of its revenues and expenditures, and it was granted the right to approve directly the authorization for functioning, or the order of revocation to investment societies.

The possibility of introducing derivatives into the Mexican stock market was considered early in 1991. The introduction of futures, options, warrants, and swaps was examined as a means to decrease volatility in the underlying market, as well as to increase capital formation and to enable Mexico to compete more favorably for resources in the international markets. Based on a viability study, the project for the introduction of warrants and options was approved. Its norms were set forth in Memorandum 10—157, which identifies the legal nature of these instruments. Later, in January 1993, a Committee of Derivative Products was formed by the Comision Nacional de Valores, the Mexican Stock Market, and the Mexican Association of Brokerage Houses to establish a working plan (Olloqui, 1993). Warrants were finally introduced in the Mexican market in September 1993.

Further institutional reforms

In addition to strengthening the banking system, stock market intermediaries and fostering the creation of universal banking institutions, financial reforms also contemplated the creation or strengthening of other non-bank intermediaries and fostering savings by creating a system of savings for retirement.

Savings banks The new General Law for Auxiliary Credit Organizations and Activities created savings banks (*Cajas de Ahorro)*, recognizing them as an important mechanism to induce savings among the popular classes. The new law aims at recognizing, organizing, and giving clear rules for the operations of savings banks, and is expected to give greater security and development possibilities to their operations (Ortiz Martinez, 1994: 1034). Four important reasons are given for their creation: (1) they ensure greater competition among agents; (2) they create greater economic rationality; (3) they stimulate economic growth and better standards of living for the people; and (4) they are the best mechanism to pool resources from small savers and channel them to productive processes. Specifically, the law sets forth that captured savings be made exclusively among its members, for posterior allocation among themselves; that the authorization of the Ministry of Finance is necessary for its constitution and formation; and that common capital must be integrated by social parts of equal value, conferring the same rights, and must be fully paid when issued. Similarly, the law specifies that savings banks will be based in a new form of organization - the savings and loans society which has legal standing, variable capital, limited responsibility of its members to the amount of their contributions, of indefinite life, and residence in the national territory - Their names are followed by the words "Sociedad de Ahorro y Préstamo (Savings and Loans Society).[12]

Savings for retirement system This system was created as a mechanism of social security and to foresee important impacts on savings and investment. This system is acknowledged in various reforms and additions to the Social Security Law, and in the Internal Revenue Law in a decree passed on 24 February 1992. Furthermore, in relation to state workers, a decree passed on 27 March 1992 created a system of savings for retirement for all those state employees subject to benefits from the Social Security Institute for State Employees (ISSSTE: its Spanish acronym). With al! this background, on 4 January 1993 the system for savings for retirement was given legal status, becoming part of LSSSTE, This system makes it obligatory for all state agencies and enterprises to make a contribution of 5 percent for housing, in addition to the 2 percent already supplied (Gonaalez-Mendez, 1993). This 2 percent is reserved for retirement. For this purpose, this law reformed, and made some additions to, the Law of the Institutions of the National Housing Fund for the Workers.

Reforms to the Law for Credit Institutions and the Law to Regulate Financial Groups The Law for Credit Institutions and the Law to Regulate Financial Groups were also modified on 9 June 1992. The most important changes were those concerning common capital for credit institutions and the capital of holding companies of financial groups. Percentages of participation now allowed are 51 percent for Series A, and up to 51 percent for Series B, the remaining 49 percent to be distributed among shares A, B, or C. Ownership in shares C cannot exceed 30 percent of that amount. Furthermore, paid-in capital can be formed by an additional part, represented by shares Series L issued up to 30 percent of common capital (Ortiz Martinez, 1994; 110). Similarly, in this reform it was specified that shareholders (legal or individual), Mexican or foreigners, have voting rights conccrning objectives, mergers, separations, transformation, liquidation, and listing and delisting in any stock market. A stipulation was also made to allow holdings of financial groups to acquire debt to increase their resources.

