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The Political Economy of Mexico's Financial Reform, 1988-1994.

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Abstract

The global dimension of Mexico's 1994 financial crisis brought a renewed interest in the institutional framework of international finance. The failure of Mexico's financial reform raises important questions. At the level of policy-making, the prescriptions based on the premise of less state intervention and a major role for the market have to be taken more cautiously. At the level of analysis, the role of institutions has to be emphasised more in the explanations of the effects of policy decisions upon economic behaviour. The purpose of this thesis is twofold. First, it tries to explain President Salinas's success in implementing a far-reaching programme of economic liberalisation, despite the fact that pro-market policies are not particularly popular in Mexico. Second, it tries to explain the apparent failure of the financial reform, despite the fact that it conformed to the dominant orthodoxy and was implemented by a technically proficient technocracy.

The favoured approach in this thesis says that Mexico's financial reform was the result of political entrepreneurship. The charismatic leadership of President Salinas aligned a powerful coalition of support for economic reform. Salinas used extensively the organisational and institutional infrastructure of the quasi-authoritarian Mexican state to overcome the 'legitimacy deficit' of his government. Regarding Mexico's 1994 financial crisis, the evidence points to the combination of three sets of interrelated factors. First, the financial reform stifled domestic savings and re-directed most of the capital inflows towards portfolio investment. Second, the end-of-*sexenio* political cycle that produced a great deal of political turmoil and economic uncertainty. Third, the policy mistakes that exacerbated the size and depth of the crisis.

The thesis is organised into three parts. The first part—chapters one to four—develops the framework, both theoretical and historical. The analysis addresses four main themes: state autonomy, external dependency of domestic states on international capital, political change under President Carlos Salinas and financial policy. The second part presents the analysis of three cases of institutional change in the financial system—development banking reform, commercial banking privatisation and autonomy of the central bank. Each case study shows how the reforms conformed to the ideas of the dominant consensus on economic policy and how they delivered an inefficient incentive structure. The third part—chapter eight—brings together all the elements presented throughout the thesis to establish the relationship between the financial reform under President Salinas and the 1994 financial crisis.

Table of Contents

Abstract i
Table of Contents ii
List of Tables iv
List of Figures vi
Acronyms vii
Acknowledgements x

1. State Autonomy and Policy Reform: A Theoretical Framework 1
 1.1 Theoretical Debate: An Overview 2
 1.2. Basic Concepts 8
 1.3 The Politics of State Autonomy 13
 1.4 State Autonomy and Policy Reform 20
 1.5 Central Hypothesis and Structure of the Thesis 25

2. The Politics of International Finance: Fostering Reform 33
 2.1. International Capital Leverage 34
 2.2. The Emergence of a New Consensus 45
 2.3. International Policy Networks 52
 Conclusions 60

3. Domestic Politics: Making the Reform Possible 63
 3.1 The Politics of a Semi-authoritarian State, 1940-1982 65
 3.2 Political Change under de la Madrid, 1982-1988 74
 3.3 Political Change under Salinas, 1988-1994 78
 Conclusions 90

4. Financial Policy in Mexico: A Historical Account 92
 4.1 Setting up an Institutional Framework, 1925-1952 93
 4.2 Financial Management, 1952-1982 100
 4.3 Financial 'Securitisation', 1982-1988 108
 4.4 Financial Liberalisation, 1988-1994 115
 Conclusions 123

5. Development Banking Reform 127
 5.1. The Ideas 128
 5.2. An Overview 130
 5.3. The Reform 139
 5.4. The Outcomes 145
 Summary 153

6. Commercial Banks Privatisation 156
6.1. The Ideas 157
6.2. The Context 160
6.3. The Reform 166
6.4. The Outcomes 174
Summary 187

7. Banco de Mexico's Autonomy 188
7.1 The Ideas 189
7.2 The Context 200
7.3 The Reform 209
7.4 The Outcomes 216
Summary 223

8. The Political Economy of Mexico's 1994 Financial Crisis 226
8.1 Financial Reform 227
8.2 End-of-Sexenio Politics 236
8.3 Policy Mistakes 242
8.4 Outcomes 249
Conclusions 255

Conclusions 258

Appendix: Methodology and Sources of Information 275

References 281

List of Tables

Table 2.1
Mexican Eurobond and Equity Issues, 1992-1993 37
Table 2.2
Conditionality Contents of IMF and World Bank Programmes 55
Table 2.3
President Carlos Salinas's Economic Team 59
Table 3.1
Policy Coalitions 73
Table 3.2
Presidential Election Results, 1952-1988 78
Table 4.1
Reserve Requirements, 1972-1976 106
Table 4.2
State securities Issues, 1978-1988 111
Table 4.3
Securities Market Development, 1982-1987 113
Table 4.4
Securities vs. Banks' Deposits, 1980-1989 114
Table 4.5
Financial Stability, 1980-1989 115
Table 4.6
Profile of Major Financial Reformers 118
Table 4.7
Summary of Mexico's Financial Policy, 1925-1994 124
Table 5.1
Large Development Banks 131
Table 5.2
Main Funds and Trust Funds 148
Table 5.3
Development Banks Profitability 151
Table 6.1
Financial Indicators of the Nationalised Banking System: 1982-1993 165
Table 6.2
Banking Divestiture Committee 170
Table 6.3
Privatisation by Sale Mechanism 171
Table 6.4
Shares Valuation of Selected Mexican Banks: 1990 173
Table 6.5
Revenues and Prices from the Banks' Privatisation 174
Table 6.6
New Industrial-financial groups 179

Table 7.1
Central Bank Autonomy and Inflation in the 1980s 192
Table 7.2
Statistics for Central Bank Autonomy and Inflation 194
Table 7.3
Stabilisation Programmes in Latin America 209
Table 7.4
Macroeconomic Policy, 1982-1994 218
Table 7.5
Public Finances, 1987-1993 220
Table 7.6
External Indicators, 1985-1995 223
Table 8.1
Total Savings, 1970-1994 228
Table 8.2
National Accounts, 1988-1994 230
Table 8.3
Ratio of Non-performing Loans to Total Loans 236
Table 8.4
Foreign Financial Firms Entering Mexico 250
Table 8.5
Mergers and Acquisitions 251
Table 8.6
The Cost of Banking Bailouts 254
Table C.1
Outcomes from the Financial Reform 265

List of Figures

Figure 1.1
Levels of Political Organisation 14
Figure 2.1
Public Deficit, 1950-1994 40
Figure 2.2
Current Account Deficit, 1970-1994 42
Figure 5.1
Assets of the Mexican Financial System, 1935-1989 132
Figure 5.2
Development Banks' second-floor Operations 140
Figure 5.3
Public vs. Private Sector Financing, 1985-1995 144
Figure 5.4
Assets of the Mexican Financial System, 1985-1995 149
Figure 7.1
Capital Inflows 222
Figure 8.1
Public Indebtedness 245

Acronyms

ABM	*Asociación de Banqueros de México* / Mexican Bankers Association
ADR	American Depository Receipt
AEROMEXICO	*Aerovías de México* / Airlines of Mexico
AMCB	*Asociación Mexicana de Casas de Bolsa* / Mexican Association of Brokerage Houses
AMIS	*Asociación Mexicana de Instituciones de Seguros* / Mexican Association Insurance Institutions
ASEMEX	*Aseguradora Mexicana* / Mexican Insurance Company
BANACCI	*Grupo Financiero* BANAMEX-ACCIVAL
BANAMEX	*Banco Nacional de Mexico* / National Bank of Mexico
BANCOMER	*Banco de Comercio* / Bank of Commerce
BANCOMEXT	*Banco Nacional de Comercio Exterior* / National Bank for External Trade
BANJIDAL	*Banco de Crédito Ejidal* / Ejido Credit
BANOBRAS	*Banco Nacional de Obras Públicas* / National Bank for Public Works
BANRURAL	*Banco Nacional de Crédito Rural* / National Bank for Rural Credit
BBV	Banco Bilbao Vizcaya
BdeM	*Banco de México* / Bank of Mexico (Mexico's Central Bank)
BIS	Bank for International Settlements
BMV	*Bolsa Mexicana de Valores* / Mexican Stock Exchange
BNCI	*Banco Nacional de Comercio Interior* / National Bank of Internal Trade
BONDES	*Bonos para el Desarrollo* / Bonds for Development
CANACINTRA	*Cámara Nacional de la Industrial de la Transformación* / National Chamber of the Transformation Industry
CBA	Central Bank Autonomy
CCE	*Consejo Coordinador Empresarial* / Entrepreneurial Co-ordinating Council
CDB	*Comité de Desincorporación Bancaria* / Banking Divestiture Committee
CEESP	*Centro de Estudios Económicos del Sector Privado* /Centre of Economic Studies of the Private Sector
CEMAI	*Consejo de Empresarios Mexicanos para Asuntos Internacionales* / Mexican Entrepreneurs Council for International Affairs
CES	*Centro de Estudios Sociales* / Centre of Social Studies
CETES	*Certificados de la Tesorería* / Treasury Bills
CMHN	*Consejo Mexicano de Hombres de Negocios* / Mexican Council of Businessmen
CNC	*Confederación Nacional Campesina* / Peasants National Confederation

CNBV	*Comisión Nacional Bancaria y de Valores* / National Commission for Banking and Securities
CNSF	*Comisión Nacional de Seguros y Fianzas* / National Commission for Insurance and Bonding
CONCAMIN	*Confederación Nacional de Cámaras Industriales* / National Confederation of Industrial Chambers
CONCANACO	*Confederación Nacional de Cámaras de Comercio* / National Confederation of Commerce Chambers
CONSAR	*Comisión Nacional del Sistema de Ahorro para el Retiro* / National Commission for the Savings Pension System
COPARMEX	*Confederación Patronal Mexicana* / Mexican Confederation of Employers
CPEUM	*Constitución Política de los Estados Unidos Mexicanos* / Political Constitution of the Mexican United States
CTM	*Confederación de Trabajadores de México* / Mexico's Workers Confederation
EFF	Extended Fund Facility
EMU	European Monetary Union
FDI	Foreign Direct Investment
FIDEC	*Fideicomiso para el Desarrollo Comercial* / Trust Fund for Trade Development
FIRA	*Fideicomisos Instituidos en Relación a la Agricultura* / Trust Funds Instituted Regarding Agriculture
FOBAPROA	*Fondo Bancario de Protección al Ahorro* / Banking Fund for Savings Protection
FONAPRE	*Fondo Bancario de Ayuda Preventiva* / Banking Fund for Preventive Aid
FONATUR	*Fondo Nacional de Fomento al Turismo* / National Fund for Tourism Promotion
FOVI	*Fondo Operativo y de Financiamiento a la Vivienda* / Operational Fund for Housing Financing
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GF	*Grupo Financiero* / Financial Group
IBRD	International Bank for Reconstruction and Development
IDA	International Development Agency
IDB	Inter-American Development Bank
IFE	*Instituto Federal Electoral* / Federal Electoral Institute
IMF	International Monetary Fund
INEGI	*Instituto Nacional de Estadística, Geografía e Informática* / National Institute for Statistics, Geography and Cybernetics
IPC	*Indice de Precios y Cotizaciones de la Bolsa Mexicana de Valores* / Index of Prices and Quotations of the Mexican Stock Exchange
ISI	Import Substitution Industrialisation
ITAM	*Instituto Tecnológico Autónomo de México* / Autonomous Technological Institute of Mexico
LDCs	Less Developed Countries

LGIC	*Ley General de Instituciones de Crédito* / Credit Institutions General Act
LOBdeM	*Ley Orgánica del Banco de México* / Banco de Mexico Organic Act
Mex $	Mexican pesos
MFOs	Multilateral Financial Organisations
NAFIN	*Nacional Financiera* / National Investment Bank
NAFTA	North American Free Trade Agreement
NGOs	Non-governmental Organisations
NIE	New Institutional Economics
OECD	Organisation for Economic Co-operation and Development
PAN	*Partido Acción Nacional* / National Action Party
PNR	*Partido Nacional de la Revolución* / National Party of the Revolution
PND	*Plan Nacional de Desarrollo* / National Plan for Development
PRD	*Partido de la Revolución Democrática* / Party of the Democratic Revolution
PRI	*Partido Revolucionario Institucional* / Institutional Revolutionary Party
PROBURSA	*Promotora Bursátil, SA*
PRONASOL	*Programa Nacional de Solidaridad* / National Programme of Solidarity
PSE	*Pacto de Solidaridad Económica* / Economic Solidarity Pact
SBH	Stock Brokerage House
SALs	Structural Adjustment Loans
SHCP	*Secretaría de Hacienda y Crédito Público* / Ministry of Finance
SPP	*Secretaría de Programación y Presupuesto* / Secretariat of Programming and Budgeting
TELMEX	*Teléfonos de México*
TESOBONOS	*Bonos de la Tesorería* / Treasury Bonds
UK	United Kingdom
UNAM	*Universidad Nacional Autónoma de México* / National Autonomous University of Mexico
USA	United States of America
WTO	World Trade Organisation

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Chapter 1

State Autonomy and Policy Reform:

A Theoretical Framework

The purpose of this thesis is to show how financial reform under President Carlos Salinas (1988-1994) was aimed to engineer new bases of support for the regime and consequently to consolidate the President's political leadership within the new parameters set by an increasing integration to the world economy, on the one hand, and by increasing political competition, on the other. The analysis is framed within the theoretical discussion of state autonomy—namely, the extent to which policy choices made by the state are influenced or determined by social groups. Nordlinger (1981) defines state autonomy in terms of the 'conscious preferences of public officials, who are said to be acting autonomously as long as they are not deliberately giving in to demands of societal actors.' Under this approach, state autonomy is simply the creative exercise of political leadership.

The issue of state autonomy in this work is relevant from two different perspectives: first, as the result of specific institutional arrangements in the political system; and second, as an essential component of policy reform. This chapter draws from Mexico's experience of policy reform under President Salinas to assess the pertinence of an analytical framework based on this notion of state autonomy.

This chapter starts with a brief overview of the theoretical debate on state autonomy: specifically, the extent to which state's policy choices are influenced or determined by interest groups. This debate serves as an introduction to the main determinants of policy-making. The second section brings the concepts of institutions and organisations into the theoretical discussion of state autonomy. The third section introduces the notion of state autonomy into the analysis of policy-making where state, interest groups and voters represent categories of agents having differential political influence. A multi-layered model that distinguishes three levels of political organisation according to the

actors' political influence frames the discussion. The fourth section explores the role of state autonomy in policy change. This section also addresses the distinction between internal and external autonomy. Finally, the fifth section links the previous discussion with the main claim of the thesis and explains how the argument is organised throughout the remaining chapters.

1.1 Theoretical Debate: An Overview

The literature of political economy does not have an encompassing theory of policy reform. In fact, this literature is characterised by a vast diversity of approaches and topics of analysis, although with an underlying unity of purpose: 'to demonstrate how economic and political outcomes reflect choices constrained by institutions' (Alt and Shepsle 1990: ix). Most of the studies in this field have taken an inductive approach and 'rather than specify a theory *a priory*, we set out to sharpen concepts of both dependent and independent variables and to specify more precisely some of the mechanisms at work and the circumstances in which they are more or less important' (Nelson 1990: 17).

The theories discussed in this section are classified according to their approach to policy reform, whether they are society-centred or state-centred.[1] The society-centred approaches concentrate on the configuration of power between interest groups, while leaving a secondary role to the state. The state-centred approaches, by contrast, explain policy reform in terms of the preferences and organisational power of the state elites. In the latter case, the state represents a set of organisations with well-defined objectives and subject to political leadership. These two approaches are the most important rival explanations within the political economy literature of the phenomenon of policy reform in the developing world during the last couple of decades.

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[1] Migdal (1988) discusses the relative strength of the state vis-à-vis society from an interesting, though opposite, perspective. We are interested in the extent to which society influence state decisions. His main interest, by contrast, is to assess the capacity of the state to influence the behaviour of the society. That is to say, Migdal wants to explain to what extent state policies can effectively transform the societies they govern.

Society-centred Approaches

Society-centred explanations to policy-making were dominant in political science and sociology during the 1950s and 1960s (see Dahl 1961). These theories were based on the pluralist model, where policy decisions are the result of competition between interest groups and the state is a neutral arena where this competition takes place (Skocpol 1985: 4; Frieden 1991).[2] Based on this premise, the 'modernisation' theory claimed that in democratic political systems, where citizens are considered to be political equals, competition among interest groups produces efficient policy-making (see Huntington 1968). Nevertheless, states adopted and then persisted in pursuing policies that increased distortions in the economy, exacerbating inefficiency and inequality. This phenomenon led Robert Bates (1981: 3), among others, to raise a new question: 'why should reasonable men adopt public policies that have harmful consequences for the societies they govern?'

In the decades of the 1970s and 1980s 'public choice' theory, another society-centred approach, attempted to answer this question with the argument of rent seeking. It says that interest groups influence self-interested politicians in order to extract rents from the state (Grindle 1991: 43; Haggard and Lee 1993: 7-8). The pioneers of these approaches developed new concepts like rent seeking, principal-agent and collective action. They used the basic assumptions of neoclassical economics but applied to political phenomena (see Buchanan and Tullock 1965; Olson 1965; Krueger 1974; Mueller 1979). This field has made great contributions to the understanding of fundamental issues in democratic political systems, like voting behaviour, public goods provision and policy-making, among others.

In the society-centred approaches, power is understood as the disproportionate responsiveness of the government to particular groups (Klein 1994: 126). Individuals perceive that the only means to attain their goals is collectively organised and their organisational capacity depends to a great extent on the economic resources they control. Lindblom (1977), in his book 'Politics and Markets', argues that economic

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[2] The pluralist model found very fertile ground, for instance, in explaining trade policy in developed countries (see Baldwin 1985; Milner 1988).

forces shape the balance of power in politics. In the US, major corporations translate their economic power into political and social power through their influence on public decisions. In this setting, policy-making does not maximise social welfare, but economic rents for interest groups. The state has, thus, a perverse role either by safeguarding the interests of some organised interest groups at the expense of the rest of the society or by supporting a predatory group of politicians and bureaucrats (Bates 1981). The obvious policy recommendation from this set of analyses is that the state should be kept at a minimal size, safeguarding private property and providing public goods (Evans 1992: 144). Most of the agenda of policy reform was shaped from this basic principle: 'less state and more market'. However, according to Peter Evans (1995: 21), 'the neoliberal attack on the state has passed its zenith. The political hegemony of neoliberalism and the theoretical hegemony of the neo-utilitarian vision, which provided its intellectual underpinnings, are on the wane.'

The phenomenon of policy reform in developing countries during the late 1980s and early 1990s poses a challenge to the pluralist model and public choice theories. It is difficult to accept the hypothesis that interest groups forced the state to implement the policy reform. In most cases, these groups were unable either to determine the precise impact of the policies on their own welfare or to mount organised campaigns either supporting or blocking the reform efforts (Bates and Krueger 1993: 457). Few studies using these approaches bothered to ask whether policy reform was in fact a result of interest groups pressure or whether it sprang from economic constraints or political leadership. Those studies did not ask how reformers overcame resistance from rent-seekers, who had a vested interest in preserving the *status quo* (Haggard and Lee 1993: 9). The public choice analysis also found puzzling the introduction of structural adjustment programmes, which are consistent with the 'benevolent state' of neoclassical economics but apparently politically irrational at the same time. For example, the removal of subsidies and the reduction of trade protection to some industries go against the interests of important groups with strong capacity for social mobilisation and economic disruption.

Another critique of the public choice and pluralist approaches is their utilisation of very stylised models that neglect the peculiarities of the wider historical and institutional context where complex political and economic events take place. For pluralists, the state

is just a neutral arena where the social forces interplay. This model, however, has provided satisfactory explanations for economic and political phenomena in countries with well-developed market economies and well-institutionalised democracies (Findlay 1991: 13-14).[3] In such cases, the assumption of rent seeking describes quite accurately the behaviour of state actors responding to organised interest groups trying to extract economic rents. Unfortunately this is not the common scenario in most of LDCs where 'political elites have inherited or built organisational structures that significantly constrain the ability of societal actors to achieve their political and economic objectives' (Haggard 1990: 3). The state tends to dominate civil society, which is weak and fragmented, and not generally organised for sustained political activity. Policy making in LDCs is centred more in the executive branch of the state, dominated by high-level administrators and political leaders (Grindle 1991: 52). Rational choice theories might be better to explain policy-making and policy reform in LDCs if they replace their society-centric view with a more state-centric perspective, based on political elites actively engaged in maximising their political power or on rent seeking bureaucrats. As I argue next, social forces do not have to be removed from the analysis but their role has to be downgraded from being active determinants of policy decisions to become broad constraints to state choices.

State-centred Approaches

State-centred approaches received a great boost from the study of LDCs as part of the effort to understand situations where the society-centred models could not explain major policy reforms (Geddes 1994: 3). In most cases, the interests injured by the reforms were those that, shortly before a shift, had appeared to be economically and politically dominant in the country. Why did the state introduce policies that go against its own traditional supporters and sources of power? This underlying puzzle of 'positive economics and negative politics' is one of the central issues in the new state-centred literature (Nelson 1990; Grindle and Thomas 1991; Evans 1992; Bates and Krueger 1993). To solve this puzzle some scholars have introduced enlightened technocrats or state leaders who are somehow liberated from the pursuit of self-interest and thus able to

[3] For two good studies on the US political economy see Alesina and Sachs (1988) and Keech (1995).

pursue the public interest beyond short-term individual goals (Srinivasan 1985: 58). Merilee Grindle (1991) went further and developed a model, where policy elites are strategic managers with a complex set of preferences, facing complex policy contexts, and seeking politically, bureaucratically and economically viable outcomes. Policy elites and political institutions were reintroduced at the core of the policy-making analysis within the new political economy literature.

As I mentioned above, in most LDCs, the pluralist assumption of a strong organised society, usually associated with an active legislature and a strong party system, does not hold with the same regularity as in western democracies (Stepan 1985: 317). It is often the case in developing countries that the most active actors shaping policy-making are not legislators or voters, but ministers and bureaucrats. Elections are less relevant for policy-making and therefore state actors have greater freedom to pursue their own agendas (Haggard 1991: 238). In these cases the process of preference formation becomes crucial to understanding the final outcomes (see Grindle 1991; 1996; Grindle and Thomas 1991). According to Ronald Findlay (1991: 18), state autonomy is chiefly associated to three factors: first, the low degree of organisation within society; second, the authoritarian nature of the existing political regime; and third, the control of the state by a small elite. Even political parties are more often mechanisms employed by elites to control mass followings rather than means by which interests are articulated from below to the top (Meier 1991: 302).

State-centred approaches to policy reform emphasise the role of institutions, political leadership and bureaucratic capacity.[4] In these frameworks, institutions and charismatic leadership determines the balance of power between policy coalitions. Ardito-Barletta (1991: 283) goes further to suggest that strong political leadership can change not only the balance of power but also the policy preferences of some groups. In the case of Latin American countries, political leadership committed to reform was determinant for the introduction of structural adjustment policies—Pinochet in Chile, Salinas in Mexico, Fujimori in Peru and Menem in Argentina (Grindle 1996). Also determinant for policy reform was the presence of a coherent technocratic elite within the bureaucracy, able to

manage the technical issues, like the speed of implementation, sequencing and packaging of different types of reforms, and the use of compensation mechanisms for the 'losers' in the new situation (Grindle and Thomas 1991; Haggard and Webb 1994). However, policy-making still involves the active participation of groups from the society. A strong and effective state requires a combination of internal coherence and external connectedness with groups outside the boundaries of the state. This is what Peter Evans calls 'embedded autonomy' (Evans 1992: 176). As John Waterbury argues (1992: 192), 'top-down' change without the support of organised constituencies probably cannot be sustained.

Models, which emphasise state actors, have successfully introduced the role of economic crises to explain policy reform (see Grindle and Thomas 1991; Ardito-Barletta 1991; Waterbury 1992). Significant institutional reforms usually face very strong opposition from those groups profiting from old arrangements. However, 'when economies stagnate or decline over extended periods, elite coalitions that had been instrumental in sustaining prior policy regimes weaken. This dynamic poses a dual challenge to governing elites: it simultaneously robs them of long-familiar political support but opens up the possibility of constructing new coalitions around alternative policy regimes' (Grindle 1996: 47). Alternatively, an economic crisis usually increases the perceived benefits of reform and therefore improves the position of those groups within the state who favour reform. Regime stability is often at stake during a crisis and therefore decision making moves all the way to the top of the political hierarchy. A double opportunity, thus, is created for reform-minded politicians. First, they gain access to the top echelons of the state hierarchy. Second, they have extraordinary control of the state apparatus to advance their own agenda of reform.

In sum, the state is neither a passive agent of society at large and its various interest groups contending horizontally, as in liberal pluralist models, nor an executive committee of a dominant class, as in vulgar Marxism, but rather a dynamic independent force (Skocpol 1985). The literature on state autonomy opens a third wave of thinking about the developmental role of the state, where 'the state is an organisational structure

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[4] See Grindle and Thomas (1991), Waterbury (1992), and Grindle (1996) for the role of political leadership; Haggard and Kaufman (1992) for the role of institutions; and Evans (1995) for the role of the

that is durable and effective with the capacity to induce change and innovation' (Evans 1992: 141).[5] The former two waves failed to find the right role for the state in development. Neither the post-war instrumental and paternal state from structuralist theories nor the minimalist state of neoliberal thinking during the 1970s and 1980s coped with the challenges of development.

1.2. Basic Concepts

This section introduces the two central analytical concepts used throughout the thesis. A frequent attack on the pluralist model and public choice theory is their neglect of the wider institutional framework and organisational environment where policy-making takes place. Not even state-centred approaches have an explicit theory of institutions and organisations despite the fact that they acknowledge them and emphasise their role. These two major concepts are the building blocks in the framework used for the analysis of policy change. They enter into the analysis by constraining the choices and decisions of rational individuals. This thesis moves away from the competition paradigm of the pluralist model and from the rent seeking assumption of public choice and concentrates in the institutional framework and the organisational environment where decision making takes place. Following the same logic than in microeconomics, policy choices take place at the intersection where individual preferences and institutional constraints meet.

Organisations[6]

Organisations represent sets of individuals that benefit collectively from specific institutional arrangements and who consequently share common objectives and policy

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bureaucratic apparatus.

[5] Evans (1992) empirical case is rested not on structural adjustment policies but rather on industrialisation policies. However, his framework can explain the important role of the state on bringing about institutional change.

[6] Organisation is a concept borrowed from new institutional economics to understand the dynamics of institutional change. According to this theory the main purpose of organisations is to promote change when it is in their interest to do so, they are entrepreneurs of institutional change (North 1990).

preferences.[7] Individuals shape organisations, but more important for the purposes of this analysis is the fact that choices are constrained by the specific environment prevailing in those organisations where individuals operate. This organisational environment has two main components: the culture of the organisation that usually takes the form of ideology, traditions and values; and the functional structure representing the hierarchies, procedures and rules regulating decision-making. This environment is usually the result of a historical process in which the organisation shapes itself according to its own objectives and the institutional framework it faces. The culture of the organisation, its functional structure and its individual members are the three main elements providing organisations with a particular identity and specific role in both politics and economics. Despite the fact that individuals ultimately make decisions and choices those decisions can also be attributed to organisations when the individual acts as a member of them. An organisation can thus be defined as a body with decision making capacity and made up by a set of individuals sharing common objectives and values within a functional structure.

Individuals usually manifest their preferences through organisations in the form of coordinated collective actions like lobbying activities, electoral support, labour and investment strikes, demonstrations, and insurrections. However, organisations are not always created despite the fact that it may be advantageous for all individuals involved. This is the problem of 'collective action' present when dealing with public goods that require individuals to act collectively but facing at the same time the incentive to free ride on the other individuals efforts (Olson 1965). The collective action problem can be resolved provided it is possible to introduce a selective incentive structure to the organisation. The larger and more heterogeneous an organisation is, the weaker it becomes and therefore the less effective to advance its own objectives. The problem of collective action will be crucial in this framework to understand why state organisations are more effective than social ones to impose their policy preferences. Attending to the 'Weberian' definition of state I distinguish those organisations within the state from those within society depending on whether they have the intrinsic capacity to make

[7] Political parties, government agencies, trade unions, and entrepreneurial chambers are different types of organisations in this setting.

binding decisions for the rest of the polity or not.[8] This may sound that by definition state organisations impose their views upon societal organisations. However, this is not always the case when the wider institutional framework is taken into account. Social forces can effective constrain the state who cannot freely choose any public policy and impose it to the rest of the society without running the risk of overturning the existing regime.

Organisations are embedded in complex and multiple social systems. For the purposes of this thesis I shall narrow down the discussion to the organisations operating in the political and economic systems. The nature and objectives of each organisation depends on the system in which they operate. Each system has its own function and institutional framework which in turn shapes the incentives of the participating organisations. The internal workings of each organisation along with the interaction between different organisations deliver the social phenomena I am interested in. This framework distinguishes two central issues regarding the role of organisations in human interaction: the process of preference formation[9] within each organisation and the balance of power[10] between organisations with alternative policy preferences. Different organisations usually have very different objectives and policy preferences considering the individual background of their members and the interests of the organisation itself. Each organisation perceives the reality from a different perspective and therefore have conflicting ideas about the direction that institutional change should take. The interaction between organisations is thus dominated by a notion of conflict and power.

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[8] In this thesis we follow the Weberian definition of state (Weber 1978). In this definition the state has the monopoly of power associated with legislative, executive, and judicial authority. The state embodies the public power in the form of organisations controlling the administrative, legal, and military apparatus with the authority to make binding decisions for people and organisations located in a particular territory and to implement these decisions (Evans 1985: 46-47). The state is thus a set of organisations but it is also and simultaneously the people who carry out the functions essential to the state —individual policy makers, bureaucrats, and administrators that are placed in authority over others (Alt and Crystal 1983: 23).

[9] The process of preference formation has been barely studied despite its crucial importance for understanding apparently politically irrational policies. Grindle and Thomas (1991) deal explicitly with the role of preferences in policy reform.

[10] The ultimate purpose of each actor participating in politics is to improve her relative influence on public decision making. Accumulation of power defined as the "...capacity of a man or a number of men to realise their own will in a communal act even against the resistance of others who are participating in the same act (Peterson 1980: 185)" is thus the main goal in politics. Power, as a concept derived and solely understood in the wider context of institutions and organisations (see Dugger 1980) cannot be excluded from any analysis of policy-making.

Although the interaction between organisations is constrained by the existing balance of power, their actions introduce a dynamic to such balance. They have strong incentives to devote resources to improve their positions in the existing configuration of power. This simple economic calculation has profound implications for the way the polity is organised and likewise for the performance of the economy (North 1990). Organisations are not only important constraints to individual choices but they are also agents of institutional change. Next section shows how institutions and public policy have this dual role too.

Institutions

Emphasising the role of institutions in social processes is not a new strand of research in academic work. Thorstein Veblen [1904] and John R. Commons [1934] first introduced institutions as an analytical concept to economic analysis early this century. These authors made pioneering work on the role of culture, power, and ideology. However, according to William Dugger (1992: 64), 'even today there is no clearly defined body of principles on which institutionalists are generally agreed and by which they are known.' In contrast to classical institutionalists, who concentrated only on the role of institutions on individual behaviour, new institutionalists combine institutions and individual preferences to explain political and economic choices. The definition of institutions used in this thesis is different to the one traditionally adopted in political science and more in the line with the literature of new institutional economics. I use Douglass North (1990: 3) definition of institutions as "humanly devised constraints that shape human interaction.' This rather loose definition introduces to the analysis the required flexibility to identify and describe the actual determinants of individual and organisational behaviour in a complex setting like the Mexican political economy.

Individuals have limited capacity to process all the information required to make decisions and therefore create rules to overcome this natural shortcoming of human rationality (North 1981; 1990; Meier 1991). These rules secure some regularity to otherwise infinite possible scenarios reducing in this way the computational requirements of everyday choices. Nonetheless these rules become at the same time major constraints to those same choices they are intended to facilitate. Public policies are the most obvious cases of this apparent contradiction; they, once implemented, are

constraints to individual behaviour, but at the same time the process itself of policy-making is constrained by formerly introduced policies. In other words, implemented policies are rules but the process through which rules are made has its own rules. This thesis is concerned with how policy-making is constrained by existing rules (rule making process), and once policies are implemented how they in turn constrain individual decisions and choices (rules themselves). The first part—how policy-making is constrained by existing institutions—falls within the field of politics exclusively. However, the second part—how implemented policies constrain individual behaviour—can be usefully applied to both politics and economics.

By studying institutions the present study intends to improve the understanding on the dynamics of how public decisions are made and enforced.[11] By enforcement I mean the process through which these decisions are actually made binding for the rest of the society. Enforcement usually takes the form of sanctions to actors' behaviour either by coercive means or by reducing the effectiveness of their actions upon desired outcomes. The set of feasible actions to achieve certain ends is limited and marked off by the institutional framework. The logic of the system force actors and organisations to observe established rules, otherwise the desired results may not be attained. For instance, a private organisation that wants to influence effectively a particular public policy must choose from the set of actions regarded as 'legitimate' given the existing constraints.[12] In the same way state organisations cannot use different mechanisms of control to those implicitly agreed upon in the original social contract, otherwise they run the risk to have the regime overthrown.

The analysis identifies two major categories of institutions: formal and informal. The first set of rules is usually the body of legislation existing within the polity that includes constitutions, international agreements, decrees, laws, by-laws, etc. They follow a formal procedure for their introduction and are enforced by the authority in most of the cases. The state has the monopoly of their enforcement but not of their introduction or modification, where social organisations have also an important role influencing their

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[11] For public decisions we understand those that are binding for the whole polity.

[12] We use the notion of private and social actors interchangeably in the same way that public, state actors, and authority are equivalent notions in our framework.

content and nature. The second set of rules comprise those informal practices, codes of conduct, conventions, and ideas that evolve over time becoming embedded constraints to actors behaviour within a given polity. The relative importance of formal vis-à-vis informal institutions depends on the specific system where the interaction takes place. In long-established democracies formal rules may be more relevant in policy-making processes than informal practices.[13] Conversely in countries with old cultural traditions but under authoritarian regimes or democratic transition, informal rules more than formal legislation constrain individuals behaviour.[14]

1.3 The Politics of State Autonomy

In the context of this thesis, the politics of state autonomy refer to the interaction between state and society in making decisions concerning the whole polity.[15] This interaction is regulated by the existing political institutions. They constrain the ability of groups to organise and press their interests and the capacity of government officials to act. Moreover, political institutions shape the configuration of power between state and society, which in turn translates into differential access to decision-making. This section introduces a framework to study the political influence of the state *vis-à-vis* society. I use this framework to evaluate state autonomy in Mexico from a historical perspective.

The Model

The framework is based on a multi-layered model where each level represents a different degree of political organisation. Voters operate at the most basic level, where the degree of political organisation is very low and political participation takes place mostly through elections. Interest groups operate at an intermediate level, where actors

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[13] The United Kingdom is an important exception, being an old democracy where evolved informal institutions are as important and maybe more than formal ones.

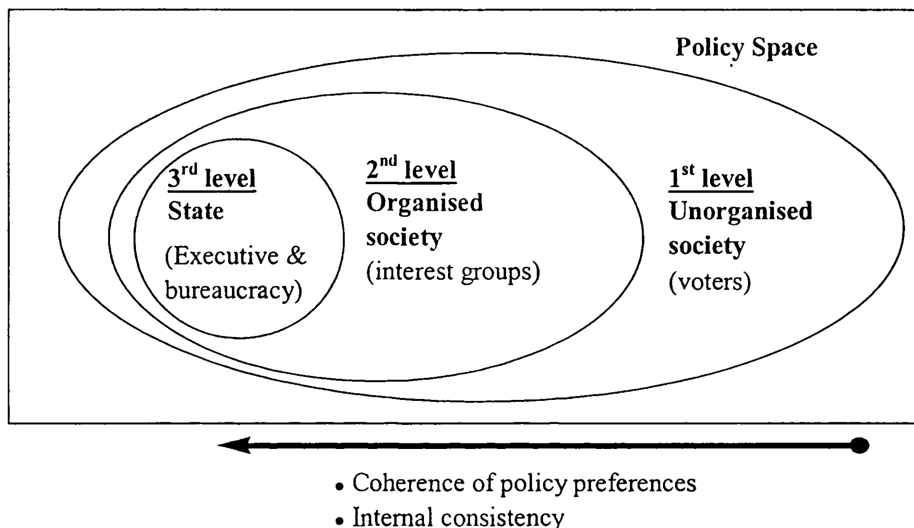
[14] Mexico is an interesting case in which imported democratic institutions were superimposed on an ancient culture dominated by myth and religion. These two sets of rules are often in conflict, however, the mechanisms for enforcement are usually more effective in the case of the old informal institutions.

[15] I make a fundamental distinction between political system and state. The state is made up of, and limited to, those organisations that are endowed with society-wide decision making authority. In this sense we follow the Weberian definition of state (Weber 1978). In contrast, the political system represented by an institutional framework is the arena where the interaction between social organisations

display greater coherence and their influence is exercised through policy networks. Finally, the government operates at the highest level, where the actors have the highest organisational coherence and direct access to decision making.

Figure 1.1

Levels of Political Organisation



The degree of political organisation is translated into political influence that is in turn represented by the size of the policy space circumscribed by political institutions under which actors operate (see Figure 1.1).[16] State autonomy is represented by the size of the policy space at the third level. Political institutions are also classified depending on the level at which they are relevant. The first and more general level includes institutions determining the extent to which society at large can constrain state actions—namely, those that establish the type of political regime, whether authoritarian or democratic. The second level concentrates on institutions structuring the interaction between the state and interest groups. Finally, the third level analyses institutions that shape the preferences and behaviour of those individuals controlling the state apparatus.

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and the state takes place. This is a fundamental departure from some other authors, who define the state in a broader sense making it equivalent to our definition of political system.

[16] The policy space is the range of options with possibilities of being introduced open to the decision maker without risking their hold of power (Grindle and Thomas 1991: 8). This space is determined by the institutional framework and organisational environment where the decision maker operates.

1st level: Voters

The social contract, understood as a broad agreement on basic rules by all the members of a given polity, is the most important institution at the first level. Compliance with this contract takes the form of political legitimacy that in a democratic system is associated with elections. At this level, unorganised individuals can voice their main concerns by casting their votes, elections are the mechanisms through which society at large participates in public decisions, in exchange for a tacit acceptance of the political leadership. Public policies will reflect voters concerns, usually related to economic issues, to the extent that incumbents face the real threat of being sacked through an electoral process. As long as elections matter, the electoral calendar will also have important implications for the timing and implementation of policy decisions.[17] The more democratic institutions are, the more influence voters have on shaping politicians agenda—median voter hypothesis—and therefore, the smaller the outer circle in figure 1.1 becomes.

Voters, given their low degree of organisation and policy coherence, are more concerned about general outcomes than specific policies. Voters in societies with low levels of political awareness accept unpopular policies—e.g. stabilisation programmes—in exchange for popular outcomes—e.g. consumption booms. The electorate in Mexico backed President Salinas's unpopular policies in the 1991 and 1994 elections. In these cases, electoral outcomes rarely convey the policy preferences of voters. In fact, it is difficult to define a coherent set of policy preferences at this level. However, electoral outcomes do represent the amount of popular support for the regime depending on the performance of the economy immediately before the elections. Political elites are continuously re-engineering the bases of popular support for the regime (Haggard 1990: 3-4).

Voters in Mexico, as a political group, do not have a coherent set of policy preferences and do not represent an internally cohesive organisation. It may be argued that political parties are the organisational representation of voters. For Joseph Schumpeter (1994:

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[17] Politicians and policy makers seeking to remain in office behave according to an electoral cycle in which important decisions that may impair their popularity in the proximity of elections will be postponed or not taken at all.

283), political organisations like parties are simply the response to the fact that the electorate cannot articulate their preferences and co-ordinate their actions without a pre-established framework. Political parties are intended to regulate competition among potential state leaders for the vote of the electorate. However, the close links between the PRI and the Mexican state further decreased the ability of voters to influence policies. Until recently, elections were not effective mechanisms of social participation and therefore legitimacy was more associated to ideological discourse. The Mexican regime rested on the foundations of the PRI and its allied unions of peasant organisations, a powerful political machine that based its claim to power in Mexico's revolutionary past. In Mexico, political leaders have not so much incorporated threatening social organisations into state agencies as they have into the PRI (Migdal 1988: 232).

President Salinas, aware of increasing political constraints at the first level resulting from effective electoral competition, replaced the traditional corporatist structure of the PRI by a new network of geographical units organised under the umbrella of the *Programa Nacional de Solidaridad* (PRONASOL). This programme represented a major change in the patronage machinery. The automatic right of PRI operatives to distribute state resources was extensively curtailed and the availability of resources for local development was increasingly channelled through PRONASOL. This programme meant that quick disbursing of funds was distributed to organisations from local communities by the President's office. The old PRI-dominated networks of patronage were increasingly directed to reassert the President's popularity (Grindle 1996: 94). According to Miguel Centeno (1994: 65), PRONASOL was the key to consolidate the position of President Salinas, who built new bases of support at the same time that he dismantled the old ones.

Finally, Mexico's political democratisation increased the influence of the electorate in policy-making, further limiting the autonomy of the state. Political parties, the Congress and non-governmental organisations are increasingly capturing political spaces where they can exercise some influence on the President. The political reform still has to make a deep and comprehensive reform of the legislative, including procedures, committees, re-election, staff and 'profesionalisation'.

2nd Level: Interest Groups

At the second level, the most important institutional feature of the political system is the society's organisation into interest groups. The institutions at this level structure the relationship between the state and organised groups within society. The form of this interaction depends on the incentives for individuals to organise themselves into interest groups. States with greater executive autonomy are exposed less to influence from interest groups than those with an active legislature that are more receptive to them. Interest group activity in an executive-dominated state usually takes place through informal links and negotiations with the bureaucracy, whereas in a state dominated by the legislative interest groups pressure is exercised in the form of lobbying. Interest groups have more coherent policy preferences and are internally more cohesive than voters but less so than the state. They are more concerned with specific policy outcomes rather than with policies themselves. As long as policies deliver economic rents, secure property rights, or provide public goods, interest groups will not promote a change in those commanding the state.

In Mexico under President Salinas, the political discretion of major businessmen, the absence of an explosively sensitive public opinion and the political pragmatism of state officials enhanced the communication and collaboration at this level. In fact, the organisational structure of some state agencies, like the Ministry of Finance or the BdeM, provided the right conditions to develop one of the best-established policy networks. Juan Ignacio Gil, President of the National Insurance and Bonding Commission (CNSF), conceded that 'the nature of Mexican politics is such that personal contact between state officials and private financial executives is a common practice' (Interview: Mexico City, September 1st 1995). The exchange of personnel between the state and commercial banks became an important element in the policy network for the financial system. The experience of these ex-public officials provided an excellent asset in terms of connections and knowledge about the internal structure of public organisations and the actual functioning of the policy-making process. Because of the profitable relationship between the financial sector and the state, former bureaucrats often move to financial firms where they have good business and career opportunities (Camp 1989: 85). In addition to their obvious economic importance, the private

financial organisations are politically significant because they usually represent or lead the private sector in general (Garrido and Quintana 1987: 108).

The most prominent private organisations for the financial system are the large financial groups, usually organised around a bank. Three major banks only have traditionally dominated the system, namely: *Banco Nacional de México* (BANAMEX), *Banco de Comercio* (BANCOMER) and Banca SERFIN.[18] These three major financial groups control most of the financial resources in the country and the network of connections with the state.[19] Regular collaboration usually takes place between the state organisations and the large financial groups only. Despite this phenomenon of market concentration, the nature of each major private organisation and its relationship with the government is different. For instance, BANAMEX is a leading private financial organisation with a reputation for being a sympathetic collaborator with government policies, in contrast to SERFIN, which is considered more critical and distant regarding its relationship with the government.[20]

The marriage of finance and industry further increases the 'political leverage' of these interest groups. Large groups enjoy privileged access to decision making and the benefits derived from those policies. For instance, the foremost beneficiaries of state policy during the borrowing period in the 1970s were large financial and industrial groups. These groups had better access to foreign finance, state subsidies, subsidised development finance, parastatal orders and (if relevant) trade protection (Frieden 1991: 193). More recently, the divestiture programme under President Salinas mostly benefited this group. Foreign investment was forbidden during the privatisation in order

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[18] This configuration has changed somewhat in recent years as a result of the commercial banks' privatisation and the banking crisis in 1995.

[19] The concentration in Mexico's financial markets dates back to last century, but it speeded up during the 1940s and the 1950s. In 1950, 14 banks controlled 60% of total resources, and by 1960 only 7 banks controlled the same share of the market. Furthermore, 13 banks controlled 72 per cent of the 1,003 branches, 80 per cent of private bank resources, 77 per cent of exhibited capital, 81 percent of profits. The largest four banks (BANAMEX, BANCOMER, Banca Serfin, and COMERMEX) controlled 57 percent of the total branches, 63 percent of total resources, 63 per cent of exhibited capital, and 61 per cent of profits. By 1968, the same four banks controlled 67 per cent of private bank resources, 49 percent of exhibited capital and 65 percent of private bank profits. BANAMEX and BANCOMER alone controlled 41 percent of the branches, 45 percent of the total resources, 32 percent of exhibited capital, and 40 percent of the profits (White 1992).

[20] In the 1930s the Legorreta family. controlling BANAMEX, identified themselves with Eduardo Suárez and his views towards development. More conservative fractions within the business elite found an ally in Luis Montes de Oca (Hamilton 1982: 131).

to protect the interests of domestic investors. The deregulation of banking operations also improved the banks' profitability between 1991 and 1994. The state policies have consistently favoured the interests of major businessmen but always within the policy parameters set by the state itself.