Further liberalization and deregulation of the securities market

In May 1993, the President sent to the Congress six new important bills to reform the financial system; the Law for Credit Institutions, the Law to Regulate Financial Groups, the Law for the Securities Exchange Market, the General Law for Auxiliary Credit Organizations and Activities, the General Law for Institutions and Mutualist Societies for Insurance, and the Federal Law for Bonding Institutions. The main objective of these reforms was to promote greater competitiveness among financial intermediaries, as well as granting them new powers in their operations, and to deregulate their operations significantly. It was also sought to harmonize the laws applicable to different financial intermediaries, particularly in relation to sanctions, administrative procedures, and a redefinition of transgressions and faults.

The most important changes concern the Law for the Securities Exchange Market. This law was modified in order to adapt the securities market to the growing internationalization of the financial markets. A system of international prices was created to enhance the dealing of local intermediaries in foreign securities, as well as strengthening trade in foreign markets, particularly titles issued by local firms at international markets. Public offerings of foreign issues were also allowed locally, independently of the nationality of the issuer.

To promote efficiency and transparency in the market, the concept of privileged information was redefined.[13] Sanctions were also established to prevent the misuse of this type of information. Concretely, the law stipulates that Board members, top executives, managers who misuse privileged information will face a veto from five to six years long. Other important reforms of this law refer to rating institutions, which originally were approved to operate in 1989. In the reforms proposed in 1993 regulations governing the operation of these institutions were increased. The law indicates that Comision Nacional de Valores can pass any provisions relating to the periodic information that these institutions must provide it with; the Commission can also require them to release certain information to the public, and other aspects relating to the services given to their clients. It is also stipulated that any misleading information can lead to the revoking of their operations.

Concerning foreign securities, the reform also contemplated making use of foreign governmental institutions devoted to the custody of securities, as well as making available the services of the Mexican Institute for the Custody of Securities to foreign financial institutions. It also considered that securities received for deposit be kept at foreign financial institutions, as well as at other centralized deposit institutions, whether national or foreign.

In relation to brokerage bouses, the law specifies that their specialized activities can be freely carried out in foreign markets, It also regulates their systems of accounting and the register of their securities operations. Similarly, provisos were introduced authorizing brokerage houses to carry out trust activities in relation to business related to their activities. Reforms to the Law of the Securities Exchange Market also allow the purchase of shares by issuing companies, including brokerage houses, which should be made with charges to their common capital account, In relation to issuing shares with no voting rights, or with restricted voting rights, criteria were unified. Thus, as in the case of banks and financial holding institutions, and taking into account the law of foreign investments, a cap of 25 percent was established in relation to common capital, considering that for this type of share brokerage houses and brokerage specialists can only issue shares of Series L.

Finally, the law also establishes that boards governing the exchange market be composed equally of members representing brokerage houses and brokerage specialists up to 50 percent, and the remaining 50 percent with members of recognized professional achievement and who don't have administrative positions at financial institutions.

Autonomy of the Central Bank

One of the most important reforms of the financial sector was the approval of the law giving autonomy, from the executive power, to the Central Bank, Banco de Mexico. The original bill was presented to the Congress by the President on 17 May 1993 and was finally approved in December of the same year. The initiative also contemplated reforms to Articles 73 and 123 of the Constitution. These Articles needed to he changed to give Congress the right to legislate on matters concerning central banking and the intermediation of financial services, and to reform some stipulations relative to the law applicable to employees from that institution, originally considered under the law for public employees. The constitutional reforms were approved on 20 August 1993 and published in *Diario Oftciat*, Mexico's public records gazette. The text of the reformed Articles indicates that the state will have a central bank, which will be autonomous in the execution of its functions and administration. Its main objective is to secure the stability of the purchasing power of the national currency, and in addition to strengthen the states national development. No authority can order the Central Bank to grant finances to the state.

The functions carried out exclusively by the Central Bank in strategic matters concerning coining currencies and issuing bills are not considered to constitute a monopoly. The Central Bank, in the terms established by the law and with the participation of specific finance authorities, regulates the exchange rate, controls financial intermediation and financial services, and with the necessary authority has rights to carry out such regulations and provide for their observance. The bank is administered by a Governor appointed by the President with full approval by the Senate, or else the Permanent Legislative Commission were the Senate not in session.[J4] Finally, the reforms to the Law of Banco de México, approved by the Senate on 14 December 1993, underlie the intention of the Mexican government to maintain the stability of the purchasing power of the national currency and to promote a healthy development of the financial and payments system (Banamex-Accival, 1994: 30).

The Law also sets the maximum limit that the Central Bank can lend to the Federal government, which is equivalent to 1.5 percent of expenditures contemplated in the Federal Expenditures Budget. Those resources can only be used to compensate for temporary discquilibria between revenues and expenditures, and the Bank can decide if the government can make use of that credit alternative (Banamex-Accival, 1994: 30). However, this limit can be exceeded in order to service internal debt.

Other important stipulations establish that the Central Bank can set restrictions to assets and liabilities operations, from credit institutions, brokerage houses, foreign exchange houses, and financial groups, which imply exchange rate risks. The Central Bank can compensate for increases in the money supply by acquiring foreign exchange (sterilization of foreign flows), or by placing securities from the federal government in the market. Reserve requirements cannot exceed 20 percent of the liabilities from banking institutions and 50 percent in the case of trust institutions (except those from the Federal government).

In relation to the goal of maintaining a smooth functioning of Mexico's financial system, the Law does not specify any supervision criteria. In relation to the administration of the Central Bank, it is established that this must be carried out by a governing board consisting of five members: the Governor, who presides over it, and four lieutenant governors elected by the Senate by nomination from the Executive, The Governor is designated by the President from the members of the Board, and the choice must be confirmed by the Senate. The mandate periods are six years for the Governor and eight years for Board members. They can be elected for more than one term. The Governor's mandate starts at the beginning of the fourth calendar year of each presidential term.[35]

The law approved by the Senate set 1 April 1994 as the date to start the new regime of the Central Bank. In a transition proviso, the term of office of the first Governor will be just over three years (the term expires 31 December 1997), in order to adapt this new central banking regime to expected changes in presidential terms. Finally, the Central Bank must report to the government and the public at large about its functions. In

January of each year it must send to the executive power and to the Congress its goals concerning the monetary policy to be followed during the year, and each April must give a report about the preceding year (Banamex- Accival, 1994: 30-5).

NAFTA and financial reforms in Mexico

Finally, it is worth noting that FLD was implemented in accord with, and to a great extent was influenced by, Mexico's negotiations for economic integration with its developed northern neighbors. Chapter 14 of the North American Free Trade Agreement (NAFTA), finally approved to start in January 1994, deals with financial services. There each country agreed to grant national treatment to the financial institutions of its trade partners.

However, Mexico's financial opening was programmed as a gradual process and with some restrictions to foreign investors.[16] Basically, Canadian and US financial institutions were granted immediate access to the local market, but with some limits until the year 2000. Banking institutions initially face an individual coiling of 1.5 percent and on the aggregate of 8 percent of total domestic capital in the sector. The aggregate limit increases to 15 percent by the year 2000. Concerning securities services, the initial limit is 10 percent and increases to 20 percent the same year. Security brokerage firms can have an initial participation of 4 percent of the market. After the year 2000 limits would be relaxed, but Mexico retains the right to impose limits if aggregates of Canadian and US banks move beyond 25 percent of domestic capital.

The individual limit of 1.5 percent should be removed by the year 2000 for banking institutions growing through internal funds, including allocations from the parent. However a 4 percent limit will be in effect. If a subsidiary of a Canadian or US bank has interests of 0.5 percent in a Mexican bank, the foreign institution can buy a local bank whose share of the market is 3.5 percent, which would be within the maximum allowed of 4 percent.

Finally, a 30 percent limit on common stock is fixed for joint investments carried out by Canadian and US investors in the Mexican banking sector. The limit docs not apply to investments made in foreign subsidtaries. Similariy, foreign investment in brokerage houses is also limited to 30 percent: individual investment should not exceed 10 percent. Individual Mexican investors, however, can invest up to 15 percent of capital of these institutions, with the authorization of the Ministry of Finance, The above rules do not apply to investments made by foreign subsidiaries.