3rd Level: The President and the Bureaucracy

Finally, the third level is concerned with how institutions shape the behaviour of political leaders and state managers, the actors who actually make the final decisions. The state, as an organisation mainly engaged in policy-making, usually has a well-defined and coherent set of policy preferences. As opposed to the other two aggregates, voters and interest groups, the state is concerned about both, outcomes and policies themselves. That is to say, state actors are not only concerned with remaining in power by delivering the outcomes demanded by the society, but they are also interested in advancing their own specific views over competing ones on how to deal with public issues. Decision-makers have some discretionary power to handle the public issues, regardless of institutions and organisations (see Grindle and Thomas 1991). Within this policy space they articulate their responses according to personal experience, values, ideology, or training. Political leaders have the policy space to define the content, timing and sequencing of reform alternatives. However, they shape policies to make them politically and bureaucratically acceptable for divergent interests in the society.

In Mexico, one of the most prominent political institutions at this level is the centralisation of decision making in the executive branch of the state, especially in the presidency. This state actor wields maximum power for a six-year period. Among the political responsibilities of the President, according to Merilee Grindle (1996: 49), are: to keep the stability of the political regime; to settle the most important disputes that cannot be solved at lower levels; to build support coalitions for the regime; and to create confidence among social groups. Regarding policy-making the President's main tasks are to set the broad outlines of official policy; to determine the objectives for national development; and to appoint and empower high level officials (Thompson 1979: 56; Grindle 1996: 185-189).

Mexico has a relatively well institutionalised public bureaucracy that expands the capacity of state leaders to set the terms of policy-making. The President relies to a great extent on the bureaucracy for policy development and implementation. The bureaucracy in Mexico is a centralised body, deeply embedded into the economic and social relationships of the state, and highly sensitive to the leadership of the President. Opinions about possible policy measures are solicited and channelled back to the President, usually through communication networks that the bureaucracy has established with the PRI and the private sector (Thompson 1979: 53).

1.4 State Autonomy and Policy Reform

Most of the institutional studies on policy reform are structured around variables like institutional framework (Haggard 1990; Geddes 1994), bureaucratic capacity (Evans 1995), international forces (Maxfield 1990; Stallings 1995) or political leadership (Grindle 1996). However, few of them have explored how these variables enter into each specific stage of the process of policy reform.[21] I found it useful to introduce this dimension to the analysis because the effect of these variables on the final outcome is neither unique nor homogenous throughout the process. The process of policy reform can be decomposed into two meaningful analytical stages: agenda setting and implementation.[22] These two stages are essentially different in terms of the decisions made, the organisations and institutions involved and the role played by the wider historical and international context. Yet the issue of state autonomy is crucial in both of them.

At the stage of agenda setting, actors make decisions on what ought to be done. The politics of international capital, either shaping ideas and preferences of state elites or inducing policies, is essential at this stage. The international context in the form of economic conditions and policy trends is more influential in shaping the policy agenda of domestic states the more dependent they are on international capital, which has been

[21] Grindle and Thomas's (1991) study on policy reform is one of the few that goes deeper into the analysis of each of the stages of the process itself.

[22] The stage of agenda setting is sometimes referred to as decision making. We avoid using this term because it may create some confusion since decisions are made throughout the process, including the implementation stage.

the case in most LDCs throughout history. At the stage of implementation, actors make decisions on how to get things done. Political negotiation, bureaucratic capacity and balance of political power come to the fore at this point in the process. The relative strength of interest groups to negotiate with the state also shapes the implementation of policies. External factors set the general parameters for the policy agenda, whereas domestic institutions shape the specific political processes of the implementation (Bowles and White 1994: 244).

The role of an autonomous state in policy reform is better perceived by looking at the specific conditions where this shift takes place. Williamson (1994) discusses several hypothesis about policy reform; they can be grouped into two different categories: first, those related to the specific context in which the reform takes place; and second, those about the state capacity required for a successful reform. From this perspective, the phenomenon of policy reform is usually the combination of external connectedness, on the one hand, and internal autonomy, on the other (Evans 1992: 176). External connectedness provides the initial stimulus for reform through economic shocks transmitted from abroad and conditions the policy responses through the prevailing international policy culture (Haggard 1990: 28).

The financial system provides an excellent case to illustrate the two main dimensions of analysis, namely: international dependence and domestic autonomy. Regarding the first dimension, the financial system is the most important link between the domestic political system and international capital. With regard to the second dimension, the policy coalition organised around the financial division of the executive bureaucracy is the dominant group within the state. The interest groups operating in the financial system are among the most influential and best organised in the Mexico. Furthermore, the outcomes from the reform to the financial system are particularly consequential for economic performance: the financial system determines savings and investments decisions; the most important prices in the economy, interest and exchange rates, are determined in the financial markets; and state financing depends crucially on the conditions in the financial system.

Agenda Setting: The Politics of International Capital

The agenda is formed by two types of issues depending on the circumstances under which they come to be included (Grindle and Thomas 1991: 73). The issues introduced in the context of a crisis, often imposed on the state by the wider historical and international context, are usually linked to essential political goals like regime stability. Alternatively, issues from politics-as-usual situations, usually the result of technical analysis, are often related to the day-to-day management of the state. Policy reform belongs to the first type of policy issues, those in which the stake at play is very large and involves the top levels of the state's hierarchy. They come to be included in the agenda as a reaction to situations threatening the stability of the regime, like sustained periods of economic stagnation or increasing international pressure for reform.

The financial dependence of LDCs places their political leaders in a disadvantaged position vis-à-vis international capital. Policy trends concerning capital in the international arena are major guidelines for domestic political leaders when setting their policy agenda. In fact, at this stage political leaders often become agents of international capital, translating the demands of capital into concrete policy actions in their domestic countries. Capital exercises its influence mainly by threatening politicians and policy makers with capital flight. They do not engage in negotiations, they only react to policies. Policy makers are, however, very well aware of the demands of these groups and use the behaviour of capital markets as an indicator of capital approval of their policies.

At this stage, the international dimension enters, in the form of international policy networks in which some ministries or agencies within the state are in continuous communication and collaboration with international organisations. External influence is usually stronger the more centralised decision making in the executive is relative to the legislative, and the more insulated it is from domestic interest groups. All these elements have a strong content of an international policy culture, transmitted either through policy networks or political leaders and bureaucrats educated in major intellectual centres (Ikenberry 1990; Kahler 1992). To the extent that state elites control the process of policy-making, this international policy culture is more influential in the content of public policies. As at the other levels, the more autonomous the state is the

larger is the space for external forces to influence policy decisions by shaping the preferences of the state elites. It is always easier to influence a small circle of top elite officials than to change the views of a whole society.

In an increasingly interrelated world, dominated by market economies, international capital in the form of investment has become a condition *sine qua non* for economic growth (Block 1977: 15). This means that domestic states cannot ignore the implicit demands of external finance when shaping their policy agendas. Furthermore, power relations between states also constrain domestic decisions. Powerful states committed to the worldwide spread of democracy and free-market economies like the US may press other states through economic incentives or sanctions to introduce some changes to their political economy.

As mentioned earlier, an economic crisis is a major component of policy reform in which opportunities for reform are created. Lying between economic circumstances and policy reform is a political process, by which international influence translate into effective political actions aimed at policy reform (Bates and Krueger 1993: 454). For example, the effects of external shocks during the 1980s were mediated by pre-existing institutional arrangements leading to a shift in the balance of power between different groups. In states heavily reliant on international capital, the financial agencies gained substantial power and their responses were shaped according to the policy prescriptions of major international actors (Maxfield 1990; Stallings 1992). The content of the reforms thus reflected not only the severity of the external financial constraints but also the nature of the political conflicts surrounding the crisis and the political strategies of state leadership.

Implementation: Domestic Politics

At the stage of policy implementation the requirements of international capital moves to a second place and domestic political negotiation take the prime role. Operational issues like timing, scope, and contents are decided upon at this stage (Bates and Krueger 1993: 11-16). It is at this stage where most interest groups articulate their actions in order to advance their interests. In other words, most collective demand making occurs, interests are accommodated, and conflicts are resolved, when policies are implemented (Meier

1991: 305). The distribution of power among those with competing views on how to deal with the issues already included in the agenda determines how the policies will be implemented. State managers and bureaucrats become middlemen between state resources and domestic interest groups (Evans 1985: 205). They design the schemes through which funds are distributed among competing domestic groups. Lobbying and rent seeking find their most profitable opportunities when resources are distributed at this stage.

As opposed to international capital, those groups with fixed assets not easily transferable between countries become active rent-seekers, devoting resources to gain preferential access to state benefits. Transnational corporations and domestic industrialists were very influential during the 1960s and early 1970s when the main form of international capital was direct investment (Bates 1988: 7). However, by the late 1970s and throughout the 1980s, multilateral lending replaced direct investment as the main form of international transfers and hence conditionality more than direct negotiation became the major determinant of how policies were implemented.[23] By the 1990s, investment in securities, in turn, replaced loans as the main financial instrument in international transactions. In the new framework, signals of sound economic policies and investment climate became paramount.

A state apparatus with significant autonomy from social forces, and supported by capital is essential for the implementation and management of policy reform. In other words, a coherent bureaucracy prevents the state from being captured by rent seeking interest groups, but also provides institutional channels for societal involvement in the reform (Evans 1992: 163-165). Internal autonomy allows the state to break up the existing alliances favouring the *status quo*. The initiative for reform usually comes from groups within the state,[24] despite being originally motivated by external events. According to Douglass North (1981: 32), 'institutional innovation will come from rulers rather than constituents since the latter always face the free rider problem.' Most of the policy

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[23] Conditionality refers in the literature as the negotiation between MFOs and domestic states over a set of changes to economic policy that had to be implemented in return for a loan or a grant (Lipson 1988: 48).

[24] Frieden (1991) argues, however, that economic interest groups are the most compelling explanation of economic policy in Latin America during the 1970s and of regime change in the 1980s. This view sharply contrasts with most of the literature on policy reform, which affirms the prime role of the state bringing about change.

reform in the 1980s was promulgated through presidential decrees rather than as law debated and passed through legislatures (Grindle 1996: 35; Veltmeyer et.al. 1997: 80). Some authors go further to suggest that policy reform in LDCs was designed in Washington and imposed without debate, or any input whatsoever from the social sectors that were expected to bear the costs of their implementation (Veltmeyer, et.al. 1997: 19-20). Nevertheless, top-down reform without the support of organised groups probably cannot be sustained; therefore, to account for the stability of policies, they have to be included in the analysis (Waterbury 1992: 192; Bates and Krueger 1993: 457).

Policy reform usually represents a break from existing arrangements and therefore requires new bases of support to make it viable in the long run. These bases of support are often groups from the society expecting to benefit from the new order of things. However, these future benefits are still uncertain at the moment of reform and, therefore, strong political leadership is required to align these groups behind the reform efforts. Investors must be among the supporters of the reform efforts, otherwise the success of the reform may be jeopardised. Without money flowing into the economy, is difficult to convince a sceptical population of the benefits of reform.

Finally, the organisations involved in Mexico's financial reform were agencies in the financial branch of the executive bureaucracy and the financial groups. Financial liberalisation never reached the electorate. The Congress was also excluded from the actual discussion and implementation of the financial liberalisation. Isaac Katz, an expert on the Mexican financial system at ITAM, acknowledged that 'the Congress has not been a major player in the design of the policy for the financial system... Most of the regulation for the financial system comes from proposals of the executive sent to the congress for their approval. This legislation requires a high degree of technical expertise that rules out the possibility of an actual debate in the Congress; and it is usually approved without major modifications' (Interview: Mexico City, September 13th 1995).

1.5 Central Hypothesis and Structure of the Thesis

The main claim of this thesis says that the main stimulus for Mexico's financial reform came from political imperatives as understood by President Salinas and his economic

team. The analysis of Mexico's financial reform shall try to show how economic reform was intended to engineer new bases of support for the regime and consequently to consolidate the President's political leadership within the new parameters set by economic globalisation and political democratisation. Economic reform, gradual democratisation, and social spending were all policies subordinated to the goals of reasserting presidential authority, government capacity and the PRI's electoral hegemony. Mexico's financial reform was the result of political entrepreneurial initiative *à la* Meier (1991). The charismatic leadership of President Salinas aligned a powerful coalition of support for economic reform. Each case study discusses how Salinas used extensively the organisational and institutional infrastructure of the quasi-authoritarian Mexican state to overcome the legitimacy deficit he inherented from the 1988 elections. President Salinas, I claim, devoted an important part of the state's resources to gain popular support for the regime from the beginning of his term. His government was very well aware of political constraints. Largely for this reason, Salinas sought to boost the purchasing power of the peso, leading to an enormous increase in the current account deficit. The deficit went up from $2.7 billion dollars in 1988 to $24.4 billion in 1992 and $28.8 billion in 1994 (Presidencia de la República 1995: 68). President Salinas emphasised the need to provide a positive image of Mexico in the outside world in order to attract investment and boost the economy.

Mexico's financial reform represents a case where President Salinas redefined the economic role of the state in order to reduce the state's exposure to economic swings and to increase state capacity. According to Jorge Domínguez (1987: 76), while good economic performance helps regimes and incumbents to generate legitimacy, poor performance serves to undermine legitimacy. Salinas sought to avoid potential conflict and to make new alliances with powerful groups, like financiers and large industrialists, by scaling down the economic activities of the state. His reform also intended to release state resources so they could be re-directed to strategic areas where the state could exercise more effective control upon society and the economy.

The political discourse during this period stressed the importance of improving state capacity to satisfy the needs of the poor. In his inaugural speech, President Salinas outlined this vision:

> '...the crisis has shown us that a larger state is not necessarily a more capable state; a state that owns more is not necessarily a state that is more just. The truth is, in Mexico, more state has meant less capacity to respond to the social needs of our fellow countrymen and, in the end, greater weakness of the state itself. All the time the activity of the public sector was increasing, attention to the problems of the highest social priority was decreasing' (quoted by Golob 1997: 132).

Anne Krueger's (1974) 'pluralist' hypothesis represents an alternative approach to the one presented in this thesis. According to this approach, public policy is the result of competition between interest groups. In other words, organised interest groups push the government to introduce reforms. Considering Mexico's financial reform from her perspective, it follows that the coalition of interests that favoured the reform outweighed the coalition that opposed it. However, I claim that broader state priorities like regime legitimacy weighted more heavily than support from specific constituencies when the decision to reform the financial system was taken. The interest groups that benefited from the reforms, though powerful, did not have the capacity to subordinate the government's political agenda to their own private interests. In this case, the relevant groups—international and domestic capital—displayed considerable influence but the state still preserved the power to set the parameters for economic policy-making. For instance, President de la Madrid's financial policy favoured a new interest group organised around the stock exchange and the brokerage houses. Important policy decisions served the interests of this group like the sale of non-banking concerns after the nationalisation and the emission of government securities. However, these decisions responded in the first place to the financial needs of the state during the 'debt crisis'.

Alternatively, according to the 'benevolent planner' hypothesis of neoclassical economics, the financial reform responded to the legitimate need to improve efficiency and foster economic growth. Under this approach the reform was an economic imperative for the government, which is the guardian of the public good. I claim that although appealing from a normative perspective, this explanation has obvious shortcomings. First, it is based on the rather naive assumption that policy makers and politicians are selfless agents. Second, it does not explain why Mexico did not reform the financial system earlier, in the 1970s. At that time, the financial system already

lacked the flexibility to adjust to external shocks that called for reform (Aspe 1993; Ortiz 1994). In fact, there was already a trend all over Latin America towards financial liberalisation. Edward Shaw (1973) and Ronald McKinnon (1973) laid down the theoretical foundations for financial liberalisation as early as 1973. Moreover, President Salinas was not more 'benevolent' than President Echeverría.

The combined facts that President Salinas did not run his electoral campaign on economic reform, and that the Mexican electorate is not pro-market, appears to reject the public choice hypothesis of the 'median voter'. The answers to Mexico's financial reform provided by the pluralist, neoclassical and public choice approaches seems unsatisfactory and, therefore, require further analysis. Given the *sui generis* characteristics of the Mexican political system, this thesis looks for the answer on the political imperatives of the state. Policy change in Mexico cannot be understood without addressing issues like political leadership, state financing and coalition building.

Financial Collapse

Despite the fact that the thesis is mainly concerned with the casues of policy reform, it was not possible to avoid an enquiry into the consequences of these decisions in terms of the Mexico's 1994 financial crisis. This event illustrated how politically motivated decisions have very often-pernicious economic effects. I claim that the financial reform was one of the two main elements that caused the 1994 crisis, the other being the political cycle associated to the presidential succession. The incentive structure resulting from the financial reform under President Salinas reduced the margin for policy error while political democratisation pushed the government to take decisions whose outcomes were difficult to anticipate. The lack of effective reform to Mexico's presidentialism made the combination of free market reforms and stronger political competition mutually frustrating. The financial system is highly sensitive to political events. In the case of Mexico specifically, the financial system is one of the most important institutional arrangements through which the consequences of the political transformation currently taking place are transmitted to the rest of the economy.

I believe that the combination of financial reform and a quasi-authoritarian regime brought about an incentive structure that fostered speculative, short-term and extremely

volatile investment, at the expense of productive, long-term and more stable investment. Reasserted presidentialism in a liberalised economy created a fragile equilibrium where investment and capital inflows depended to a great extent on the perceived strength of the President and not on the stability of genuinely democratic institutions. The six-year cycle of presidential authority seems to explain very well how the same bureaucracy, same managers and same government, has different degrees of economic and political control along the *sexenio*. Towards the end of the term, presidential power wanes at a very fast pace leaving the bureaucracy and the political machinery without effective mechanisms to steer the economy and discipline the political elites.

As opposed to the 1994 crisis, the economic crises in 1976 and 1982 are easily explained by orthodox economic theory. Fiscal and external imbalances induced by the government's expansionist policies became critical at the end of the presidential term. The accumulation of debt and over-dependence on oil characterised the economic policy between 1979 and 1982. Capital flight was the ultimate cause of the collapse of the peso and the subsequent economic crisis. However, under this perspective it is much harder to explain the failure of economic policy to avoid the crisis in 1994 (Philip 1998: 24). This crisis has two fundamental differences to those in the past: public balances were in equilibrium, and external imbalances were not caused by the government's expansionist policies. Yet, they share a remarkable similarity: all of them were ultimately caused by capital flight at the end of the presidential *sexenio*.

Thesis Structure

The thesis is organised into three parts. The first part—chapters one to four—develops the framework, both historical and institutional. The first chapter outlines the theoretical discussion on state autonomy and develops a simple analytical framework to study public policy decisions. The subsequent three chapters address three main themes: external dependency of domestic states on international capital, political change under President Carlos Salinas and financial policy in Mexico. The second part presents the analysis of three main institutional changes to the financial system—development banking reform, commercial banking privatisation and autonomy of the central bank. Each specific case study shows how the reforms conformed to the ideas of the dominant consensus on economic policy and how they delivered an inefficient incentive structure.

The third part—chapter eight—brings together all the elements discussed throughout the thesis to explain Mexico's 1994 financial crisis. Finally, the appendix explains the methodology followed in this thesis and describes the sources of information.

Each of the three case-study chapters is divided into four sections. The first section of each chapter shows how the postulates of the dominant economic orthodoxy shaped each institutional change in the financial system. The second section presents the specific circumstances under which each particular reform took place. The third section illustrates how the political imperatives of President Salinas's government pushed for each one of the reforms. Finally, the fourth argues that the outcomes from the reforms failed to deliver a sound institutional framework for the financial system. This structure resembles Robert Bates and Anne Krueger's (1993: 11-16) policy stages: the period prior to the reform, when the issues are the political and economic factors leading to the decision of policy change; the reform itself, when the emphasis switches to timing, scope, content and implementation; and finally, the post-reform period, when the questions are the outcomes and their institutionalisation.

Chapter two discusses the politics of international finance as the initial source of reform. The chapter is divided into three sections. The first establishes the 'political leverage' of international capital from three different angles: financial globalisation, state financing and balance of payments financing. The second section describes the new consensus on economic thinking, how it was reached and how it is related to the financial reform in Mexico. Finally, the third section introduces the notion of transnational policy networks, in order to show how the existing institutional arrangements in the world economy favoured the rise to power of a technocratic elite committed to pro-market reforms in Mexico during the 1980s.

Chapter three is chronologically organised into three sections. The first section argues that the present autonomy of the Mexican state is the result of a quasi-authoritarian framework dating back to the 1940s. The second section shows how the reconfiguration of power between policy coalitions during the 1980s placed reform-minded *technocrats* in key positions of government. Finally, the third section argues that policy reform under President Salinas was intended to engineer new bases of support for the regime

within the new parameters set by an increasing integration to the world economy, on the one hand, and by increasing democratic competition, on the other.

Chapter four is also chronologically organised into four sections, each part dealing with a specific period in the history of Mexico's financial policy. The first section comprises the period between 1925 and 1952, when the government introduced the institutional framework of the financial system existing prior to the reform. The second section deals with the period between 1952 and 1982, when the financial policy was characterised by strong state intervention. The third section presents the period between 1982 and 1988, when the first attempt of financial liberalisation took place. Finally, the fourth section presents the main period of study of this thesis (1988-1994), when the government removed all the controls on banking operations.

Chapter five presents the case of the reform of development banking. This is a special case because there was not an explicit attempt at reform, yet the state changed fundamentally the traditional role of development banking during this period. This case also introduces an additional element to the analysis: interest groups, closely linked to development banking but outside the financial system, like small entrepreneurs, workers and peasants organisations, were relegated from the decision making process. This fact has important implications for interest groups activities. I shall argue in this chapter that the limited influence of non-financial interest groups in the reform of development banking, despite having big stakes in the reform, was caused by the reconfiguration of power within the state in favour of the 'financial coalition'.

Chapter six analyses the case of the privatisation of the commercial banks. I argue that, among all the reforms to the financial system implemented under President Salinas, this was the most representative case of a state-engineered change. The state deployed its institutional capacity to bring about swift and fundamental change to arguably the most important sector in the Mexican political economy. This policy was pivotal to advance President Salinas's economic and political agenda. First, the privatisation improved the investment climate in Mexico more than any other single policy—capital inflows skyrocketed during the second part of the *sexenio*. Second, the privatisation consolidated President Salinas's political leadership by securing the support of the financial elite and providing liquidity to finance the social spending programmes.

Chapter seven discusses the reform to the legal status of Banco de Mexico (BdeM). I argue that the reform was mainly 'cosmetic' and aimed at increasing capital inflows and securing financing for the state. Late in the 1980s and early 1990s, Central Bank Autonomy (CBA) ranked very high in the new international economic consensus and the change to the legal status of BdeM in 1993 responded to this trend. In fact, I argue that this reform was motivated more by the need to improve investment conditions and not so much by the goal of achieving price stability in the long run, as is claimed by economic theory. Capital inflows, increasingly guided by signals of future macroeconomic stability, were critical for the success of the economic transformation pursued by the state under President Carlos Salinas.