In short, although financial reforms in Mexico were intense, during the 1988—94 period, financial institutions and financial markets remained somewhat protected in spite of an important agreement on trade and investments with the United States and Canada.

FINANCIAL LIBERALIZATION AND DEREGULATION AND THE PERFORMANCE OF THE MEXICAN SECURITIES MARKET

Trends in foreign direct and portfolio investments in Mexico

Mexico's recent financial crisis has illustrated that the integration of "emerging capital markets" to the world financial markets can be also accompanied by high instability and
economic setbacks. Financial liberalization and deregulation have often been identified as important causes for the crisis. Trends in the Mexican securities markets seem to confirm this hypothesis, but the root of Mexico's crisis is essentially related to erroneous policy-making.

In 1980 total capitalization of the stock market amounted to only $12,994 million and traded value to $3,262 million. By the end of 1988 these indicators had increased to $13,784 and $5,732 million, respectively.

During the following years, Mexican Stock Market (MSM) activity grew spectacularly as a result of financial liberalization and deregulation, and in response to favorable investment regulations and laws and the positive economic perspectives, partly due to the North American Free Trade Agreement, By 1994, market capitalization increased to $129,850 million, while trading value amounted to $84,101 million.[17] Furthermore, foreign investments in the MSM became an important part of foreign direct investment flows during the 1988-94 period. Table 5.1 shows that foreign direct investments reached a total of $77,938.4 million by the end of 1994. Thus during the period under consideration, FDI more than tripled the amount of $24,087.4 million accumulated until 1988.

Table 5.1 Direct and stock market investments in Mexico, 1989-94
(million dollars)

	Annual			*Cumulative balance*		
Year	*Total*	*Direct*	*Stock market*	*Total*	*Direct*	*Stock market*
1971				3,882.4		
1976				5,315.8		
1982				10,876.4		
1988				24,087.4		
1989	2,913.7	2,499.7	414.0	27,001.1	26,587.1	414.0
1990	4,978.4	3,722.4	1,256.0	31,979.5	30,309.5	1,670.0
1991	9,897.0	7,015.2	2,881.8	41,876.5	37,324.7	4,551.8
1992	8,334.8	5,705.1	2,629.7	50,211.3	43,029.8	7,081.5
1993	15,617.0	4,900.7	10,716.3	65,828.3	47,930.5	17,897.8
1994	12,110.1	8,026.2	4,083.9	77,938.4	55,956.7	21,980.9

Source: Seco ft. Dirección General de inversión Extranjera.

Table 5.1 also reveals another important change in foreign investment patterns in Mexico. Until 1988, portfolio investments were negligible in Mexico, to the extent that they were not formally registered. This was the result of restrictive regulations to invest in the local securities markets. Other problems like economic instability, lack of confidence in the peso, and restrictive regulations in the developed countries also contributed to this problem. However, financial liberalization in Mexico made its capital markets accessible to foreign investors. Furthermore, deregulation in the developed countries played a key role in making possible the portfolio investments of its nationals in securities from emerging capital markets. In the US this is the case of regulation 144 A. Indeed, 33 Mexican corporations have issued ADRs at the New York exchange markets since 1990.

As a result cumulative portfolio investments during the 1989-94 period were $21,980.9 million, which accounted for 28.2 percent of total foreign investments received.[LS] Moreover, portfolio investments increased steadily in importance till 1993, In 1989 these investments accounted for only 14.2 percent of foreign investment flows for that year, in 1993 portfolio investments accounted for two-thirds of foreign investments in Mexico. In 1994, direct investment flows increased sharply, but flows to the stock market showed a sluggish growth, a total of only $4.1 billion for the year.

Foreign flows to the Mexican money markets were also of significance. Table 5.2 reveals that by November 1994 foreign investors held a total of $23,292.8 million of total domestic debt (29.11 percent). These holdings concentrated in *Tesobonos* ($13,552 million in February 1995), an instrument denominated in dollars, created in 1991. Thus, foreign portfolio investments became the Achilles heel of the liberalized Mexican securities markets. Indeed, Table 5.3 shows the market value and composition of portfolio investments in the stock market and the amounts and composition of foreign investments in the money market. The fall in the stock market from November to December was 36.14 percent in dollar terms; the fall in the market value of foreign holdings in the capital market neared $15.9 billion, i.e. 31.6 percent of the total market value reported in November. This suggests that the fall in the market value of foreign holdings reported for December was due to significant withdrawals from foreign investors. The contribution of portfolio disinvestments to the Mexican crisis is confirmed by examining the market value of foreign stock market holdings for the following two months. By February 1995 the stock market had fallen 190 percent from its November level, while the value of foreign holdings plunged to $18.9 billion, a fall of $31,365.45 million - 62.3 percent lower than its November level. In the short term securities market the picture was also dramatic. Foreign holdings of domestic debt decreased by the end of December to $19,576.8 million, that is by $3,716 million. These trends would seem to confirm reports that on the days surrounding the peso

Table 5.2 Holdings on Mexican domestic debt, 1994 (million dollars)

	Total	%	*Banking sector*	%	*Banco de Mexico*	%	*Foreign nationals*	%	*Mexican nationals**	%
Cetes	20,230.90	25.3	277.80	32.4	12,270.00	26.5	5,637.57	24.2	2,045.80	21.3
Bondes	3,109.47	3.9	99.72	11.6	1,898.45	4.1	63.57	0.3	1,047.73	10.9
Tesobonos	47,630.47	59.6	132.54	15.5	28,001.77	60.5	16,299.66	70.0	3,196.50	33.4
Ajustabonos	9,049.00	11.3	347.00	40.5	4,116.00	8.9	1,292.00	5.5	3,294.00	34.4
Total	80,019.84	100.0	857.06	100.0	46,286.22	100.0	23,292.80	100.0	9,584.03	100.0
Percent – Nov.	100.0		1.07		57.84		29.11		11.98	
Total	74,660.5		1,348.6		42,407.6		20,632.6		10,271.7	
Percent Dec.	100.0		1.8		56.8		27.6		13.8	

Source: Bolsa Mexicana de Valores, Anuario Bursatil, 1994.

* Corporate and individual holdings – includes stock brokerages firms.

Table 5.3 Market value of foreign portfolio holdings in the Mexican money and stock markets

	Foreign investments in the capital markets					
	*Total**	*ADR's*	*Mexico fund*	*Free subscription**	*Neutral fund*	*Other†*
Million dollars						
1989	808.00	402.00	264.00	107.00	35.00	
1990	4,079.46	2,086.83	243.85	1,072.74	676.03	
1991	18,542.51	13,733.46	499.33	2,960.96	1,348.76	
1992	28,668.00	21,153.95	619.00‡	5,096.98	1,798.08	
1993	54,484.29	33,959.55	1,238.06	12,906.07	6,380.61	
1994 (Nov.)	50,311.45	29,056.66	1,183.25	12,968.64	7,102.89	
1994 (Dec.)	34,395.00	21,163.00	766.00	8,100.00	4,348.00	19.00
1995 (Jan.)	22,973.00	14,681.00§	562.00	4,791.00	2,913.00	26.00
1995 (Feb.)	18,946.00	12,612.00§	450.00	3,549.00	2,292.00	43.00
Percent						
1989	100.00	49.75	32.67	13.24	4.33	
1990	100.00	51.15	5.98	26.30	16.57	
1991	100.00	74.06	2.69	15.97	7.27	
1992	100.00	73.79	2.16	17.78	6.27	
1993	100.00	62.33	2.27	23.69	11.71	
1994 (Nov.)	100.00	57.75	2.35	25.78	14.12	
1994 (Dec.)	100.00	61.53	2.23	23.55	12.64	0.06
1995 (Jan.)	100.00	63.91	2.45	20.85	12.68	0.11
1995 (Feb.)	100.00	66.57	2.38	18.73	12.10	0.23