Chapter eight provides an explanation to Mexico's financial collapse and it is organised into four sections. The first section presents the links between the financial reform and the 1994 crisis. The discussion centres on the surge in portfolio investment and the banks' lending boom. Both events were direct consequences of the financial reform and important causes of the 1994 crisis. The second section introduces the political conditions leading to the crisis. In this part, the main issues are increasing electoral competition, the political business cycle and the political turmoil during 1994. The third section discusses two crucial policy mistakes: namely, the government's delaying corrective action in the exchange rate, and changing the term-structure and exchange rate exposure of the public debt. Finally, the fourth section describes the main outcomes of Mexico's 1994 financial crisis: foreign investment in the banking sector and the banks' bailout.

Chapter 2

The Politics of International Finance:

Fostering Reform

This chapter elaborates on the international dimension of our explanation to the phenomenon of economic reform in Mexico under President Carlos Salinas. In order to show how external events influenced the decisions of the state, this chapter starts by establishing the link between international trends and domestic policy choices and then identifies the dominant economic policy paradigm along with the transmission mechanism. The increasing integration of international finance and the historical financial needs of the Mexican economy have often subordinated the policy choices of the state to the preferences of international capital (see Maxfield 1990). Mexico's economic reform under President Salinas was heavily reliant on capital and therefore most of the reforms aimed to improve the investment conditions. The government expected that capital inflows would create the required leeway to engineer new bases of support for the regime.

This chapter is divided into three sections. The first section establishes the political leverage of international capital from three different angles: (1) the increasing integration of domestic economies into a new global economy; (2) the financial needs of the state to sustain its bases of support; and (3) the balance of payments financing.[1] The second section is a description of the new consensus on economic thinking: how it was reached and how it is related to the financial reform in Mexico. Finally, the third section introduces the notion of policy networks in order to show how organisations and institutions were the crucial link between the preferences of international capital and the initiative for economic reform in Mexico.

[1] In the literature on Multilateral Financial Organisations (MFOs), political leverage refers to the sources of these organisations' influence on decision making in domestic states.

2.1. International Capital Leverage

During the 1980s most of the highly indebted developing countries experienced massive capital outflows. These countries not only stopped receiving financing for their own development, but they were also transferring their own resources to rich countries. Yet, most of the states in these countries did not default on their debts, despite the enormous costs for their own economies. More strikingly, they were very receptive to policy recommendations coming from international capital. If these states were not having any capital inflows then, why they were so keen on compliance with their financial liabilities. Alternatively, from a more specific perspective, external savings in Mexico have represented barely 2.2 percent of the GDP on average from 1950 to 1990 compared to 18.3 percent of domestic savings. Nevertheless, international capital has been a major influence in Mexican economic policy choices. I argue that the integration of international finance has increased the political and economic costs of defecting from the new economic world order. The notion of a global economic system, outside which any country cannot really prosper and develop, has fostered economic integration, both in trade and in finance.

Success stories of countries geared towards this global economy like the Southeast Asian tigers have pushed the rest of the developing world to accept this idea of integrated economies. From a purely practical point of view, nations that expect to conduct multilateral trade require short- and medium-term financing plus other bank services and therefore cannot stop relying on the international financial system (Lipson 1988: 44). In this new world order, international capital has become one of the major policy actors with the capacity to create a coherent set of policies and effectively impose them upon domestic states. There are three features of international capital that allows it to act as a coherent organisation: first, close interdependence between financial organisations at a worldwide level; second, strong capacity to co-ordinate between them; and third, Multilateral Financial Organisations (MFOs) permanent organisational infrastructure (Lipson 1988: 44).

Economic and financial integration has greatly enhanced the leverage of international capital to influence domestic policy choices. However, this leverage is ultimately rooted on domestic needs, namely: economic development and financial stability are heavily

reliant on capital inflows. The destabilising potential of capital movements is paramount in terms of the configuration of political power and the economic costs for the whole society. Small economies thus depend to a great extent on avoiding big swings on these movements and the survival of states in these economies is therefore conditional on the legitimacy granted by powerful states and MFOs (Centeno 1994: 24).

Financial Integration

In the 1980s the phenomenon of economic integration accelerated at a great pace. Commodities, money and information moved across national borders faster and more efficiently than ever before. The average annual growth rate of world exports from 1980 to 1990 was 5.3 percent, significantly higher than the average annual growth rate of world GDP that amounted to 3.1 percent (World Bank 1996: 209). Larger flows of goods and services brought along greater exchange of ideas, information and policies between countries. Technological innovation in telecommunications and the development of international markets, organisations and networks reduced to an important extent the costs of economic transactions, and consequently increased the interaction between international and domestic actors. The phenomenon of integration, however, has not been more rapid and complete in any economic sector than in finance. The annual average growth rate in securities operations between 1980 and 1992 was nearly 10 percent, the same figure for foreign exchange operations was around 25 percent (Woodall 1995).

Financial integration has been mainly the result of the relentless search of international capital for new business opportunities. The thrust on emerging markets,[2] the development of the euromarkets,[3] the experience with the 'junk-bonds',[4] among others, are examples of the international capital need for profits. This emphasis on profits has

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[2] The financial markets in developing countries with middle income levels are known as emerging markets. They became very profitable and therefore the most preferred destination of international capital during the 1980s.

[3] The eurodollar markets or euromarkets referred initially to those dollar-denominated deposits made in banks outside the US. Their purpose was to avoid the banking regulations of the US. However nowadays these markets also include those deposits denominated in other strong currencies in banks made outside the country where the currency is legal tender.

[4] During the 1980s part of the third-world debt was transformed into tradable bonds as a result of the Brady Plan. These bonds were known as 'junk-bonds' because of their high-risk and high-yield.

been accentuated by recent trends, especially the expansion of institutional investors, on the one hand, and the 'securitisation' of funds, on the other. Nowadays international capital is increasingly concentrated in organisations such as pension funds and insurance companies. These organisations try to maximise the amount of capital under their control by offering higher yields to potential investors. Facing strong competition from each other, their managers are constantly looking for new investment opportunities in stock exchanges from all over the world. In doing so, they move enormous amounts of funds from one country to another. At the same time the securitisation of funds—firms borrow directly from the markets rather than through the banks—has increased the supply of financial assets that are tradable and hence priced openly in the global markets. This increased supply of tradable stocks on the global financial markets means more and larger transactions across national borders. According to a survey published by *The Economist* (October 7th 1995):

- Daily foreign exchange trading increased from an average of only $10 billion-20 billion dollars in 1973 to $60 billion in 1983 and then to $900 billion in 1992. The ratio of foreign exchange transactions to world trade jumped from 10:1 in 1983 to more than 60:1 in 1992.
- US cross-border security transactions increased from 3 percent of the GDP in 1970 to 9 percent in 1980 and then to 135 percent in 1993. The same figure for Britain soared from virtually nothing in 1970 to more than 10 times the GDP in 1993. The IMF estimated that total cross-border ownership of tradable securities in 1992 was $2.5 trillion dollars.
- The stock of international bank lending surged to $4.2 trillion dollars in 1994 from $265 billion in 1975. The outstanding volume of international bonds jumped to more than $2 trillion dollars in 1994 from $259 billion in 1982. Heavy issues of debt have fueled the growth of the global bond market by governments. The total stock of government bonds has risen from 18 percent of global financial assets in 1980 to 25 percent in 1992.

According to Clive Crook (1993) the boom in portfolio investment in LDCs is associated to the economic reforms that have captured the attention of foreign investors. LDCs are also perceived as more creditworthy than they were in the 1980s thanks to the reforms and the easing of financial restrictions. The removal of controls in rich countries regarding investment in foreign investment has also contributed to this expansion. For

instance, at present a company from an LDC can issue shares in the US using an American Depository Receipt (ADR).[5] ADRs issued under a procedure called Rule 144[a] do not have to comply with the rules usually insisted upon by the Securities and Exchange Commission. In 1991 Mexico raised more capital by issuing ADRs than through syndicated loans and bond sales combined (*The Economist*, August 25th 1993).

Table 2.1

Mexican Eurobond and Equity Issues, 1992-1993(1)

Eurobond Issues			**Equity Issues**		
Issuers	**Amount(2)**	**No.**	**Issuers**	**Amount(2)**	**No.**
Government	1,580	10	TELMEX	1,243	6
CEMEX	1,400	3	**BANCOMER**	638	2
BANCOMER	750	1	CEMEX	460	2
NAFIN	724	6	ICA	283	2
BANACCI	700	3	Grupo Carso	235	2
BANCOMEXT	456	3	TRIBASA	210	2
TELEVISA	400	3	DINA	173	3
FEMSA	300	1	Grupo Embotellador	138	2
DESC	275	2	Coca-Cola Mexico	134	2
Volkswagen	262	1	Liverpool	133	2
ICA	225	1	Sears the Mexico	101	2
MCTTR Trips	207	1	TMM	75	2
CREMI	200	2	Grupo Radio Centro	52	1
HYLSA	175	1	SIMEC	42	3
DINA	150	1	QUADRUM	34	1
La Moderna	150	1	Grupo Posadas	28	1

(1) Until October 12th 1993
(2) $ Million dollars
Source: IFR (1993)

The Mexican financial markets have increased substantially their cross-border securities transactions (see Table 2.1). Changes introduced in October 1989 to the Foreign Investment Act granted greater freedom to foreigners to invest on the Mexican stock exchange. Since then it is possible for foreign investors to buy shares with full corporate rights of any Mexican company. This decision aimed to make the Mexican exchange the most open to foreign investment of any in Latin America (*The Financial Times Business*

[5] ADRs are tradable securities, quoted in dollars and paying dividends in dollars. They are issued by American banks, which certify that the receipts are backed by a corresponding amount of equities, held abroad on behalf of the bank.

Reports, November 3rd 1989). In July 1994, there were 72 stock issues from Mexican blue chip companies like BANAMEX, BANCOMER, Cemex, Televisa, Telmex, Vitro, among others, in the hands of US investors. At the end of December 1993, the balance of foreign investment in the Mexican stock exchange reached a historic high of $54.6 billion dollars, an increase of 90.3 percent over that registered a year earlier (Mexico Company Handbook 1994: 30-32). In 1993, further changes to the Securities Market Act and to the Mutual Funds Act introduced the possibility of trading foreign securities in the Mexican financial markets, opening the possibility of Mexico becoming a regional financial centre.

To the extent that financial markets are internationally integrated, money and capital move to the markets, instruments and currency denominations that offer the highest return. According to Maxfield (1990: 7), 'policy makers must act within the constraint of a policy's impact on capital inflows and outflows or suffer the balance of payments consequences.' With increasing capital mobility the government cannot set both interest rates and exchange rates simultaneously. A fixed exchange rate with capital mobility implies endogenous monetary policy such that returns on capital are equal across countries. This competition between countries to attract capital leaves states with an enormous disadvantage vis-à-vis international capital when it comes to deciding upon financial matters. Important state decisions that have also contributed to financial integration like the deregulation of domestic financial markets or the liberalisation of international capital flows were dictated to a great extent by the needs of international capital, namely by the need to find new profitable business opportunities. Financial integration is thus partially the result of international capital initiative but now that has become an essential feature of the new global economy it is also one of the pillars upon which international capital exerts its power and influence over states.

State Financing

As mentioned before, the leverage of international capital, though greatly enhanced in the context of financial integration, is ultimately originated from the financial needs of states to remain politically and economically viable. The financial requirements of the Mexican state after the second world war were relatively modest since it maintained its finances in balance until the 1970s (Aspe 1993: 126). Over all these years the public

deficit was consistently below 3 percent of the GDP (see Figure 2.1), the borrowing requirements of the state were thus minimal, and so was the leverage of international capital. In the 1940s and 1950s foreign credit came from MFOs that did not have any strong conditions attached (Gurría 1994: 12). These credits, however, were contracted for specific investment projects and could not be used to finance other expenditures. During this period private capital inflows were in the form of foreign direct investment and therefore international capital was represented by multinational corporations, who were very influential in the design of sectoral policies but scarcely significant in general policy-making. This period in Mexico was characterised by sustained growth, and economic and political stability. The state did not experience any major challenge to its legitimacy and gradually consolidated its control over society.

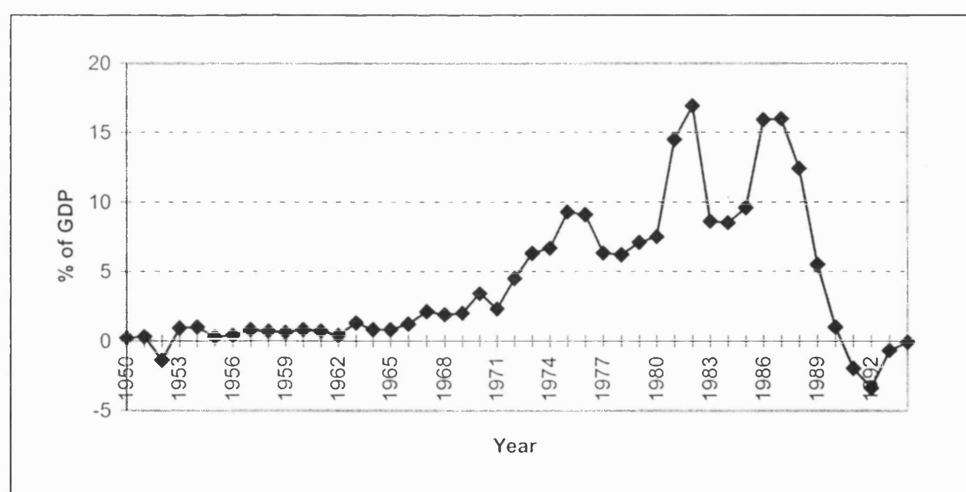
Then, in 1968 the Mexican state faced the first of various crises that would take place over the following three decades (see Basáñez 1991b). This was a political crisis, which took the form of increasing tension between the state and social organisations, most prominently universities; and the turning point was the killing on October 2nd at the *Plaza de las Tres Culturas* in Mexico City. Sergio Zermeño (1978: 55) identifies three main causes for this political crisis: (1) the state lacked responsiveness to the demands of the society; (2) the state reduced its economic support to universities; and (3) the nationalist ideology that emerged from the revolution conflicted with the state's development strategy.

The immediate response of the state to this first crisis was a new development strategy with stronger emphasis on income distribution and a more active role of the state in the economy. On average, public spending increased in real terms by 15.9 percent every year from 1972 to 1982 (Gurría 1994: 15). This expansionist economic policy was however not accompanied by the corresponding increase in public revenues creating an enormous gap in the public accounts that had to be closed by increasing reliance on international capital. The public deficit jumped from 2.3 percent of the GDP in 1971 to 9.1 percent in 1976 (see Figure 2.1) and consequently the public debt also increased from 2 percent of the GDP in 1971 to 6 percent in 1973 and then to 10 percent in 1975 (Fitzgerald 1979: 42). The strategy of increasing public spending partially re-built the traditional bases of support for the regime, namely workers, peasants and middle-classes. However this increase in public spending was possible only because the state

had access to new sources of international lending (Haggard and Maxfield 1993: 297), especially from the euromarkets that received a great amount of funds from oil exporting countries after the rise on the international oil prices in 1973 (Gurría 1994: 13). Commercial banks replaced MFOs as the main providers of external credit; countries like Mexico that had good credit ratings, and with good economic prospects became the main recipients of these funds. According to Jeffrey Frieden (1981: 411), 80 to 90 percent of commercial bank eurocurrency lending to developing countries consisted of loans to various public sector entities: central governments themselves, central banks, state-owned enterprises, national development banks and state-owned public utilities. The cost of greater freedom in domestic economic policy was stronger leverage of international capital. On August 31st 1976 external financial pressures forced the government to devaluate the peso, after more than twenty years of fixed exchange parity to the dollar. The exchange rate jumped from 12.50 pesos per dollar to 15.69 and then to 22.69 in 1977 (INEGI 1994: 1006).

Figure 2.1

Public Deficit, 1950-1994



Source: Aspe (1994: 69); Zedillo (1995: 51)

After a brief interlude of stringent conditions from the IMF to reduce the public deficit, external borrowing and public indebtedness (Basáñez 1991b: 63);[6] the state resumed its

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[6] The credit extended to Mexico by the IMF in 1976 included a clause setting a maximum limit to the external annual borrowing at $3 billions dollars. This limit was nevertheless exceeded by far in the next few years.

rapid expansion of public spending in 1980 (see Figure 2.1). This time the emphasis on public expenditure to achieve faster economic growth was based on the grounds that the new oil wealth would finance Mexico's development in a non-inflationary way (Aspe 1993: 128). Taking advantage of such wealth required the expansion of public investment and therefore once more the state resorted to international capital looking for financing with the corresponding exposure to its influence. This time, both the public and the private sector started a rapid expansion of external borrowing. For instance, between 1980 and 1982 the stock of public foreign debt grew from 20.9 percent of the GDP to 29.8 percent, whereas private indebtedness went from 7.9 percent to little more than 18 percent of the GDP (Aspe 1993: 129).

In 1982, another crisis associated with balance of payments difficulties not only brought to a halt capital inflows, but for the next six years a substantial amount of internal resources were mainly directed to satisfy the increasing cost of the external debt. It became evident that international capital had enough leverage to extract domestic resources even at the expense of economic growth. Throughout the presidential administration of Miguel de la Madrid the economy stagnated and the traditional bases of support of the regime were severely weakened. In the 1988 presidential elections the dominant group within the Mexican state faced the strongest challenge in its history from a left-wing coalition headed by Cuauhtémoc Cárdenas. The state under President Carlos Salinas turned to international capital for the third time since the 1970s in order to gain political legitimacy and create new bases of support for the regime. However, for the first time for 20 years, international capital did not finance the public deficit—it was for private investment instead, mainly portfolio investment.

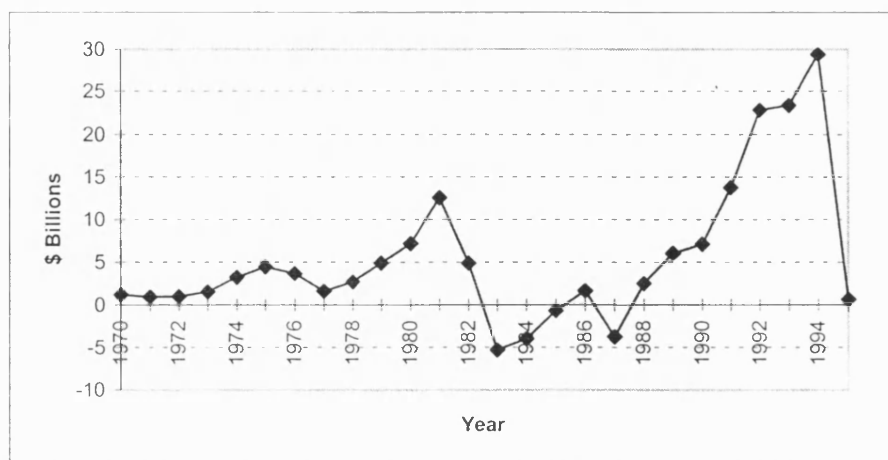
Balance of Payments Financing

The Mexican state has been committed to exchange rate stability and free convertibility since the 1940s. It has been state policy to overcome public fear of devaluation and the consequent capital flight by intervening in the exchange market to guarantee the peso's value (Maxfield 1990: 127). The importance of securing international credit was crucial to the Mexican state after the foreign exchange crisis of the late 1940s and the early 1950s (Maxfield 1993: 248). The recent phenomenon of financial integration has further increased the ability of the state to intervene in the exchange markets by expanding its

access to foreign exchange in the form of capital inflows. International capital made possible the enormous growth in the balance of payments deficits in Mexico since the early 1970s (see Figure 2.2).

Figure 2.2

Current Account Deficit, 1970-1994



Source: INEGI (1994: 877-900); International Financial Statistics, IMF (various years).

As a result of the development of the euromarkets, commercial banks started to offer credits to developing countries without strong conditions regarding the final destination of the funds, although with higher interest rates and shorter periods for repayment. Credits coming from the euromarkets were used to finance to a great extent the current-account deficit allowing states to run bigger deficits for longer. Before, under fixed exchange rates and restricted capital flows current account deficits had to be financed out of capital inflows in the form of direct investment or multilateral lending. In the past, credits for these purposes had been severely restricted because of US regulations on the subject (Gurría 1994: 13).

In this context increasing current account deficits produced recurrent balance of payments crises in each of the last four presidential 'sexenios' in Mexico (see Figure 2.2). During the first four or five years of each presidential term current accounts deficits grew continuously until one or two years before the end of the sexenio when they were no longer sustainable. Currency devaluation and capital flight then brought down those deficits. Most political leaders were very aware of the enormous costs of currency devaluation in terms of support for the regime. A devaluation in 1954

weakened the workers support for the regime, in 1976 Echeverría delayed devaluation because he thought something similar could happen in an election year (Basáñez 1991b: 58), and President López Portillo declared in 1982 that 'a President who devalues, is devalued' (*Proceso,* March 22nd 1982). Therefore a great amount of resources are employed to avoid currency devaluation every time there is pressure to do so. When international capital starts to leave the country, states use their international reserves to finance current account deficits and then, when their reserves start to falter, they resort to international capital, especially to the MFOs.

Every time there is a balance of payments crisis the intervention of international capital is central, both in producing it and in providing support to overcome it. In Echeverría's sexenio, as a result of fiscal and external imbalances there were some signals of peso overvaluation and capital flight started as early as 1973, pressing for devaluation (Basáñez 1991b: 58). However, access to commercial bank loans made it possible to finance these imbalances delaying devaluation until 1976 when finally international reserves were completely exhausted and commercial banks stopped their lending. This crisis situation brought the active intervention of the IMF, which extended a credit to the Mexican state for $800 million dollars in order to replace the extinguished international reserves and avoid any major disruption on international transactions (Gurría 1994: 18). In exchange the IMF had a very strong input in the design of the stabilisation programme for the next couple of years (Aspe 1993: 128; Basáñez 1991b: 59). Nevertheless, the stringent conditions from the IMF to eliminate the fiscal and external imbalances did not last for long, and in 1981 they reached very high levels again. This time, however, an especially adverse international context was added to the precarious domestic situation: higher interest rates and lower oil prices.

Interest rates in the euromarkets started to increase in the last quarter of 1980 in order to control inflation in the US, which is damaging for financial investments and against the interests of international capital. By December of 1981, LIBOR reached almost 17 percent, the highest level in history.[7] American interest rates shot above 20 percent for

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[7] LIBOR refers to the London Inter-Banking Operations Rate. This was the common reference interest rate for the operations in the euromarkets.

brief periods (Frieden 1991: 60-64).[8] This was a major change in current trends, from having negative real interest rates in the 1970s, by 1981 they were 8 percent on average. This situation prevailed throughout the following years, though to a lesser extent (Gurría 1994: 21). Oil prices started a continuous fall on May 26th 1981, when the OPEC announced its failure to curb production in order to stop the fall in oil prices initiated at the beginning of that year. Pemex announced a decrease of four dollars per barrel to its export price of oil on June 2nd 1981 in order to defend its market share; other countries followed Mexico and then the fall in oil prices became generalised (Gurría 1994: 22). Falling oil prices had a double effect on the balance of payments, exports stagnated and international lending came to a halt.