	Foreign investments in the money market					
	Total	*Cetes*	*Pagafes*	*Bondes*	*Tesobonos*	*Ajustabonos*
Million dollars						
1991	5,466.28	2,952.34	21.08	725.84	257.03	1,509.99
1992	14,206.87	9,150.98	0.00	1,236.64	197.37	3,641.12
1993	22,083.16	15,478.45	0.00	836.53	1,241.78	4,526.40
1994 (Nov.)	23,292.80	6,071.20	0.00	187.70	15,654.70	1,379.10
1994 (Dec.)	19,576.80	2,531.70	0.00	28.60	16,491.00	524.70
1995 (Jan.)	19,411.90	2,870.00	0.00	16.10	16,052.60	473.30
1995 (Feb.)	17,424.30	3,393.60	0.00	41.50	13,552.90	436.30
Percent						
1991	100.00	54.01	0.39	13.28	4.70	27.62
1992	100.00	64.41	0.00	8.70	1.39	25.63
1993	100.00	70.09	0.00	3.79	5.62	20.50
1994 (Nov.)	100.00	26.06	0.00	0.81	67.21	5.92
1994 (Dec.)	100.00	12.93	0.00	0.15	84.24	2.68
1995 (Jan.)	100.00	14.78	0.00	0.08	82.69	2.44
1995 (Feb.)	100.00	19.48	0.00	0.24	77.78	2.50

Sources: Developed from Bolsa Mexicana de Valores, Anuario Bursátil, 1993 and 1995, and Bolsa Mexicana de Valores, Indicadores Bursátiles, various issues, 1993–5.

Notes:

* Since 1992 includes Investment Societies and the accounts for third parties from Citibank.

† Includes derivatives and intermediate market shares.

‡ October 1992.

§ Includes ADRs and GDRs.

Nevertheless, the crisis cannot be attributed directly to financial liberalization and deregulation, but rather to bad policy-making. The figures on securities market trends, previously analyzed, show that the liberalized Mexican securities markets have an enormous potential to promote Mexico's economic development. But that potential remained rather unexploited because an effective link between investments in the capital markets and corporate activity was not established. Similarly, foreign investments in the money markets, due to their short term nature, were not tied in to any development plans either. Simply, they were government domestic debt held by foreign nationals. Since large amounts of this debt were denominated in do liars; those holdings drastically changed the character of domestic debt to that of foreign debt. Foreign portfolio investments therefore had a high potential to be withdrawn if negative conditions appeared.

Unfortunately, that situation took place because by 1994 it became obvious that the economic bonanza of the previous years was illusory. Since 1988 the balance of trade of the Mexican economy showed huge annual déficits; $20.7 billion in L993 alone and an accumulated amount of $82.2 billion for the 1989-93 period.[19] Moreover, m order to control inflation the peso was overvalued. Its overvaluation neared 30 percent by the end of 1994.

Nevertheless adjustments were not made in time, they were postponed on purpose since the end of 1992, when the first symptoms of disequilibria came to the forefront. Thus, instead of adjusting the exchange rate and the balance of payments, foreign portfolio investments were promoted to increase international reserves. Thus, foreign portfolio investment flows, rather than supporting investments, were used to support *consumption*, for deficits were mainly due to imports of intermediate goods for the production of consumption goods, and imports of consumption goods *per se*, too. Less than 20 percent of imports were related to purchases of capital goods or technology (Ortiz, 1994),

The reasons for resisting adjustment seem to be rather political, albeit with an economic slant, and personal. To diminish opposition to the North American Free Trade Agreement in the United States, Mexico needed to show an image o f prosperity and to give an assurance that it would not take jobs away from US workers. Economic bonanza, although sustained artificially, coupled with high imports from the United States reinforced that view, giving the image that Mexico would be a sound trade partner whose long run growth would create local and US employment. That image was so well maintained and promoted on a worldwide basis that Mexico even became a member of the OECD in April 1994. Mexico seemed to be in a process of rapidly becoming a "first world country," and **its President,** Salinas de Gortari, was internationally considered to be a great statesman.

The Indian uprising in the State of Chiapas exacerbated the situation of Mexico. That movement started precisely when the government was ready to celebrate the formal initiation of the North American Free Trade Agreement on 1 January 1994. Although this uprising raised some worries among investors in the Mexican securities markets, it did not lead to massive withdrawals of capital. Thus, adjustment policies could have been implemented early in 1994, but the President continued resisting this because presidential elections were due to take place. A devaluation would have increased popular discontent against Partido Revolucionario Institucional, PRI, the ruling party.

Further, the political environment got more complicated because on 23 March 1994 the PRI candidate was assassinated in Tijuana. Then massive withdrawals took place, estimated at $11 billion, to the extent that President Clinton hastily created a $6 billion rescue package for the Mexican economy. This allowed the Mexican government to sustain its overvalued peso and high imports policies. Elections took place on 22 August 1994. Ernesto Zedillo, the official candidate, was elected President by a narrow margin. Beyond this event, independently of further political instability due to further political assassinations, the decision not to devalue the Mexican peso seems to have been solely determined by President Salinas's ambition to become the first president of the emerging World Trade Organization. Traditionally in Mexico, devaluations have been carried out by the outgoing president, which allows the incoming president to start "without blemishes." But President Salinas refused to assume this role, even though meetings between Zedillo and Salinas and his cabinet to take that decision were reported to have taken place. Thus, when President Zedillo began his term, the problem had become unmanageable. The situation was aggravated by the fact that his own cabinet was also incapable of proposing smooth devaluation policies. As a result the peso devaluated drastically, and irate local and foreign investors defensively withdrew their investments from the local markets, leading to Mexico's most profound crisis of the century.

CONCLUSION: THE MACROECONOMIC CONDITIONS NECESSARY TO ACCOMPANY FINANCIAL LIBERALIZATION

The economic situation leading to the Mexican crisis underlies the fact that legal reforms *per se* are not sufficient to stimulate savings and investment processes and to promote the development of a strong, financial system well linked with the real sector. For FLD to be successful It is also necessary to achieve and maintain certain favorable macroeconomic conditions. Otherwise, financial reform could have negative effects on the economy. Viewed from another angle, economic goals require fast liberalization and deregulation reforms, but these reforms must be consistent with the economic goals. That is, economic and financial plans must move together and complement each other. In this respect, the Mexican FLD experience, before the crisis, has been summed up in ten important principles (Aspe, 1993: 92-4).

1 Before starting financial liberalization economic stabilization must be achieved, above all in public financing.
2 Financial liberalization must go beyond the simple liberalization of interest rates and the elimination of quantitative restrictions on credit.
3 Timing and sequencing of reforms to be enforced is very important.
4 The financial system should not be subject to experiments.
5 Greater financial liberalization and innovation must be accompanied by effective supervision taws and mechanisms.
6 The financial system must be financially sound when liberalization takes place.
7 Financial intermediaries must be kept apart from their industrial and commercial clients.
8 Before opening the financial sector to foreign competition it is advisable to give domestic financial institutions time to become aware of and used to conditions prevailing in international competition.
9 Once the financial liberalization process ends, the next step is to move towards the establishment of universal banking,
10 It is important to bear m mind that financial institutions can and must have strong lasting social impacts.

Undoubtedly, these guidelines derived from the Mexican FLD processes are sound and should be followed by governments from developing nations implementing liberalization and deregulation policies. But paradoxically they were not fully applied in Mexico.

However, to some extent they do reflect the Mexican case before the peso devaluation of 1994. But even then they reveal that FLD in Mexico was not well undertaken. Stabilization was not firmly entrenched when financial liberalization started. Moreover, financial liberalization does not seem to have followed a well-thought-out and timed plan. An examination of Mexico's FLD processes reveals, rather, that they were undertaken in a heuristic manner. Only in that way can it be explained why, for instance, reforms to the banking system required several laws, each one tuning-up previous resolutions, indeed, contrary to the recommendations outlined above, the financial system does seem to have been subjcct to experiments, even if they were unintentionally instrumented. Similarly, supervision seems to have faltered because the government was unable to detect and prevent failures in the banking system, and failed to set up mechanisms to prevent panic withdrawals from investments in the local securities markets. The weakening of the banking system, due to excessive overdue loans, also reveal that state-owned banks were not really financially sound before reprivatization and FLD.