International bankers mentioned the need for devaluation as early as 1978 setting forth a debate between different state actors about the convenience of devaluation (Maxfield 1990: 129). President López Portillo, however, decided to maintain the prevailing exchange rate of 22.80 pesos per dollar with a minimal slide of 4 percent during 1981. Foreign loans made it possible to delay the peso devaluation and capital inflows were increasingly used to defend the peso. Nevertheless as overvaluation increased, capital flight mounted to an estimated $11.8 billion dollars for 1981, almost two-thirds of new foreign debt contracted (Gurría 1994: 25).[9] Capital had a double role in the making of the crisis: by leaving the country domestic capital had exhausted the stock of international exchange required to finance the current account deficit and the external debt itself, on the one hand; and commercial banks loans made possible capital flight at a grander scale by providing additional international exchange, on the other. The fight against devaluation was the main cause of the rapid expansion of the external debt, but it was mainly a politically motivated fight. At the end, devaluation became a decision related to the political viability of the existing regime and international capital was the strategic supporter of the Mexican state in this decision. President López Portillo declared: 'I did everything humanly possible to avoid devaluation... I was tremendously

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[8] The increases in interest rates during this period was caused mainly by the restrictive economic policies implemented by the US and other industrialised countries in order to control inflation. Furthermore, these policies appreciated the dollar and induced to an economic recession in the developed world (Gurría 1994: 21).

[9] Estimates of capital flight for the whole sexenio of President López Portillo range from $25.3 billions dollars in Dornbusch (1989: 8), to $27 billions in Frieden (1989: 31), to $36 billions in Maxfield (1989: 77).

anxious to avoid the political weakness of devaluing before the presidential succession... I did not want to weaken the political system with a devaluation when there only remained a few months before the choice of my successor...' (quoted by Maxfield 1990: 131-132).

In the next two sexenios, under Presidents de la Madrid and Salinas, the threat of devaluation was still a continuous problem, but the fight against inflation moved to the top of the state's agenda. The stabilisation programme under President Salinas, less so under de la Madrid, was based on the exchange rate. The policy of exchange rate overvaluation brings down inflation without major economic recession in sharp contrast to those orthodox programmes based on fiscal and monetary restraint. Nonetheless, a side effect of exchange based stabilisation is the loss of international competitiveness that translates into large current account deficits. Though economically risky, the increasing deficit in the current account was politically profitable. Rapid import growth benefited the Mexican electorate and therefore the PRI at a time when economic growth was slow.

The support of international capital is crucial to making this policy viable, otherwise the lack of financing for the current account deficits may eventually lead to capital flight (see Rodríguez 1997). At first, the stabilisation programme was a success and annual inflation went down from 159 percent in 1987 to less than 12 percent in 1992 (Presidencia de la República 1995: 41), but at the same time the current account deficit reached almost $25 billion dollars in 1992 and 1993 (Presidencia de la República 1995: 68). The exchange requirements to finance these deficits were paramount and could only be provided by international capital. At this point, the state speeded up economic reform in order to keep international capital flowing into the country and thus sustain the fight against inflation without economic recession. All the policies in the reform programme were strictly conforming to the new international consensus on economic policy.

2.2. The Emergence of a New Consensus

Economic ideas are important because they eventually become policy choices (Kahler 1990: 33). This process takes place through two different mechanisms: (i) power relations in which international capital uses its leverage to induce the adoption of

policies conforming to specific ideas; and (ii) social learning in which the exchange of ideas between policy elites from different countries creates a limited set of policy options. The fact that certain ideas may be dominant at a given moment does not mean that they convey the 'truth', it means only that they are adopted, out of conviction or convenience, by most of the relevant actors. Very often these ideas are effectively challenged on logical and empirical grounds by alternative views. Therefore the dominance of the ideas is not given by their logical and empirical foundations, though still important, but by the coalition of interests supporting them.

The previous section already established the leverage of international capital; now this section turns to the content of the ideas and policies that have shaped the reform efforts in LDCs during the last couple of decades. I am interested in how these policies and ideas became a new consensus by the 1980s, when capital flows seemed to spread neoliberal economic ideology all over the world, including former socialist countries. As I mentioned before, under the assumption of procedural rationality,[10] ideas and ideologies are essential to structure the everyday interaction among individuals and organisations. They represent a framework composed of a set of shared assumptions on how to understand reality and aimed to provide guidance to individual choices. The ideology embedded in each organisation and the cultural and personal backgrounds of their leaders limit therefore the range of policy options available to tackle public issues. These ideas however are not specific to domestic environments anymore. The increasing interaction between policy elites and economic agents from different countries has created a common 'international policy culture' that supports particular views for dealing with common public issues (see Ikenberry 1990). This culture has become the 'intellectual lenses' through which policy makers perceive reality everywhere (Centeno 1994: 23).

The questions that come to mind when looking at the widespread introduction of neoliberal policies during the 1980s are why so many countries and why at that moment? John Ikenberry (1990) argued that common economic and political circumstances at international level engendered a common policy response orchestrated

[10] For a deeper discussion on the role of institutions under the assumption of procedural rationality see North (1990: 22-24) and Grindle and Thomas (1991: 28).

by leading industrial countries and MFOs. There are two essential elements in this approach: (i) important events at international level in combination with analytical developments, success stories and competition among countries for capital created a new consensus or in Ikenberry's words an 'international policy culture'; and (ii) policy change being a governmentally engineered change required the alliance between domestic policy elites and MFOs in the form of international policy networks. This section concentrates in the content of this new consensus, leaving for the next section the analysis of the international policy networks.

Neoliberalism[11] vs. Structuralism

Neoliberalism and structuralism have been the two major policy trends influencing the content and orientation of development strategies followed by most developing countries in Latin America, including Mexico, since the Second World War.[12] In the 1960s James Street (1967) recognised that the trust in the free market has been one of the principal exports of industrialised countries to the developing world (Street 1967: 48). Earlier, Raúl Prebisch (1963) expressed his concern about the role of neoliberal ideas and policies shaping the development efforts in Latin America. Prebisch (1963: 14) thought that the main challenge to development thinking was to avoid 'the traditional propensity to introduce from abroad nostrums that are largely alien to the real requirements of Latin American's situation.' Structuralism was thus born as a critique to the imported models of neoclassical economics and tried to be rigorously inductive, more concerned with the specific distinctions between countries in terms of available resources, cultural backgrounds and historical factors than with first principles (Street 1967: 53-54). At the core of the debate between these two positions is the role of the state in economic development: structuralism supported an active state to promote and protect the industrialisation process in its initial stages, on the one hand; and

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[11] By Neoliberalism we understand the set of policies based on the assumption that the market is a better resource allocation mechanism than central planning, and therefore that are intended to create the conditions for a market oriented economy.

[12] A similar debate has taken place between monetarism and keynesianism. However the main issue in this debate is macroeconomic management, more than structural development strategies. The role of the state is also at the core of this debate but in this case it is about the possibility to smooth economic fluctuations through the traditional economic policy instruments, namely fiscal and monetary policy. Their main contested issue is whether monetary and fiscal policies have real effects on the economy.

neoliberalism advocated a minimalist state, the 'night watchman', acting as a third party responsible for securing the conditions for market competition, on the other.[13]

The development strategy of Import Substitution Industrialisation (ISI) followed by Mexico and many other developing countries, especially in Latin America, had its inception in the writings of Raúl Prebisch while he was at the United Nations' Economic Commission for Latin America. Prebisch (1950) claimed that the existing international economic structures condemned developing countries to have low rates of economic growth if active government intervention was not undertaken to promote industrialisation. The sole action of the markets could not deliver the right conditions for development because of structural imbalances in international trade. Prevailing structures led to industrialised countries specialising in the production of manufactured goods and new technologies, and middle and low-income countries relying on exports from primary activities such as mining and agriculture. Increasingly adverse terms of trade for the poor countries created a two-tiered international economy. This phenomenon posed the urgent need for poor countries to break the dependency relationship on rich countries for manufactured goods and technology. The prescribed way to attain this goal was by upgrading the productive structure of primary-exporting countries through an active promotion of the infant domestic industrial base (Edwards 1995: 44). Most of the Latin American countries introduced protectionist policies during this period in combination with selective credit controls, subsidies and direct ownership in some strategic economic sectors. Countries like Mexico and Brazil built a relatively strong industrial sector as the result of these policies up until the 1960s.

In opposition to the policies prescribed by structuralism in favour of an active state in economic development, neoliberalism championed free market policies and restricted the role of the state to provide public goods and enforce property rights (see Friedman 1962). The main neoliberal critiques of ISI were that protectionist policies ignored the benefits of participating in the international division of labour, the costs and distortions

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[13] In the literature on policy change the role of the state is nevertheless ambiguous, on the one hand it is expected to be very restricted; but on the other, economic reform requires a strong and very active state to bring about change. Neoliberal policies like privatisation, trade liberalisation, and deregulation presumes the existence of a state apparatus with a significant degree of autonomy from social forces, and supported by external forces such as the MFOs (Veltmeyer et.al. 1997: 95).

of state intervention were paramount, and countries pursuing market-conforming strategies were performing much better than those who did not (Haggard 1990: 10-13). Neoliberalism's main claim is that unleashing market forces improves the efficiency of the economic system and thus raises the population's living standards. In order to secure these conditions the state has to implement some fundamental policies: reduction of public deficits, independent management of monetary policy, privatisation of state-owned enterprises, opening-up to international trade and reforms to the regulatory framework. Neoliberalism has become the dominant policy trend for the last couple of decades and thus the economic reforms introduced during this period in most of the developing countries were oriented towards dismantling the state intervention in the economy. This rise of neoliberal thinking in Latin America is associated to the recurrent balance of payments crises throughout the region since the beginning of the 1970s. Another historical event reinforcing this new trend was the collapse of the Soviet Union with the corresponding failure of the centrally planned economies to provide a viable option for long term development. The failure of the socialist state to operate the economy left the neoliberal paradigm without an effective ideological counterweight and therefore it became the only effective policy paradigm for the developing world (Centeno 1994: 21).

New World Order and the Washington Consensus[14]

Major events at the international level, both political and economic, took place during the 1980s that changed dramatically the configuration of the world order and strengthened neoliberal ideas. Increasing flows of commodities, capital and ideas across countries gradually weakened the old world order at the same time that laid the foundations for the new one. The end of the cold war, which had dominated the relations between national states since the Second World War, had profound consequences for the emergence of a new consensus on economic thinking. In the new world order military rivalry is replaced by economic competition. The traditional bipolar system that emerged after the second world war and dominated by the military powers, the US and the USSR, has been replaced by a tripolar system dominated by the

[14] The term of Washington Consensus, introduced by Williamson (1994), comes from the fact that it was originally sponsored by Washington-based organisations like the IMF and the World Bank.

economic powers, the US, Japan and Europe (Stallings 1995: 350-351). Stallings (1995: 2) argue that there was not a unique response to this new international policy context but three different ones based on geopolitical factors: (i) the western hemisphere dominated by the US where radical reforms were introduced; (ii) East-Asia under the leadership of Japan where moderate market reforms took place; and (iii) the European Community led by Germany and where the reforms have been of a mixed nature. In this new world order, divided into three major blocks, ' policy packages (models) selected by third world countries will resemble those advocated by the countries that buy their goods, supply their finance and provide their ideological guidance' (Stallings 1995: 365). Mexico and most of Latin America had no other choice but to follow the Anglo-American model of capitalism based almost exclusively on free markets.

The second major event at a global level that had profound implications for the developing world was the debt crisis of 1982 and the ensuing negotiations between states and international capital. The Baker plan announced in the fall of 1985 was a major boost for the introduction of structural adjustment policies and the influence of MFOs.[15] The main interest shifted away from adjustment in public and external imbalances to structural economic changes aimed to create free-market economies. The main points of this plan according to Dornbusch (1989: 11) were: (i) new loans from commercial banks as required in the rescheduling of debt; (ii) increased participation and lending from the MFOs, especially the World Bank; (iii) focus on debtor country economic liberalisation, with emphasis on free enterprise and supply side economics; (iv) improved world macroeconomic environment to complement debtor countries efforts; and (v) greater access to foreign markets for all countries. These points expressed what later would be known as the Washington Consensus. The new consensus on economic thinking is grouped broadly in three main themes: (i) macroeconomic stability, which means balanced public finances and independent management of monetary policy; (ii) reduced state intervention in the economy that implies privatisation, deregulation and greater emphasis on property rights; and (iii) greater openness to international trade, which requires reduced barriers to trade and

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[15] IMF Managing Director and World Bank President express broad support for the debt initiative proposed by U.S. Treasury Secretary James A. Baker. It calls for comprehensive adjustment measures by debtors, increased and more effective structural lending by multilateral development banks, and expanded lending by commercial banks.

capital flows (Edwards 1995: 58; Stallings 1995: 12; Veltmeyer et.al. 1997: 21-22). The most well known expression of this consensus is found in Williamson (1994: 26-28) and cover the following issues:

1. Fiscal discipline, no inflationary financing;
2. Public spending priorities, financing to those areas with higher economic returns such as health, education and infrastructure;
3. Tax reform, broadening the tax base and cutting marginal tax rates;
4. Financial liberalisation, market determined interest rates;
5. Exchange rates, sufficiently competitive to induce a rapid growth in non-traditional exports;
6. Trade liberalisation, eliminate quantitative restrictions and reduce tariffs;
7. Foreign direct investment, elimination of barriers to entry;
8. Privatisation, divesting all parastatal enterprises;
9. Deregulation, eliminating all distorting regulations;
10. Property rights, clear definition and effective enforcement.

As mentioned before, neoliberal ideas found the right juncture for becoming a consensus among international policy-making circles in the 1980s after the debt crisis. The crisis increased the leverage of MFOs and hence their influence on policy-making in developing countries. Moreover, neoliberal ideas, although having been around for some time, only became dominant in the industrial countries recently, during the 1970s and 1980s, precisely when the future generation of policy makers of developing countries were studying there (Domínguez 1997: 26). The convergence of these two processes facilitated the spread of neoliberal policies all over the developing world. The next section turns to the analysis of the specific role of MFOs and domestic policy elites on the transformation of this new consensus into effective policy choices. I argue that it was not the conditionality clauses[16] attached to the credits extended by MFOs to indebted countries that induced policy change but that it was the policy dialogue that took place between key state officials trained abroad (i.e. the 'technocrats') and MFO executives through international policy networks.

[16] Conditionality clauses are those that demand specific policy actions from LDCs in exchange of external financing, whether debt rescheduling, debt relief, multilateral credits, bilateral loans, or grants.

2.3. International Policy Networks

By international policy networks I mean those transnational structures and international flows of communication that link organisations engaged in policy-making throughout the world. These organisations are usually grouped into policy communities who share a common set of ideas and have appropriate control over policy-making in particular issue-areas (Kahler 1990: 126). The specific network for financial policy is increasingly transnational, cutting across national borders in the same way as economic ideas and capital do. This network links, for instance, the organisations of international capital such as investment banks, fund managers, commercial banks and especially the MFOs like the International Monetary Fund (IMF), the World Bank, the Interamerican Development Bank (IDB), to domestic state organisations like central banks and national treasuries. Most of these organisations have a homogeneous and coherent view of the economy consistent with neoliberal postulates of economic liberalisation and economic integration.[17] Policy recommendations from MFOs and international commercial banks are met by heightened reliance on technocrats committed to neoliberalism in state organisations, who in the specific case of Mexico, gradually gained control of policy-making, especially after the debt crisis (Grindle 1996: 111).

Political leaders from major industrialised countries lead this transnational policy network, like Margaret Thatcher and Ronald Reagan in the 1980s. Top executives from the MFOs like Robert McNamara from the World Bank in the 1970s and Jacques de Larosière from the International Monetary Fund (IMF) in the 1980s are also at the top.[18] These political leaders and financial executives came into the spotlight as important promoters of policy change in LDCs after the debt crisis in 1982. They provided political leadership, financial support and policy advice to back up the ideas of neoliberalism embodied in the programmes of structural reform. However the emphasis of this analysis is on the organisational infrastructure that these individuals relied upon to carry forward their ideas—that is to say on the Multilateral Financial Organisations.

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[17] Michel Camdessus, managing director of the IMF, asserted that "...it is the job of this institution [the IMF] to remind countries that globalisation is there and that they must promptly adapt to it (Interview with *The Banker*, October 1995: 38)."

Multilateral Financial Organisations (MFOs)

What is more compelling about the international policy networks is that states are constrained less by other states than by sanctions and incentives organised primarily by MFOs. The mechanisms to do so include the deterrent threat of effective economic sanctions and the incentive of continued access to credit. For instance, LDCs' debts are politically secure because this network of multilateral banks, private lenders and leading industrial states backs them. According to Charles Lipson (1988: 44), MFOs 'are jointly capable of consolidating debts in emergencies and severely punishing those who default without insufficient cause.' The MFOs are at the core of the international policy networks; they provide the organisational infrastructure for the communication and collaboration between policy makers from industrialised and developing countries. Furthermore, according to Miles Kahler (1992: 96), they have the power to influence the economic prospects of debtor countries by: (i) inducing a particular set of economic policies through financial inducements and policy dialogue; (ii) affecting the overall confidence in the country's economy and thus the size of capital inflows; and (iii) altering the expectations of the agents in the economy, and therefore the effectiveness of any policy change.

As argued before, the globalisation of the world's capital markets increased substantially the importance of these transnational organisations for domestic policy-making. They are not only direct providers of funds but they are also agents of international capital. Their loans increasingly spearhead capital inflows to LDCs. In fact, they have now come to see themselves more as facilitators of private capital flows than sources of financing. Adjusted for inflation and for the growing needs of the developing world, the World Bank's financing role has diminished significantly (*The Banker,* October 1995: 32). Richard Frank, managing director of the World Bank explained: ' the reason that [World Bank's] lending has been going down is that countries are turning to the private sector' (quoted by *The Banker,* October 1995: 32). Now, half of the projects financed by the World Bank attract other investors and in

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[18] Although McNamara left the World Bank in 1981, before the era of so-called structural adjustment, he launched the concept of policy-based lending, meaning loans with inescapable conditions attached, and ensured its initial implementation in some highly indebted countries (George and Sabelli 1994: 55).

some cases the approval of the Bank is essential for other agencies to participate (see George and Sabelli 1994).

The two most important MFOs, i.e. the International Monetary Fund (IMF) and the World Bank,[19] have had traditionally different roles. The IMF has been concerned with securing exchange rate stability among all its member countries, its main financial activity is to provide short-run credit to domestic states in order to ensure that international transactions take place efficiently without major interruptions. The World Bank has been more concerned with long-run economic development, the main activity of the bank is financing infrastructure and sectoral investment.[20] Nevertheless late in the 1970s the World Bank and the IMF started a process of convergence and self-transformation from passive financiers to active promoters of economic orthodoxy. This process was further consolidated as a result of the debt crisis in the 1980s. Since then, these organisations have used policy-based lending extensively to induce policy makers in LDCs to align their policies with those in vogue in industrialised countries (Nelson 1990: 25).[21] The World Bank has been conditioning its structural and sectoral adjustment loans upon the adoption of policies consistent with the neoliberal paradigm.[22] The IMF has extensively used stand-by loans and Extended Fund Facilities (EFFs) to induce debtor countries to follow its policy advice, initially directed to bring

[19] The World Bank consists of two major subsidiaries: (i) the International Bank for Reconstruction and Development (IBRD); and (ii) the International Development Agency (IDA). Between 1947, the year it was created, and 1993 the IBRD has loaned or committed $235 billion dollars in more than 3,500 loans. If the credits extended by the IDA are included then this figure rose to $312 billion dollars. The IDA, founded in 1960, is concentrated in poorer countries and the credits it extends are softer than the IBRD loans. A typical World Bank loan consists of the following conditions: (i) 5 year grace period in which no repayment is required; (ii) 15 to 20 years period to pay back at market interest rates; and (iii) the loan is never rescheduled or cancelled. The World Bank funding comes from sales of its own bonds in the international financial markets and it operates as a profitable commercial bank. It has accumulated $16 billion dollars in profits (George and Sabelli 1994).

[20] The main sectors attended by the World Bank in its programme of sectoral lending are: (i) Agriculture/Forestry/Rural development with 19 percent of total lending; (ii) Energy with 18 percent; and (iii) Transport with 14 percent (George and Sabelli 1994).

[21] In 1980, over half of the lending agreements between the IMF and LDCs included clauses on public spending and a quarter included trade liberalisation conditions (Goldstein 1986: 9). The same was true for the structural adjustment loans of the World Bank.

[22] The structural and sectoral adjustment loans represent 15 percent of all-time lending of the World Bank. The bank under the leadership of Robert McNamara invested heavily in physical infrastructure for the developing world and by virtue of its importance as a project financier earned itself a seat at the table as an adviser to governments on macro-economic policy reforms during the 1980s era of "structural adjustment" (*The Banker*, October 1995: 30).

down inflation and secure exchange rate stability, but since 1985 increasingly to bring about structural change (see Table 2.2).[23]

Table 2.2

Conditionality Contents of IMF and World Bank Programmes

Policy Area	IMF (2)	World Bank (3)
Trade liberalisation	35	79
Exchange rate action	79	45
Tax reform	59	67
Financial reform	44	51
Privatisation	59	65

Source: Edwards 1995: 57
(1) Percentage of programmes including specific conditions
(2) All conditionality programmes from 1983 to 1985
(3) All structural adjustment loans from 1982 to 1989

MFOs are controlled by representatives of rich countries, and therefore are active promoters of their policy preferences despite the fact that LDCs are also represented. In other words, these organisations are agents of supranational interests to influence policy choices in LDCs (Street and James 1982: 680). Miles Kahler (1990: 57) argued that the new orthodoxy served the interests of the leading industrial countries during the 1980s and as long as it continues to do so, the international dominance of this orthodoxy is likely to remain.[24] For instance, financial liberalisation in Latin America was essential for US capital to remain globally competitive; liberalisation opened new business opportunities to US investors (Veltmeyer et.al. 1997: 113). In fact, Veltmeyer et.al. (1997: 16) go further to argue that liberalisation, actively promoted by MFOs, was intended to expand exports and therefore generate foreign exchange to pay for their imports and foreign debt.

The MFOs' involvement in LDCs' policy-making has not been free of controversy or conflict. Their policy strictures are very often at odds with the political interests of many states in LDCs, mainly regarding the content of the programmes and the nationalist

[23] The main elements of the EFFs are: (i) longer periods of IMF support; (ii) directed to programmes attacking structural shortcomings; and (iii) the main policy areas covered are: trade liberalisation, public sector pricing and subsidies, and interest and exchange rates policies (Kahler 1990: 42).

[24] Kahler (1990) uses the expression of G-5 to denote the group integrated by the US, the UK, Germany, France, and Japan.

resentment for their strong intervention (Kahler 1990: 100). Adding to this controversy is the semi-secret nature of their operations and agreements. Jeffrey Sachs (1994: 523) denounced that 'the IMF's performance has not been properly scrutinised. Under current procedures, detailed and independent scrutiny is all but impossible. All IMF operational documents, including IMF advice as well as the terms of the loan agreements, are treated as confidential in perpetuity.'

The influence of MFOs has gone through three different periods. The first period went from their creation after the Second World War up to 1982. During these years there was a clear division of functions between these organisations: the World Bank promoted infrastructure investment; the IMF advised governments on macroeconomic policy; and the IDB had a basically political role. The second period ran from 1982 to about 1989 and was dominated by the promotion of structural adjustment reforms. During these years all the organisations worked together to overcome the effects of the 'debt crisis'. Finally, the third period took place mostly in the 1990s and was characterised by the 'Washington Consensus' first and then 'good governance'. The purpose was to help LDCs to grow within the framework of the new international political economy.

In the 1980s, the record of policy reform implementation was dismal despite the strong intervention of the MFOs pushing for reform in LDCs. Stephan Haggard (1986) found that twenty four EFFs agreements were not implemented in their original form and sixteen of these were cancelled out of the thirty cases studied. Inadequate finance and often confused cross-conditionality were the main factors limiting these organisations' influence during the 1980s despite the increasing financial needs from LDCs. Furthermore a reputation for compliance seemed to produce little additional lending from the MFOs. Instead the tightness of conditionality was linked to the bargaining position of the recipient country: those countries most dependent on MFOs' financing received the most stringent conditions (Kahler 1992: 108). Mexico, for instance, was a reluctant reformer until the late 1980s despite the conditionality of several programmes contracted with the IMF and the World Bank (Cook 1991).

According to Miles Kahler (1992: 123) the bargaining model based on conditionality clauses does explain part of the pattern of limited influence of the IMF and the World Bank on LDCs that was apparent in the 1980s. However it does not explain the apparent

increase in economic policy change over the following years. An alternative model of influence based on social learning and policy dialogue provides a better answer to this trend. Although MFOs played a less central role than is sometimes argued, they influenced the new convergence of doctrinal views in Latin America through empirical research, economic and sector analysis, lending practices, policy dialogue and conditionality (Edwards 1995: 56). These organisations were more effective influencing policy change in LDCs through the construction of a common base of consensual knowledge than through direct conditionality. In fact, policy change in Mexico was possible thanks to the process of learning through technocratic alignment with transnational epistemic communities who share a common set of cause-and-effect beliefs (Kahler 1992: 126).

Technocratic Alignment in Mexico

Dominant ideas do not only influence human choices for their own internal and logical coherence but also for their ability to change the configuration of power within decision making circles (Biersteker 1995: 174). Influential actors in the international arena support those organisations within each country that have similar policy preferences to theirs (Ikenberry 1990: 100). This support can take a wide range of forms, but the most important are external recognition and financial support, both of them crucial to define the configuration of power between competing groups within any given state. According to Kahler (1992: 127) international capital supports those organisations and individuals that advocate a model of economy that matches mainstream economics, usually technocrats within agencies responsible for macroeconomic and budgetary oversight like the Ministry of Finance and the central bank. In fact, the process of international networking starts early in the policy maker's career when they study abroad at top universities from industrialised countries. It is usually at these educational centres where the new orthodoxy in the international policy culture shapes the views of policy elites in LDCs.

According to Centeno (1994: 24), US support for Salinas's economic reform was based on the ability of the US-educated Mexican elite to establish working relationships with their American counterparts, on the one hand; and on a policy agenda along the same line as US interests, on the other. The intellectual legitimacy of the Salinas's reforms,

both within policy-making and academic circles and in general, was perhaps the most important international factor (Centeno 1994: 25). This support was reflected in the behaviour of the World Bank; between 1980 and 1985 Mexico received only one structural adjustment loan for the amount of $352 million dollars. In contrast, between 1985 and 1989, when Mexico received eight of these loan for the total amount of $3.32 billion dollars (Stallings 1992: 78).[25] Mexico's government established a close communication with the MFOs under President Salinas. Year after year, the government and the IMF signed 'letters of intention' that contained the major guidelines for economic policy. This process was an implicit certification on Mexico's economic policy.

In Mexico, close relations between international policy communities and anti-inflationary technocrats in the Ministry of Finance and Banco de Mexico (BdeM) date back to the late 1940s; the long tenure of key officials within these organisations has lent considerable stability to the alliance (Kahler 1990: 127). Since then, BdeM has been sending bright Mexicans to attain post-graduate degrees in economics to top US and British universities and then placing them in key positions in the economic agencies of the Mexican state (Ardito-Barletta 1991: 288-289). However, it was not until the outbreak of the debt crisis in 1982 that the rise of the technocrats to the top of the state hierarchy found the right juncture (Centeno 1994: 159). At that moment they were already in strategic positions favoured by the upcoming orthodoxy, for which their skills were especially suited. The team in the Ministry of Finance designed and implemented solutions to some of the most difficult problems facing Mexico during the 1980s: tackling inflation, tax reform, external debt, public-sector deficits and the privatisation of state enterprises (Golob 1997: 108).

The 'technocratic revolution' had its first major boost in 1982, when Miguel de la Madrid, who had a career based on the Ministry of Finance-BdeM network[26] with an

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[25] Mexico became the all-time largest borrower of the World Bank towards the end of the 1980s, ahead of India, Brazil, Indonesia, Turkey, China, the Philippines, Argentina, Korea, Colombia, Morocco, and Nigeria (George and Sabelli 1994: 11).

[26] According to Torres (1997) the creation of the Ministry of Programming and Budget consolidated the rise of the technocrats to power. Despite the fact of being a separate and independent organisation from the Ministry of Finance-BdeM network, most of its leaders were technocrats from this network. Therefore we do not make a distinction between the whole network and the specific Ministry of Programming and Budget.

MA degree from Harvard University, became President.[27] President de la Madrid strongly backed the resurgence of this faction within the governing elite. Thirteen out of his eighteen cabinet appointees and a large number of deputy ministers and local governors had based their careers in this same network (Kaufman 1989: 115; Heredia 1992: 274). In fact, the most important command centres of the economic bureaucracy were filled by powerful figures with strong commitments to economic orthodoxy: Jesus Silva Herzog, a MA in economics from Yale University as minister of finance; Miguel Mancera, a prominent orthodox economist as head of Banco de México; and Carlos Salinas, a Harvard PhD in political economy, as minister of programming and budgeting. All these appointments facilitated the negotiations with the ex-bankers and the international financial community throughout the administration of President de la Madrid (Hamilton 1985: 166).

Table 2.3

President Carlos Salinas's Economic Team

	Position	**Degree (University)**	**Field**
Carlos Salinas	President	PhD (Harvard)	Political Economy and Government
Pedro Aspe	Minister of Finance	PhD (MIT)	Economics
Ernesto Zedillo	Minister of Budgeting and Planning	PhD (Yale)	Economics
Jaime Serra	Minister of Industry and Commerce	PhD (Yale)	Economics
Manuel Camacho	Mayor of Mexico City	MA (Princeton)	Public Affairs
Miguel Mancera	Head of Banco de Mexico	MA (Yale)	Economics
Jose Córdoba	President's Chief of Staff	PhD* (Stanford)	Economics
Donaldo Colosio	Head of the PRI	PhD** (Pennsylvania)	Economics

Source: Grindle 1996: 113.
* Obtained his degree in 1994.
** Did not obtain his degree.

[27] Centeno (1994) introduced for the fist time the term technocratic revolution to denote the take-over of key state positions by a cohesive group with specific technical qualifications and a specific policy agenda.

Miguel de la Madrid managed to deliver the presidency to Carlos Salinas, another technocrat, despite a poor economic performance throughout his presidential term.[28] Salinas started to re-engineer the bases of support for the regime as soon as he took up the Presidency. His first major move was the configuration of a strong and coherent economic team; all the members of this team held degrees from the most prestigious American universities and had made their political careers in the above-mentioned Ministry of Finance-BdeM network (see Table 2.3). They also displayed cosmopolitan attitudes, and were skilled and confident negotiating partners with banks, foreign governments and MFOs. By the 1990s, Mexico had achieved an international reputation as a country in which technocratic elites and technocratic decision making was incontrovertible (Grindle 1996: 111).

Since international confidence building was so crucial to the success of Salinas's economic reforms, his economic team was free to act on its 'cosmopolitan' vision. According to Stephanie Golob (1997: 128), Pedro Aspe, one of the most prominent members of this team, 'saw no contradiction between Mexican sovereignty and respect for IMF guidelines and the rules set down by creditor banks.' The policy elite in Mexico was favourably disposed toward economic orthodoxy despite the sacrifices required to pay the external debt and the costs of internationalising the economy. These policies reflected their social and professional biases but more importantly, they also brought non-interference. For Centeno (1994: 202), 'economic interdependence allowed the elite to pursue internal policies autonomously.'

Conclusions

This chapter discussed the issue of domestic states' dependence upon international finance, and linked it to policy reform. That is to say, how the flows of ideas and capital across national borders have become the transmission mechanisms through which policy trends at a global level are translated into domestic policy choices.[29] However, the strength of the link between international trends and domestic economic policy

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[28] Between 1982 and 1988 income per capital fell in real terms and inflation peaked up towards the end of the *sexenio*.

depends on the relative needs of the state to finance itself and to finance the balance of payments. Capital inflows, increasingly guided by signals of sound economic policy, are fundamental for the success of development strategies pursued by states in LDCs.

These policy trends are determined by the prevailing orthodoxy in economic thinking. I argued that there is a symbiotic relationship between ideas and policy preferences, in which they shape each other, sometimes blurring the frontier between the two. It is difficult to say whether ideas shape the policy preferences of international capital and create global trends; or alternatively, international capital creates new consensual knowledge through financial inducements. The dominant consensus on policy-making, also known as 'Washington Consensus', stressed balanced public finances, (non-inflationary state financing), less state intervention in the economy (privatisation and deregulation) and trade and financial liberalisation.

The mechanism through which these ideas were translated into policy choices in Mexico was the aligment of President Salinas's economic team with an international policy network. MFOs are at the core of these epistemic international policy communities that cut across national borders. They exercise their influence more by building policy consensus (social learning) rather than by direct conditionality.

This chapter showed how the 'political leverage' of international capital fostered economic reform in Mexico under President Carlos Salinas (1988-1994). Now that the role of international forces shaping the configuration of power in Mexico is well established, the next chapter moves on to the analysis of the domestic political institutions in Mexico. They granted state organisations the required autonomy from

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[29] Stalling (1992) argues that international factors are crucial in explaining broad shifts in policy, both in contrasting the 1980s with the 1970s, and explaining the thrust of change during the 1980s.

social forces to engineer new bases of support for the regime and consolidate the traditional hegemony of the state in the Mexican political system.

Chapter 3

Domestic Politics:

Making the Reform Possible

In the last chapter, I argued that the structural dependency of domestic states on the world economy and the emergence of a new consensus on economic thinking during the 1980s were the initial drives for policy reform in Mexico and throughout the developing world. This chapter introduces the domestic component in Mexico's economic reform. I argue that President Carlos Salinas (1988-1994) used extensively the institutional and organisational infrastructure of the Mexican state to introduce a comprehensive programme of economic reform aimed to reassert his political leadership. As opposed to former Presidents, Salinas' political strategy was further constrained by increasing electoral competition. The two most important elements in the argument are the semi-authoritarian nature of the Mexican political institutions and their transformation during this period.

Mexico's semi-authoritarian political system has permeated policy-making and the state has traditionally dominated society regarding policy initiatives. According to Merilee Grindle (1996) public policies are the result of an autonomous state. Alternative interpretations, however, assert that the state has the capacity to deflect pressures from the regime's popular constituencies, but is vulnerable to pressures from key segments of the Mexican business elite and their allies from international capital (Hamilton 1982, Luna 1992). The evidence is not conclusive in favour of any one of these two interpretations. The role of the state in policy-making depends to a great extent on the period and the particular policy issue under study. For instance, during Salinas's *sexenio*, when the state was perceived as autonomous to a great extent, it was not possible to liberalise the oil sector because of pressures from the left-wing Partido de la Revolución Democrática (PRD) (Pedro Aspe, interview with George Philip, London January 1992). In contrast, trade liberalisation after 1986 is an example where the state acted with great autonomy and entered GATT and signed NAFTA despite strong

opposition from organised business groups. Alternatively, Salinas's financial reform illustrates how the state is very responsive to the policy preferences of international capital, while preserving the capacity to check popular opposition to pro-business policies.

The precise circumstance under which the state is more or less autonomous depends on the specific institutional arrangements. There is a vast literature that has attempted to identify those institutions.[1] This literature has produced some well-established facts pointing towards a state-dominated, corporatist and semi-authoritarian political system (Cosío Villegas 1975), built upon a contradictory political culture that includes authoritarian and liberal qualities (Hamilton 1982; Basáñez 1991) and dominated by the President and a bureaucratic elite (Philip 1991; Torres 1997). The analysis of policy-making in Mexico since 1988, however, must be complemented with the process of democratisation currently taking place.

This chapter is organised in three parts. The first part presents the major political institutions and organisations that have historically dominated policy-making and argues that the present autonomy of the Mexican state is the result of a semi-authoritarian framework dating back to the 1940s. The second part shows how the reconfiguration of power between policy coalitions during the 1980s placed reform-minded *technocrats* in key positions within this institutional framework, so they could advance their policy agenda. Finally, the third part discusses the issue of democratisation in Mexico since 1988 and shows how policy reform under President Salinas was intended to engineer new bases of support for the regime within the new

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[1] Among the most important studies on the political economy of the Mexican State are: Vernon (1963), González-Casanova (1965), Glade (1968), Hansen (1971), Córdova (1972), Cosío Villegas (1975), Hamilton (1982), Camp (1989), Kaufman (1989), Basáñez (1991b), White (1992), and Grindle (1996). Their approaches, however, have vastly differed. González-Casanova (1965), for instance, examines the political forces that have determined the decisions about economic promotion and development, providing a link between political institutions and economic performance. Glade (1968) also looks at the interaction between the political and the economic sphere but he concentrates on the role of development banking. The mixed nature, political and economic, of development banks, according to Glade, illustrate how political institutions impinge upon economic performance. Hansen (1971) tries to explain the Mexican economic miracle during the 1950s and 1960s based on the political institutions. Córdova (1972) and Camp (1989) assess the role of political institutions in the relationship between political power and economic development by concentrating on the specific interaction between the private sector and the state.

parameters set by an increasing integration to the world economy, on the one hand, and by increasing democratic competition, on the other.

3.1 The Politics of a Semi-authoritarian State, 1940-1982

The institutional framework of Mexican politics that emerged after the revolution[2] created a sort of 'Weberian' state, where public policy was usually the result of bureaucratic initiatives mediated by the interests of large business and political elites (Kaufman, Bazdresch and Heredia 1994: 363).[3] Broadly speaking, the politics of policy-making in Mexico between 1940 and 1988 were dominated by three major institutional features: (1) the existence of a powerful social control mechanism built into the Mexican political system, i.e. the Partido Revolucionario Institucional (PRI); (2) the organisational capacity of big business and their ability to create major economic disruptions through capital flight; and (3) the centralisation of decision-making power in the President and the executive bureaucracy. The stability of the Mexican political system during this period was based on the capacity of the PRI and its popular corporatist organisations to dominate the electoral arena, on the one hand, and on the ability of the President and executive bureaucracy to introduce coherent policies and deliver good economic performance, on the other.

This section discusses how the political institutions prevailing in Mexico before 1988 created an *embedded* state *à la* Evans (1992), sensitive to popular concerns and receptive to business interests. At the first level, the manipulation of electoral processes by the PRI, through corporatist structures,[4] left unorganised groups without effective influence on policy decisions. At the second level, an increasingly organised and

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[2] Some of the most important institutions and organisations of the present-day Mexican political system were created and consolidated during the two decades following the Mexican Revolution: specifically, the presidency, the Partido Nacional de la Revolución (PNR), which later became the PRI, and the popular corporatist organisations. In this new configuration of power, the President became the most prominent figure, although crucially reliant on other institutions. The executive bureaucracy and business corporatism are two other major political institutions that developed during the 1940s and 1950s and complemented the original ones.

[3] Max Weber (1978) developed the idea of an autonomous or bureaucratic state, dominated by a group of administrative personnel with coherent policy preferences and independent of interest groups influence.

[4] The PRI is formally integrated by three different corporatist organisations: the National Peasant Confederation (CNC), the Workers Confederation of Mexico (CTM), and the National Confederation of Popular Organisations (CNOP).

wealthy business elite managed to open the state to their economic interests. Finally, at the third level, the concentration of decision-making power in the President and the executive bureaucracy granted them the capacity to reform the political and economic structures according to their own agendas. Roderic Camp (1989: 239), who addressed explicitly the issue of state-society relations, asserted that the state has historically led this relationship. In the literature on Mexico's pre-1988 political system, the empirical base of society-centred approaches is still weak at best.

The Institutional Revolutionary Party (PRI)

Political parties, defined as organisations acting on the boundaries between state and society, are crucial to determining the capacity of the state to reform critical economic and political relationships. Political parties in democratic countries are organisations mainly directed to gain political power and as a by-product of their activities they articulate social demands and policy preferences. In Mexico, however, competition for political power was hindered by the PRI's electoral hegemony, at least until 1988.[5] According to Robert Kaufman (1990: 91), 'between the 1920s and the 1980s, government elites deployed this machinery to mobilise electoral legitimisation and co-opt competing labour and business interests, combining highly concentrated executive authority with considerable tolerance for public debate and dissent.' The PRI was an electoral apparatus aimed at securing continuity and stability for the regime, while creating an image of a democratic system. It was responsible for political mobilisation, control and conflict resolution, all at the same time.[6]

Consequently, the PRI had a limited role as an organisation articulating voters' demands. Its own organisational structure was of the 'top-down' type, where directives were set by the top echelons of the hierarchy, enforced by a large party bureaucracy and followed by the party's massive popular constituencies. At the top of the hierarchy was

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[5] Since the foundation of the PNR (predecessor of the present-day PRI) in the late 1920s, the party has not lost a single presidential election; and before 1988 it had not lost any election for governor either, and the Congress had always been dominated by the party.

[6] Dale Story (1986a: 131-132) summarises very well the role of the PRI up to 1988: "...with national elites becoming so technocratic, the PRI provided the President with the necessary political legitimacy, the symbolic aura of the Revolution, and the machinery for running campaigns, winning elections, and maintaining contacts with the masses."

the President, although not formally, subordinating *de facto* the party to the state. Popular mandate was non-existent under this scheme, electoral politics was just a matter of ritual. Electoral platforms were just the irrelevant repetition of the general principles of the Mexican revolution rather than the articulation of voters' preferences. The structure of the PRI allowed for individual political mobility but not for formal consultations on policy issues among the party supporters. Broad social concerns had to be articulated by the executive bureaucracy as a mandate from the President.

This presidential mandate was formally legitimised by the ideology of the revolution embedded in the electoral platform of the PRI and by winning periodical elections using the organisational infrastructure of the PRI. However, the real legitimisation of the regime was based on the ability of the President and the executive bureaucracy to produce the impression of economic progress.[7] According to Arnaldo Córdova (1972: 13) and Roderic Camp (1989: 224), economic development was the most important goal of public policy. In fact, as soon as the state started to deliver bad economic results in the 1970s, the legitimacy of the regime weakened and the task of wining elections became increasingly difficult for the PRI. Since then, a perverse political business cycle started to develop, where Presidents ran economic policy with short-term electoral purposes further damaging the economy and deteriorating the regime's legitimacy. The task of wining elections was more difficult every time.

In sum, the PRI's electoral hegemony excluded the possibility of having a political organisation that effectively articulated demands from the unorganised segments of the society. However, the President and the bureaucracy apparently placed economic development as a major policy goal, if not out of adherence to the electoral mandate, then out of fear of causing disturbances which could threaten the regime viability (Thompson 1979: 55; Camp 1993: 127).

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[7] Nora Hamilton (1982: 3) and Miguel Basáñez (1991a: 56) argue, however, that the Mexican state embodies an ideological contradiction between its historical origins in the Mexican Revolution and its contemporary function of maintaining conditions for peripheral capitalist development. Populism and capitalism have coexisted as ruling principles for the state in the ideology emanated from the revolution, in what Basáñez (1990a) called the *contradictory state*.

Business groups

Rogelio Hernández (1988) pictures business groups in Mexico as passive recipients of the benefits granted by the state.[8] This was a true representation of the private sector in the early 1940s but to the extent that the state's economic policy favoured a small economic elite during the subsequent years, business groups consolidated, their economic power expanded, and their political influence became institutionalised. At present the influence of these groups upon the state's economic policy is strongly institutionalised into continuous consultations, both formal and informal.[9] Antonio Ortiz Mena, former minister of finance (1958-1970), conceded: 'our contact with the private sector leaders was constant when I was in government. We would call them, given them our ideas about a policy, wait for their reaction, and then we would analyse these reactions, take them into account, and incorporate them in our final policies' (quoted by Camp 1987: 116).

According to Jeffry Frieden (1989: 29), large business groups derived their political influence mainly from their ability to organise into sectoral chambers mainly intended for lobbying, and from their potential to upset the economy by taking their capital out of the country (i.e. capital flight). Their organisation into business chambers was a long process that started in the mid-1930s and consolidated over the years. The first step in this process was the introduction of the Commerce and Industry Chambers Act in 1936,

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[8] At present there is in Mexico still a group of medium-size entrepreneurs that depend on the benefits of the state. For instance, Pedro Aspe, minister of finance (1988-1994), in an interview with *Este País* (January 1992) told the story about a businessman who went to see him and told him:

-Mr Minister, I do not have the pleasure of knowing you, but I need to talk to you: I am willing to give up all my assets. I have been educated not to fight against the state, not against the government.

-Excuse me, but I do not understand, Aspe replied.

-Yes, I am here to place all my goods at your disposal, the businessman insisted.

-Excuse me, I still do not understand anything.

-Doctor, please, do not make it more difficult to me. Last week I received a fiscal audit and I understand, in these cases sometimes you win, and sometimes you lose. Just let me know what do I have to do.

-Listen to me, we generate numbers randomly in our computers and in that way you were selected. There is not any political or harassing reason behind it.

This case is very illustrative of the political culture of the businessmen who grew and developed assisted and protected by the state.

[9] Roderic Camp (1993: 143), however, argues that the decision making process listens to demands from business groups more through informal internal channels than through formal public channels.

which made compulsory the organisation of the private sector into chambers.[10] These organisations were the only legitimate actors for formal consultations on economic policy.

During the 1980s, however, some large entrepreneurs decided to expand their sphere of political participation becoming active members of the Partido Acción Nacional (PAN), the old opposition party in Mexico, traditionally representing middle classes and small entrepreneurs. The most notable case was that of Manuel J. Clouthier, former President of the CCE, who ran as presidential candidate for the PAN in the 1988 elections. Still, the actual leaders of the business elite restricted their sphere of action to the traditional mechanisms of negotiation and consultation. In December 1987, however, the signing of the Economic Solidarity Pact (PSE) changed in a fundamental way these mechanisms.