In sum, FLD in Mexico was rapid and led to profound changes in its financial institutions and markets. However, it was not actioned via a well- thought-out plan, and above all it was implemented in an unbalanced economy and with insufficient links with the real sector. Thus, although financial intermediaries grew significantly and revealed a high potential to support local investments and economic growth. FLD also led to some "perverse effects,"[20] including massive withdrawals of portfolio investments, which led to the peso crisis now affecting Mexico.

Thus, from the Mexican experience, it can be concluded that in addition to the macroeconomic conditions outlined above FLD requires that economic stabilization and equilibria be firmly achieved, the external sector must be balanced, and the exchange rate must be in equilibrium. Overvaluation and its use as a mechanism to control inflation should be avoided. Also, adjustment and financial liberalization and deregulation, policies should not be subordinated to political and personal interests. And most important of all, FLD processes should be enforced in order to promote strong links between financial activity and investments in the real sector.

NOTES

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1 Deregulation is really part of financial liberalization. That is the meaning taken in this work, although for clarity in. the exposition sometimes both concepts are used simultaneously. However, it is worth mentioning that liberalization is often only identified with the elimination of restrictions on monetary policy and with the opening of local markets to foreign markets and foreign investments, Deregulation is often limited to changes in laws and regulations that hinder free market activity, or else promote market-oriented institutions,

2 These three goals, particularly the promotion of local savings, remain in the forefront and are the basis of policies designed to overcome Mexico[1] s current crisis and to set the ground for long run growth.

3 SAR was introduced as part of a bill for social security reforms in 1992. See Mans ell Carstens <1992).

4 In this respect it is worth noting that Mexican authorities were open to lessons derived from the Chilean experience. See Cortes-Douglas (1992).

5 These reasons for low savings are stressed by Aspe (1993). For other causes for low savings in Mexico see Garrido (1995).

6 Unless otherwise indicated this section is based on Ortiz Martínez (1994>.

7 For a summary on this debate see Ortiz Martinez (1994: 71—87).

8 CNB, *Ley de Instituciones de Crédito, J990,* Arts 11-15.

9 *Ley de instituciones de Crédito,* Arts 32—3. These shares were cieatcd during the government of President De la Madrid, 1982-8, right after the nationalization of the banking sector (carried out by the previous president, Lopez Portillo) to curb down dissatisfaction from the private sector.

10 See Comision Nacional Bancaria, *Ley de instituciones de Crédito*, Titulo VII, Capitulo 1.
11 *Ley del Mercado de Valores*, Art. 17, 17 July 1990.
12 *Ley General de Organizaciones y Actividades Auxiliares de Crédito,* Art. 38— A, 1990. The new law passed in 1993 retains this regulation (Cap. II).
13 It refers to knowledge of actions, wrongdoings, etc. that could lead to influencing securities prices in the stock markets, while such information is not publicly known. See Ortiz Martinez (1994: 114).
14 *Constitución Política de los Estados Unidos Mexicanos*, 1994, Aris 28, 39.
15 Summarized in Banamex-Accival, *Examen de la Situación Económica de Mexico,* (Enero 1994), pp. 30-5.
16 For an evaluation of the implications of this issue see Ortiz (1994).
17 International Financial Corporation, *Emerging Markets Fact Book 1995,* Washington, DC: 1FC, 1995.
18 Portfolio investments are registered as foreign direct investments because the above figures basically refer to new issues at the international capital markets, which therefore should be intended for capital expansion.
19 Excludes subcontracting (*maquila*) activity, which began to be reported in the trade balance in lieu of services since 1993. Banco de México, *Informe Anual,* various issues, 1988-94.
20 On this issue, see Chapter 4 by Rollinat in this book.

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