The Entrepreneurial Co-ordinating Council (CCE), founded in May 1975, became the most important business organisation. It was the result of the increasing politicisation among entrepreneurs. The CCE was explicitly created to articulate the political demands of large business and soon became the major entrepreneurial organisation used for the state consultations on economic policy. The CCE grouped both specialised organisations with compulsory membership like CONCAMIN, CONCANACO, CANACINTRA and ABM, and mixed organisations with voluntary membership like COPARMEX and the CMHN. Consistent with its technocratic nature, the CCE groups also specialised professional organisations like the Centre of Economic Studies of the Private Sector (CEESP), the Mexican Entrepreneurs Council for International Affairs (CEMAI), the Centre for Social Studies (CES) and the Centre for Law Studies. These last sets of organisations are the main think-tanks of the private sector for economic, social, international and law studies.

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[10] The most important business chambers are: the Confederation of Industrial Chambers (CONCAMIN), funded in 1918; the Confederation of National Commerce Chambers (CONCANACO), founded in 1917; and the Mexican Bankers Association (ABM) founded in 1928. Later on, other entrepreneurial organisations complemented the above-mentioned sectoral chambers, like: the National Chamber of the Transformation Industry (CANACINTRA) created in 1941 for small and medium firms and characterised by its pro-governmental positions; the Mexican Confederation of Employers (COPARMEX) founded in 1929 as a response to the Labour Federal Act, and regarded as the employers' trade union; and finally the Mexican Council of Businessmen (CMHN) founded in 1962 as a reaction to the reforms introduced by President López Mateos.

Business groups have also resorted to informal practices to enter the decision-making circles of the state. According to Camp (1989: 229), the dual role of some actors and the exchange of personnel between public and private organisations are two of the oldest and most important informal practices in the politics of the Mexican state. The exchange of personnel, mainly in the financial sector, strengthens the personal contact between the financial executives and public officials. As Raymond Vernon (1963: 154) put it, 'for a political structure such as Mexico has managed to achieve, the familiar iceberg analogy has special reference. Most of the struggle between the private and the public sectors over the subject of government policy goes on sub-rosa, beyond the ken of newspapers and the public. Only a bit of the process is visible to the naked eye.' Mexico's public sector decision making is characterised by a protective ambiguity. Very little about the future direction of the economic policy can be known outside the inner circles of the state (see Glade 1991).

In contrast to the long process of business organisation into chambers, their ability to exit the economy as a source of political leverage is a relatively recent phenomenon associated with the increasing integration of domestic financial markets into one global financial system (see chapter two). Recent examples of their capacity to create major economic disruptions by resorting to capital flight include the exchange rate crises of 1976, 1982 and more recently 1994. Capital flight is usually the response of international capital and large domestic business groups to a deteriorating investment climate.

The President and the Bureaucracy

The autonomy of the Mexican state rests to a great extent on the extreme centralisation of decision-making power in the executive branch of the state, especially in the President.[11] The President, described by Merilee Grindle (1996: 49) as the major political leader,[12] wields maximum power for a six-year period.[13] According to Robert

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[11] The presidency is one of the most studied features of the Mexican political system. For a comprehensive analysis of this institution see: Carpizo (1979) or Philip (1991).

[12] The main political responsibilities of the President, according to (Thompson 1979: 56), were: (1) keep the stability of the political regime; (2) settle the most important disputes that cannot be solved at lower levels; (3) build support coalitions for the regime; and (4) create confidence among social groups.

E. Scott (quoted by Torres 1997: 35), the presidential supremacy stems from the deep-rooted tradition of a strong executive, broad constitutional powers and control of the official party. However, the most important source of presidential power is the informal rule that says: 'the incumbent President has the right to choose his successor.' This meta-constitutional faculty allowed the President to reassure his supremacy over other institutional actors. This single decision did not only determine the career prospects of every single individual engaged in politics and/or government, but also the business opportunities for the economic elite. As a result, absolute discipline to the presidential command became a distinctive feature of the Mexican political economy.

Besides the President, Mexico has a relatively well institutionalised public bureaucracy that expands the state's capacity to set the terms of policy-making.[14] The bureaucracy in Mexico is, according to Eduardo Torres (1997), a centralised body, deeply embedded into both the economic and political relationships of the state, and highly sensitive to the leadership of the President. Opinions about possible policy measures are solicited and channelled back to the President, usually through communication networks that the bureaucracy has established with local governments and the private sector (Thompson 1979: 53).

The relationship between the President and the bureaucracy is mediated by 'policy coalitions'.[15] Every President since Lázaro Cárdenas has reshuffled the executive bureaucracy and changed the configuration of power between policy coalitions, attending to his own government agenda, and within the parameters set by the international world order. Sylvia Maxfield (1990) distinguishes two dominant policy coalitions in the Mexican political system. On the one hand, the 'financial coalition', organised around the financial division of the bureaucracy (i.e. the Ministry of Finance, BdeM and large development banks) and advocating a conservative economic policy

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[13] The *sexenio* does not only represent the presidential term, according to Torres (1997: 35), it also sets the pace of Mexican politics, 'registering key dates and providing predictability to political action.'

[14] Torres (1997) claims that although a strong presidential institutions greatly contributed to political stability and economic growth, these outcomes cannot be fully understood without considering the emergence of two complex policy networks in charge of the management of politics and economics respectively.

[15] There is a vast literature on policy coalitions and the configuration of power within the Mexican political system. See for instance: Vernon (1963), Glade (1968), Cordera and Tello (1981), Camp (1989), Maxfield (1990), Basáñez (1991a) and Centeno (1994).

with emphasis on stability. On the other hand, the 'developmentalist coalition', organised around the ministries controlling natural resources and in large state-owned enterprises and promoting re-distributive policies. There is a strong historical correlation between the relative influence of these coalitions and the orientation of the economic policy under each particular President.[16]

Economic policy in Mexico after the Revolution can be characterised as a continuous swing between stabilisation and re-distributive initiatives. The period known as 'stabilising development' (1958-1970) was dominated by a rather conservative economic policy (see Table 3.1). The state used credit and monetary policy more for stabilisation purposes than for distributive goals. In the 1970s and early 1980s, economic policy placed greater emphasis on economic expansion and social spending at the expense of economic stability. As a response to a crisis of political legitimacy, President Luis Echeverría (1970-1976) changed profoundly the configuration of power between the policy coalitions, after thirty years of domination by the financial coalition. The office of the presidency and other 'developmentalist' agencies checked the influence of this coalition in economic policy by changing personnel and increasing the economic role of the state.[17]

President López Portillo (1976-1982) in turn restrained the financial coalition through the creation of the ministry of Planning and Budgeting. This agency, under the close supervision of the President, centralised the most important political functions in economic policy, namely planning and budgeting, and therefore effectively counter-balanced the Ministry of Finance (see Torres 1997). Supported by massive capital inflows from oil exports and international banks lending, López Portillo sought to take Mexico into the developed world through what he called '*la Administración de la abundancia*' (the management of abundance).[18] Nonetheless, exogenous shocks in international oil prices, interest rates rises and inconsistent economic policy decisions led to the collapse of the peso in February 1982.

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[16] Maxfield (1990) provides an excellent historical account of the relative influence of these two policy coalitions over time and the consequences for the state responses to trends in international finance.

[17] President Luis Echeverría (1970-1976) declared that the economic policy in Mexico was dictated from *Los Pinos* (the presidential house).

Table 3.1

Policy Coalitions

Term	President	Minister of Finance	Governor of BdeM	Coalition
1934-1940	Lázaro Cárdenas	Eduardo Suárez	Luis Montes de Oca	Developmentalist
1940-1946	Manuel Avila Camacho	Eduardo Suárez	Eduardo Villaseñor	Developmentalist
1946-1952	Miguel Alemán	Ramón Beteta	Carlos Novoa	Developmentalist
1952-1958	Adolfo Ruíz Cortines	Antonio Carrillo Flores	Rodrigo Gómez	Financial
1958-1964	Adolfo López Mateos	Antonio Ortiz Mena	Rodrigo Gómez	Financial
1964-1970	Gustavo Díaz Ordaz	Antonio Ortiz Mena	Rodrigo Gómez	Financial
1970-1976	Luis Echeverría	Hugo Margain; Jose López Portillo	Ernesto Fernández Hurtado	Developmentalist
1976-1982	Jose López Portillo	Mario Ramón Beteta; Rodolfo Moctezuma; David Ibarra	Gustavo Romero Kolbeck; Miguel Mancera; Carlos Tello	Developmentalist
1982-1988	Miguel de la Madrid	Jesus Silva Herzog; Gustavo Petricholi	Miguel Mancera	Financial
1988-1994	Carlos Salinas de Gortari	Pedro Aspe	Miguel Mancera	Financial
1994-	Ernesto Zedillo Ponce de Leon	Jaime Serra Puche; Guillermo Ortiz; Jose Angel Gurría	Miguel Mancera; Guillermo Ortiz	Financial

Source: Camp 1995

Since 1982, Presidents de la Madrid and Salinas favoured the financial coalition once again; the Ministry of Finance and BdeM regained the control of economic policy and stabilisation objectives came to the fore of the state agenda. The next section presents this reconfiguration of power between policy coalitions under President de la Madrid and shows how it placed reform-minded *technocrats* in key positions while straining the existing political institutions.

[18] President López Portillo meant by abundance the newly discovered oil reserves. The value of oil exports went from US $ 0.44 billions in 1976 to US $ 10.4 billions in 1980.

3.2 Political Change under de la Madrid, 1982-1988

The semi-authoritarian nature of the political institutions provided President de la Madrid and his economic team the required leeway for the implementation of a 'draconian' stabilisation programme (Roxborough 1989: 103). The financial coalition, according to Miguel Angel Centeno (1994: 122), advocated orthodox economic policies, not as a direct articulation of social demands, but because they believed that those policies were the best options to tackle the national challenges. The *technocrats* framed most economic problems from a strategic and long run perspective neglecting short run political consequences. Policy decisions under this perspective, although economically rational, deteriorated the political climate and created increasing popular opposition that materialised into an effective challenge to the regime in the 1988 presidential elections.

The Rise to Power of the Financial Coalition

The last important reconfiguration on the balance of political power between policy coalitions took place during the 1980s and was triggered to a great extent by the economic crisis of 1982. From a political perspective, the debt crisis represented more than purely financial imbalances: different coalitions competing for political power provided different views about the nature of the problem and the alternative strategies to cope with it. President López Portillo (1988: 1109) acknowledged himself that the nomination of Miguel de la Madrid as the PRI's presidential candidate responded to the nature of the challenge that the Mexican state would have to face in the following *sexenio*, which was essentially financial. The new elite, therefore, legitimated their rule by saying that the crisis facing Mexico in the early 1980s was financial (Centeno 1994: 140).

President de la Madrid brought back the members of the financial coalition, also known as the *technocrats*, to the most prominent positions of the executive bureaucracy.[19] The comeback of this group was favoured by the increasing dependency of the Mexican

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[19] According to various authors (Camp 1993; Centeno 1996; Golob 1997), the behaviour of individual political actors in the Mexican political system is constrained to a great extent by their membership to a particular policy coalition.

economy on the international world order and the dominant policy culture at that time. The members of the financial coalition adopted the postulates of the new orthodoxy in economic thinking and shaped their policy agenda accordingly. Homogeneity of personnel in terms of academic backgrounds and professional careers ensured economic rationality as the major methodological filter through which the public problems were analysed and worked out for the next couple of decades.

Another reason for the success of this coalition was their superior administrative capabilities vis-à-vis other agencies and the increasing importance and power of their allies, the new financial bourgeoisie and the international financial community (Heredia 1992: 271). Formulating a new development strategy became a top priority within the state and the technocrats had the best training for that task. Furthermore, the developmentalist coalition's loss of prestige favoured the financial coalition to consolidate its position within the bureaucracy.

The Mexican state under President de la Madrid launched a gradual reform of the economy comprising trade liberalisation, privatisation and rationalisation of public finances. In 1986 Mexico became a member of the Generalised Agreement on Trade and Tariffs (GATT), reducing substantially the level of trade protection. Privatisation was introduced for the first time as an explicit and comprehensive programme. Finally, the adjustment of public finances turned a primary deficit (revenues minus expenditure, excluding interest payments) of 7.2 percent of the GDP in 1982 into a surplus of 8.1 percent of the GDP in 1988 (Volj and Draaisma 1993: 129).

The financial coalition advocated a monetarist approach to macroeconomic management, which means tight monetary policy, firm commitment to free exchange convertibility, fixed exchange rates, low taxation and limited regulation of financial markets (Maxfield 1990: 13).[20] These policies greatly benefited domestic capital at the expense of the middle class and workers. The political legitimacy of the regime severely deteriorated under President de la Madrid, while the alliance between technocrats, large entrepreneurs and the new financial bourgeoisie strengthened (Frieden 1991: 221). In 1987 Agustín Legorreta, President of the CCE and former director of BANAMEX,

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[20] At some points in history, technocrats have been known also as monetarists and Chicago boys.

expressed openly the support of the business elite to the state economic policy and its chief architect, Carlos Salinas (quoted by Centeno 1994: 13).

Strain on the Political Institutions

President Miguel de la Madrid inaugurated his *sexenio* with a strained relationship between the state and large business caused by his predecessor's nationalisation of the commercial banks. The inherited debt crisis and the need to regain investors' confidence dominated economic policy under his government. The economic plan, outlined in the Programme for Immediate Economic Reorganisation (PIRE), was based on a 'draconian' reduction on public expending that placed the political system under increasing tension. The main constituents of the PRI (i.e. middle classes and workers) bore most of the costs from the stabilisation programme. The limits imposed on wage increases were decisive in curbing inflation and were only feasible thanks to the corporatist structure of labour in Mexico. By 1987 the wage share of national income had declined to 26.6 percent as compared with 35.9 percent in 1982 (Torres 1997: 132).

However, one of the striking features of Mexican politics under President de la Madrid administration and its approach to the economic crisis was the way it displaced the CTM from the centre of the political system. President de la Madrid de-emphasised the importance of negotiation with organised labour as a central element in Mexico's political economy (Roxborough 1989: 105). Labour conflicts in the steel, electrical and telephone sectors were solved unilaterally by 'unusually' strict applications of the labour code and threats of major layoffs (Kaufman 1990: 107). Although CTM leaders were unable to break formally with the dominant party, by 1985-1986 they began to express unprecedented sharp and public criticism of the administration policy.

President de la Madrid also checked democratic pressures during this period by making intensive use of the PRI machinery. The organised labour movement, despite its tensions with the government, played a fundamental role in keeping labour militancy under tight control. In 1985 the PRI won all seven governorships contended, 289 out of 300 elected seats in the Congress and almost all 845 mayoral elections despite public scepticism, fraud allegations and violence. In fact, President Miguel de la Madrid told

Roderic Camp in 1986 that Mexico was not ready for democracy (quoted by Torres 1997: 132).

To make things worse, the austerity programme failed to restore economic growth and stabilise the economy, further alienating the system's traditional bases of support. Exogenous events like the Mexico City earthquake in 1985 and the second fall in oil prices in 1986 combined with strong expenditure cuts, high foreign indebtedness and the stock market crash in 1987, delivered one of the worst *sexenios* in terms of economic performance. In 1987, a year before the presidential elections, the inflation recorded was 131.8 percent, the highest ever in post-revolutionary Mexico (INEGI 1994: 960).

Merilee Grindle (1996: 48) identified a crisis of political legitimacy for the second part of de la Madrid presidential term. Over this period there was an increasing mobilisation of social groups outside the traditional confines of the PRI, where they were less susceptible to co-optation and control. The deterioration of cohesiveness within the state elite that had helped maintain the political regime in power was reflected in defections from the long-standing support coalition. After Carlos Salinas was designated presidential successor, however, a substantial portion of the PRI's moderate and left wing broke away to support the populist electoral challenge launched by Cuauhtémoc Cárdenas—son of President Lázaro Cárdenas, one of the main architects of the Mexican political institutions (Kaufman 1990: 107). For Centeno (1994: 11), the selection of the PRI's presidential candidate for 1988 elections was the most critical point in the history of the regime since the 1940s. The crisis of legitimacy associated to the austerity measures of the stabilisation programme and the failure to deliver economic growth had weakened the regime to a historically unprecedented level.

Poor economic performance, a weakening corporatist apparatus and internal divisions within the PRI produced the worst electoral results ever in presidential elections for the state-party (see Table 3.2). The results were so contested that the allegations of electoral fraud by the new political force led by Cuauhtémoc Cárdenas sparkled massive popular mobilisations. The popular support for Cárdenas shook the foundations of the dominant party, which had routinely obtained majorities between 70 and 90 percent. Strong challenges to the legitimacy of the regime followed the electoral disaster of July 1988. By the time Salinas took office on December 1st 1988, Juan Jose Hinojosa, a prominent

political columnist, asserted that 'Salinas was the weakest President since the 1930s' (quoted by Centeno 1994: 15). Merilee Grindle (1996: 61) believes that Presidents after 1988 cannot count on the traditional bases of support nor can they assume than the PRI can ensure their election. The unexpected dimension of the political crisis exhibited by the 1988 election results had a substantial impact on the politics of reform under President Salinas, as shall be discussed in the next section.

Table 3.2

Presidential Election Results, 1952-1988

Year	Candidate	Party	% votes
1952	Adolfo Ruíz Cortínez	PRI	74.31
	González Luna	PAN	7.82
	Other		17.87
1958	Adolfo López Mateos	PRI	90.43
	Luis H. Alvarez	PAN	9.42
	Other		0.13
1964	Gustavo Díaz Ordaz	PRI	88.82
	González Torres	PAN	10.98
	Other		0.20
1970	Luis Echeverría	PRI	86.02
	González Morfín	PAN	13.98
1976	José López Portillo	PRI	100
1982	Miguel de la Madrid	PRI	70.9
	Pablo E. Madero	PAN	15.7
	Other		8.9
1988	Carlos Salinas	PRI	50.36
	Cuauhtémoc Cárdenas	FDN	31.12
	Manuel J. Clouthier	PAN	17.07
	Other		1.46

Source: Torres 1997: 142

3.3 Political Change under Salinas, 1988-1994

Carlos Salinas was the first President to face an effective electoral challenge in the last fifty years. Since Salinas, electoral competition has become a new feature of the Mexican political system. The PRI's disappointing electoral performance in the 1988 presidential elections made evident the need to restore popular support for the regime; and therefore, important changes to the political institutions and to the orientation of state's economic policy took place during Salinas's *sexenio*.

President Salinas made extensive and efficient use of the state's capacity to articulate new constituencies of support under effective democratic competition. Reasserted presidentialism was instrumental for the economic reform (Grindle 1996: 92). His strategy to restore the capacity of the Mexican state and to reassert his own authority had three major components: (1) restoring popular support for the regime by replacing the traditional corporatist organisations with state programmes of social spending;[21] (2) establishing an alliance with the domestic business elite and with international capital in order to lure capital back into de economy and secure financing for the PRI; and (3) assembling a coherent economic team able and ready to implement the structural transformation of the economy.

Elections and Political Competition

According to George Philip (1998: 23), the current trend towards greater democracy in Mexico has been expressed mainly in terms of more transparent and competitive electoral processes rather than in terms of genuine institutional changes. New organisations[22] that emerged during this period pushed for changes in the traditional *modus operandi* of the political system and therefore the government adapted old institutional arrangements to accommodate increasing electoral competition without overturning the existing presidential regime or jeopardising the electoral advantages of the PRI.[23]

President Salinas committed himself to clean elections mainly for two reasons. First, international capital pressed for democratic changes by tacitly conditioning their investments to clean elections and political stability. Second, doubtful electoral results in the 1988 presidential elections deteriorated the legitimacy of the regime, and therefore clean elections intended to legitimise *ex-post* his government.

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[21] The arrest of Joaquín Hernández, *la Quina*, the heretofore untouchable boss of the petroleum workers trade union, in combination with a showdown with Jongitud Barrios, the powerful head of the national teachers union, were the most important blows to the popular corporatism upon which the old regime was heavy reliant.

[22] The most important of which is obviously the Party of the Democratic Revolution (PRD). However several non-governmental organisations (NGOs) and political associations like: El Grupo San Angel, Alianza Cívica, and Compromisos con la Nacion, also played a role.

[23] It seems as if President Salinas had Lampedusa's (1991) immortal words in his mind: "If we want things to stay as they are, things will have to change."

Politics in Mexico during Salinas's *sexenio* were strongly influenced by the potential electoral challenge to the rule of the PRI either from the newly founded left-wing PRD or the long-established right-wing PAN. For the first time, a President had to deal with the real possibility of losing important elections and to negotiate with the opposition in the Congress. Between 1988 and 1991, the majority of the PRI in the Congress was not enough to make constitutional amendments. The distinction between the concepts of state, government and party became meaningful. At the end of 1993, the political system was far from despotic: political debate was more open than ever in both the press and the Congress; and opposition parties did effectively become government in three states (Baja California, Chihuahua and Guanajuato) for the first time in post-revolutionary Mexico and in 96 municipalities (some of them state capitals). The PRI ceased to be a state party in many respects, although it remained the most powerful by far.

In July 1993 President Salinas sent an initiative to reform the Act for Electoral Processes. The reform proposed ceilings on party spending, greater media access, more opposition representation in the Senate and the creation of electoral tribunals (*Financial Times*, July 9th 1993).[24] As a result of the reform, the government handed the responsibility of organising the electoral processes to the Federal Electoral Institute (IFE). Elections gained a great deal of transparency and most of the old practices of electoral fraud were substantially reduced. The electoral reform, however, represented a calculated decision. Without reducing the extensive powers of the executive, President Salinas could afford to concede opposition demands without endangering the PRI's hold on power. He boosted his personal popularity and the regime's legitimacy in the eyes of foreign capital. The package of political reforms gave a more democratic gloss to the country's authoritarian image. The proposals were seen, according to the *Financial Times* (August 26th 1993), as an attempt by Salinas to fulfil promises to modernise Mexico politically.

However, according to *the Economist* (July 17th 1993), the opposition remained sceptical about the President's will to equalise the electoral competition between political parties. The electoral reform came at the same time that the PRI's candidate for

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[24] The reform was announced in July and approved by the PRI-dominated Congress in August 1993.

governor to the politically strategic state of Mexico won the elections by an overwhelming majority thanks to huge campaign spending. Elections became more transparent but not more equitable. In fact, President Zedillo acknowledged that the presidential elections in 1994 were unfair (*La Jornada*, August 28th 1998).

Salinas used extensively the institutional infrastructure of the state to strengthen the electoral position of the PRI, especially regarding the presidential elections. In October 1993, a year before the elections, Salinas reached a pact with unions and businesses that called for big wage increases and tax cuts to take effect throughout 1994. Carlos Monsivais, a well-known left-wing intellectual, asserted that 'the PRI hijacked public opinion' (quoted by *The Economist*, August 6th 1994). The PRI, with seemingly unlimited sources of finance, including plenty of quiet assistance from government coffers and officials, showed it was the only party that people could count on to bestows largesse. Biased television coverage also played a big role.

President Salinas implemented an aggressive social policy where he mixed popular participation in public works and extensive financing. According to Jose Cordoba, chief of staff of the President, the state engineered a two tier social policy: it strengthened the existing social security network, on the one hand, and it put in place the National Programme of Solidarity (PRONASOL), on the other. This was a non-bureaucratic programme of community mobilisation to fight poverty 'intended to establish a close link between the general policies of structural change and the direct benefits for the communities, in order to lay groundwork for new social bases of support of the reform process' (Cordoba 1994: 266).

PRONASOL, run under the principle of 'help to those who help themselves', provided services infrastructure to communities that otherwise would have waited years. Nowhere was Salinas's personal ruling style clearer than in PRONASOL. In December 1988 Salinas created the National Commission of PRONASOL. General co-ordination and top decision-making in this commission was in the hands of a board chaired by the President and integrated by selected ministers and agency directors. An executive director appointed directly by the President managed it. At the lowest level, democratically elected 'Comités de Solidaridad' represented the communities. Centralised decision-making and decentralised operation minimised the role of the

bureaucracy and maximised the efficiency of the programme and the popularity of the President.

PRONASOL was a novel scheme of political campaigning with a clear tendency to foster popular support for the PRI. The scheme had a strong content of political propaganda and effectively gained support for the government's policy reform.[25] Solidaridad's funds tended to be spent where the PRI faced a stronger challenge from the opposition.[26] On the whole, spending tended to be concentrated in the countryside, where it is easier to foster political support in return for material benefits. By complying with what was offered, by reducing the time lag between the petition and the delivery, and by minimising corruption in the process, the government favoured the PRI to a great extent.

The victory of the PRI in the 1991 mid-term elections was the result of these new bases of support put in place by President Salinas through PRONASOL.[27] With its over seventy thousand local offices, abundant resources and ubiquitous propaganda, this programme became the new apparatus of political control. PRONASOL alienated the segments of the population with lower incomes from the possible influence of opposition political parties, linked them directly to the state apparatus, and eliminated any possible attempt to organise themselves into opposition groups. The result was a *Schumpeterian* democracy.[28] Political competition, although increasingly conducted

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[25] Community participation is at the core of the programme with a double objective: it seeks on the one hand, to empower the communities to decide about their needs, and on the other, to create a network of political organisations that could be easily co-opted. Between December 1988 and November 1993, 150,000 committees were set up by local communities. The results were very encouraging in terms of public works: 13.5 million people got access to clean water; 16 million to electricity; and 11.5 million to sewerage (Wood 1993).

[26] Dresser (1991) presents a different view. In her view, the 1988 electoral setback had little impact on President Salinas's social programme PRONASOL, which was a neopopulist solution to neoliberal problems rather than to electoral ones.

[27] Despite strong opposition from the right-wing Partido de Acción Nacional (PAN) and the left-wing party Partido de la Revolución Democrática (PRD), the results of the elections were a landslide for the PRI.

[28] So long as the political competition takes place through elections, regardless of how imperfect it may be, there is democracy in the *Schumpeterian* sense. For Joseph Schumpeter (1996: 269), democracy 'is that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote.' Schumpeterian democracy is a procedural democracy that depends on '...a *modus procedendi* ... a recognised method by which to conduct the competitive struggle, and the electoral method is practically the only available for communities of any size' (Schumpeter 1996: 270-271).

through clear and transparent elections, remained largely unfair. Massive resources poured into PRONASOL and other government programmes clearly favoured the PRI. The institutional resources and organisational infrastructure of the state were used by the PRI to win elections without resorting to outright 'fraud'.

Business-government alliance and PRI financing

Financing to the PRI became a critical issue in the context of stronger political opposition and elections scrutinised by an autonomous agency (i.e. the IFE). Oscar Vera (1991) argued that the comprehensive privatisation programme under President Salinas served the clear purpose of building a support coalition among the domestic business elite whose capital repatriation was crucial for economic recovery and whose contributions were expected to secure financing for the PRI.

Favoured investors consolidated their financial and industrial conglomerates thanks to the privatisation of large public firms. The programme was a great act of business engineering led by the Salinas's government. The state strengthened some large business groups by transferring to them its share of economic control on strategic sectors, like banking, telecommunications and mining (Garrido 1994: 167). These groups became successful players in the global economy and strong supporters of the government and the PRI in the domestic political arena. Most of the investors favoured by the privatisation of state-owned enterprises were linked to President Salinas in one way or another. Some of them were members of the PRI's Financing Commission during Salinas's campaign for President in 1988. Among the most important were: Carlos Slim (TELMEX and CARSO); Roberto González (BANORTE); Pablo Brener (MEXICANA); Carlos Peralta (IUSACELL); Fernando Senderos Mestre (DESC); Enrique Molina Sobrino (SAN LUIS); and Antonio Madero (Consorcio Industrial Escorpión) (*Este País*, January 1992).

At the same time, there was a reconfiguration in the alliance between the state and the business elite: stockbrokers strengthened their links and collaboration with the state relative to other groups from the business elite. Industrial groups suffered the effects of an international slump and trading firms were severely hit by inflation, the only group that grew and developed over these years were the stock brokers (Mateos and Roman

1993: 124). Traditional business groups, according to Grindle (1996: 35), lost their political influence and economic hegemony. The magazine *Businessweek* in an article titled *Salinas's Friends* argued that the economic reform in Mexico was supported by a new generation of entrepreneurs without financial antecedents but nurtured during the 1980s in the stock exchange and with the explicit support of the state (quoted in *Proceso*, July 28th 1991: 8).

Newcomers like Carlos Slim and Roberto Hernández replaced the 300 families that after the revolution were in charge of the most important business in the country.[29] These two personal figures, for instance, whose capital was accumulated through operations in the stock exchange during the 1980s (Mateos and Roman 1993: 117), led the groups of investors that acquired the two largest public enterprises sold to date, TELMEX and BANAMEX respectively. These new players joined some large industrialists and ex-bankers to build a new economic elite that now controls banks, brokerage houses, insurance companies and most major business concerns in Mexico.

Towards the end of Salinas's *sexenio*, when the time came to prepare the presidential succession, Oscar Espinosa, head of NAFIN, was appointed treasurer of the PRI for the elections in 1994. His position as head of the most important development bank provided him with important connections with the new Mexican business elite who was expected to make contributions to finance PRI's electoral campaigns.

Members of this new economic elite were involved in scandals regarding fund-raising for the PRI. The first event that brought to public light the close links between the business elite and the government was the dinner party organised by Antonio Ortiz Mena, former minister of finance (1958-1970) and Genaro Borrego, President of the PRI, on February 23rd 1993. At this dinner, attended by President Carlos Salinas, Genaro Borrego demanded a contribution of $25 million dollars for the presidential campaign in 1994 for each one of the guests (*La Jornada*, August 27th 1998). The list of guests at the

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[29] The Carso Group, the largest business group in Mexico, for instance, was founded by Carlos Slim from the profits on his stock market activities in the late 1970s and gradually incorporating big firms from industrial, merchant, and services sectors. The acquisition of TELMEX, however, turned this group instantly into one of the giants among the groups operating in the country (Garrido 1994: 168). Because of its size and economic importance and for the type of management practised by its new owners,

dinner party included the richest businessmen in Mexico, who in most of the cases had close ties with the government. Among the present were: Emilio Azacarraga (TELEVISA); Carlos Slim (TELMEX); Roberto Hernández (BANAMEX); Lorenzo Zambrano (CEMEX); Bernando Garza (ALFA); Adrian Sada (SERFIN and VITRO); Claudio X. González; Carlos Hank (HERMES); Angel Lozada; Alfonso de Garay; Jose Madariaga (PROBURSA); Eloy Vallina; Aurelio López Rocha; Carlos Abedrop; Jerónimo Arango; Alberto Bailleres (PEÑOLES); Antonio del Valle; Manuel Espinoza Yglesias; Diego Gutierrez Cortina (GUTSA); Jorge Larrea; and Gilberto Borja (ICA) (*Proceso*, December 4th 1995).

According to the multiple accounts of the event, most of the businessmen agreed to the requested contribution without major hesitations. Emilio Azacarraga's statement was remarkable: 'I have earned so much money during these years, that I commit myself to provide a higher amount [than the requested $25 million dollars]' (*Proceso*, December 12th 1995). Porfirio Muñoz Ledo, leader of the PRD, said about the 'infamous' dinner: 'this does nothing but lay bare the obvious—the oligarchic nature of the party and its collusion with the country's great fortunes' (quoted by the *Financial Times*, March 4th 1993).

Subsequent scandals came to light, especially after the 1994 elections. On June 13th 1995 the PRD presented documents revealing that Roberto Madrazo's campaign spending for governor in the state of Tabasco fairly exceeded the legal limits (*Proceso*, April 12th 1998). Roberto Madrazo spent almost $80 million dollars on his campaign for governor of Tabasco, more than 50 times the legal limit and $30 million more than the official cost of Zedillo's presidential campaign that same year (*La Jornada*, August 27th 1998).[30]

The PRI's campaign financing for the 1994 presidential elections also became closely associated to fraud allegations, especially in the newly privatised banking sector. Personal and institutional contributions from businessmen currently facing fraud charges—Gerardo de Prevoisin, Carlos Cabal, Angel Rodríguez and Jorge Lankenau—

TELMEX has become a key element in the functioning of the present-day Mexican economy and has put the Carso Group at the head of the big national private groups (Garrido 1994: 168).

became public (*La Jornada*, August 17th 1998). All of them benefited from the government's privatisation programme under President Salinas.

Gerardo de Prevoisin, executive director of Aerovías de Mexico (AEROMEXICO) after its privatisation, was forced to resign in September 1994 under the charges of fraudulent management. He later disclosed documents with information regarding contributions up to $8 million dollars for the PRI's presidential campaign in 1994. De Prevoisin argued that 'the contributions were demanded by the ruling party to AEROMEXICO during the electoral campaign. Payments were made under the name of AEROMEXICO with the acknowledgement of the firm's board of directors, which include some top government officials. Furthermore top party officials instructed the method of payment, (*Proceso*, February 2nd 1996).

BANPAIS under the management of Angel Rodríguez, financed part of the PRI's electoral campaign in 1994. Cash contributions amounted almost one million dollars; the bank paid for the rent of one of the buildings used by the PRI's finance committee; and ASEMEX, the group's insurance company, paid the insurance policy for whole presidential campaign, with an estimated cost of another one million dollars (*La Jornada*, August 28th 1998). Then, in July 1996, the Attorney General found out that Roberto Madrazo received money from Carlos Cabal, former owner of Banco CREMI-UNION. Cabal deposited more than $4 million dollars into a trust fund managed by Madrazo himself (*Proceso*, April 12th 1998). Finally, Banca CONFIA, formerly owned by Jorge Lankenau who is currently facing fraud charges, managed the $80 million dollars of Madrazo's campaign through four different bank accounts (*La Jornada*, August 27th 1998).

The huge spending in electoral campaigns, besides being purely rent seeking and economically unproductive, illustrates how President Salinas's used the state institutional resources to favour a small group of businessmen in exchange for financial support for the PRI and economic backing for his reforms. The capital repatriation of large domestic investors was an important component of the massive capital inflows

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[30] As a matter of comparison, Bill Clinton spent $50 million dollars in his 1992 presidential campaign.

financing the state and the current account deficit. The alliance between business and government was extremely beneficial for both parties, at least while it lasted.

Reasserted presidentialism and economic reform

Reasserted presidentialism was instrumental for the introduction of the economic reform in Mexico. In this period, the presidency merged Salinas's strong leadership with extensive institutional and financial resources—comprehensive decision-making power; subordinated legislative and judicial branches of government; a non-accountable and clientelist bureaucracy; massive access to the media; networks of collaboration with the business elite; mechanisms of social control (Grindle 1996: 81-82). The excessive concentration of political power in the President was barely touched by the political transformation that took place during this period. The new institutional arrangements accommodated the increasing electoral competition without reducing the President's ability to impose his policy agenda. Despite the fact that many constituencies did not back Salinas at the elections, he captured the extensive power of the Mexican presidency at the moment he took office. He was as powerful as any former Mexican President.

President Salinas was praised for his decisiveness during 'his first one hundred days' in office, when he used his decision-making authority to reassert his personal authority (Camp 1993: 143). Salinas's impressive achievements during his *sexenio* relied crucially on his decisions during this period. Those decisions had the clear and unmistakable purpose to show who was in power.[31] The message was primarily directed to the country's most influential political actors rather than to the electorate. An extensive, decisive, and bold exercise of presidential power proved crucial in creating the political environment required for economic restructuring. President Salinas also empowered José Córdoba, his chief of staff, to exercise key executive assignments. Córdoba held a supra-ministerial position from which he reasserted the presidential control over the economic policy-making process. As a matter of comparison and leaving ideological considerations aside, Presidents Echeverría and Salinas used

extensively the President's power to strengthen their own leadership and imposing their programme of government (Torres 1997: 144). In both cases, presidentialism was reasserted as a result of lost of legitimacy stemming from deep political crises, namely the 1968 student killing and the 1988 electoral crisis.

Another crucial element for the economic reform was the articulation of a coherent and highly qualified economic team. The weekly magazine *the Economist* (December 14th 1991: 19) lauded the team assembled by President Salinas, as 'probably the most economically literate group that has ever governed any country anywhere.' The recruitment of their members was especially important to preserve the coalition's homogeneity and cohesion. As Pedro Aspe, minister of finance and one of the most prominent members of this economic team, wrote:

> 'Without well-trained politicians and economists ready to put their minds to work on the solution to very complex problems—and with the will and unity to take the necessary decisions—no modernisation programme could be successful. It is indispensable to have top-grade people who are also convinced of the philosophy of stabilisation and structural change in the areas of budget control, domestic and international trade, privatisation, industrial regulation, social security, labour management, social development, taxation and financial policy' (Aspe 1993: 56).

Leopoldo Solís, an UNAM professor and head of the economic and social programming unit in the office of the President in the early 1970s was a crucial link in the economic team assembled by Salinas. Solís shared common links at Yale University with Jaime Serra (minister of industry and trade) and Ernesto Zedillo (minister of programming and budget); he met President Carlos Salinas and Manuel Camacho (Mexico City Major) during their student days at UNAM; and finally, he was related to Pedro Aspe (minister of finance) and Francisco Gil (deputy minister of finance) through Miguel Mancera (governor of BdeM) and Gustavo Petricholi (Mexico's ambassador to the U.S.); both of them studied with him at Yale University.

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[31] Many people agree with Rodolfo Junco, executive director of the newspaper *El Norte*, in his characterisation of President Salinas as 'a man who knows the old ways as well as the new ones. He uses either depending on what he wants to accomplish' (quoted by Wood 1993).

Jose Córdoba (1994: 282), chief of the President's staff and prominent member of this team, illustrated the cohesion of the economic team in the following passage: '...since 1988, the economic cabinet has met over 200 times, or once a week on average, and is always chaired by the President himself. Evidence of this effective teamwork is the more than 1,600 agreements that have been issued after these meetings, of which 95 percent have already put into practice. Even more compelling evidence is the fact that no confidential discussion on economic matters has ever been leaked to the press.'

The members of this team began their ascent in the bureaucracy at the time when the previous development strategy was perceived to have failed and new ideas and expertise became valuable political assets (Golob 1997: 98). As economic problems overshadowed all other issues during the 1980s, the influence of the economic cabinet expanded (Camp 1993: 143). In fact, their main claim to power was their ability to introduce a structural transformation of the economy. The disappointing performance of the Mexican economy created some leeway for the introduction of economic reform. Reformers were placed in positions of extensive authority and technical analysis units became central to policy-making at all levels. According to Grindle (1996: 92-93), they were expected to be completely identified with neoliberal policies, have the skills and perspectives needed to support a market economy and a rational state, and be ready to confront those wedded to the old and discredited system. Carlos Salinas and all the members of his economic team shared the policy culture of the MFOs favouring economic liberalisation.

Under Salinas, the financial coalition achieved the hegemony within the state apparatus. The state itself was able to re-establish a working relationship with the most powerful fraction of the business elite (Veltmeyer et. al. 1997: 144). Throughout President Salinas's term this coalition remained well positioned within the Mexican state and no major conflict developed over economic policy despite the social costs of the measures. The control exerted by this coalition on the state apparatus, both geographically and functionally, does not have a parallel in recent presidential administrations (Waterbury 1990: 301). Economic reform was possible thanks to a strong President with a clear agenda of reform, supported by a coherent economic team, with new mechanisms of social control and a reinvigorated alliance with the business elite.

Conclusions

As a result of the institutional framework that emerged after the revolution and consolidated during the 1940s, policy-making became almost completely dominated by the state. Voters and most social groups, with business organisations being the only notable exception, were controlled by the PRI's corporatist structures. Elections were more a legitimising ritual than an effective mechanism of political competition. Business groups were always close to the state, making sure their interests were taken into account. The state remained strong under the leadership of the President and the management of a coherent and loyal bureaucracy.

The first signs of political change started to appear in the late 1960s. However, the system remained viable without major changes until the 1980s. At his point, increasing social and political mobilisation outside the traditional political institutions forced the state apparatus to accept effective electoral competition. Two major events during this period exacerbated the political tensions: poor economic performance and the rise of the financial coalition to power. However, the political changes were mostly restricted to electoral politics, while leaving the hegemony of the state in policy-making essentially untouched. The PRI was, perhaps, the institution that changed the most in order to face the continuous electoral challenges from the PRD and the PAN. The state, however, remained largely bureaucratic and autonomous with strong links to the PRI.

President Salinas's strategy to cope with the increasing pressures for democratisation was to open up the electoral processes just enough to prevent the sort of violent protests that would attract international attention, but without curtailing the powers of the presidency that enabled him to implement the far-reaching economic reform. The ultimate goal was not assuring the party's hegemony as much as providing the political stability required to carry out his socially costly economic reform (Torres 1997: 159). Salinas reinforced the patron-client relationships that traditionally linked the most successful Presidents to both economic elites and large popular groups. President Salinas, although increasingly willing to accept the authentic outcome of elections, was actually more prepared to use the 'meta-constitutional' and extra-legal powers of the presidency than several of his predecessors (Philip 1998b). The result was a *Schumpeterian* democracy characterised by more transparent electoral processes but in

which the government used its financial and organisational infrastructure extensively to favour the PRI. Elections were legal but not fair. The old-practices of rigged ballots and unreliable voters' records were eliminated and replaced for more sophisticated mechanisms to favour the PRI, like greater access to financial resources and mass media time.

Mexico's reform to the financial system took place in the middle of this simultaneous political transformation. Greater electoral competition exacerbated the political business cycle observed in Mexico since President Echeverría. Since then, every *sexenio* closed with a financial crisis. The economic consequences of this simultaneous process of financial reform and political transformation shall be discussed in chapter eight while discussing the financial crisis that followed the peso devaluation in December 1994.

This chapter introduced the argument of state autonomy to show how the Mexican state under President Salinas engineered new bases of support and adapted old institutional arrangements to accommodate increasing electoral competition without jeoparsiding the President's political leadership. Next chapter narrows down the discussion of state autonomy to the specific organisations and institutional arrangements involved in policy-making for the financial system.

Chapter 4

Financial Policy in Mexico:

A Historical Account

This chapter explores the link between state autonomy and financial policy in Mexico from a historical perspective.[1] The purpose of this chapter is to make a case for financial policy as a relevant area where state decisions can be explained using our analytical framework. The reasons why financial policy is especially important for the study of decision making within the state are several. First, the capacity of the state to govern depends to a great extent on its ability to finance itself. Second, the interest groups involved in the financial sector are among the wealthiest and better organised within the society and therefore represent an effective counterweight to the state. Third, the financial policy determines the long-term growth potential of any economy inasmuch as it influences saving and investment decisions.

The cyclical economic crises observed in Mexico from 1976 to 1994 illustrate the importance of the financial policy for the country's economic performance. All the crises experienced during this period share two remarkable similarities linked to the political economy of Mexico's financial system. First, all of them took place towards the end of a presidential term. Second, each one of them was ultimately caused by inconsistent financial policies. This chapter addresses the second element, namely the government decisions that triggered each crisis during this period. The link between the political calendar and the cyclical nature of the economic crises shall be explored later in chapter eight while analysing the 1994 financial crisis.

Chapter one introduced our conceptual framework based on institutions and organisations. In that setting, history is essential to identify the constraints that

determine the government's decisions and structure the relationship between state and society at the same time. The historical account in this chapter intends to identify those constraints in order to outline the institutional framework underlying the financial reform under President Salinas. The scope of the analysis, however, is restricted to the subset of political institutions and organisations involved in financial policy-making only. External influence and domestic politics were analysed in greater depth in chapter two and three respectively. This chapter concentrates on the role of interest groups and state organisations operating in the financial system.

This chapter is organised in four parts, each part dealing with a specific period in the history of Mexico's financial policy. The first period (1925-1952) was characterised by the introduction of a new institutional framework for the financial system. Banco de Mexico, business corporatism and development banking are institutions that were introduced during this period. The second period (1952-1982) was characterised by strong state intervention: interest rate ceilings, reserve requirements on banks' deposits and selective credit controls.[2] This period is divided into two sub-periods: in the first the framework worked well and the economy recorded high rates of annual growth; in the second the same framework failed to cope with changing economic conditions and produced two economic crises. The third period (1982-1988) represents the first attempt of financial liberalisation. The most important event during this period is the development of a parallel financial circuit around the Mexican Stock Exchange. Finally, the fourth period (1988-1994) represents the second attempt of financial liberalisation. In this period the government removed all the controls on banking operations.

4.1 Setting up an Institutional Framework, 1925-1952

Mexican history during most of the nineteenth century was dominated by continuous political conflicts leading to weak and unstable governments. The institutional framework in the economy produced badly specified and weakly enforced property

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[1] For financial policy I mean all those government's decisions concerning the regulation of the financial system, the exchange rate regime and the sources of state financing (i.e. external borrowing, money printing, reserve requirements and securities' emissions).

[2] The programme of selective credit controls consisted of banks' lending quotas to pre-specified sectors.

rights leading to an environment of high uncertainty and poor economic performance.[3] However, President Porfirio Díaz (1877-1910) suppressed political conflicts towards the end of the century and introduced economic institutions that promoted rapid growth.[4] During this period and for the first time in Mexican history there was an explicit attempt to introduce a 'proper' financial policy. In March 1897, Jose Ives de Limantour, minister of finance under President Díaz, obtained the consent from the Congress to draft the General Act for Credit Institutions (Ley General de Instituciones de Crédito, LGIC) (White 1992: 15).[5] The financial system gained depth and strength thanks to foreign investment, which during this period poured in.

The Mexican Revolution during the 1910s, however, triggered a new round of political conflicts with the corresponding uncertainty. The modest achievements in terms of creating an institutional framework for the financial system under President Díaz were completely wiped out. President Venustiano Carranza (1917-1920), for instance, strongly opposed the banking organisations inherited from the *Porfiriato*[6] arguing that they were 'antithetical' to the principles of the Mexican Revolution. Carranza confronted the banks even prior to his assumption of power threatening to liquidate and seize all banks operating with insufficient metallic reserves (White 1992: 34). At the end, his hostile policies against bankers were largely ineffective but the financial system was severely weakened anyway.

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[3] For instance, according to Russell White (1992: 9), the most profitable business of the financial sector during last century was the extension of loans to both, conservative and liberal governments. These loans to the government often empowered the financiers and merchants to extract important political-economic privileges. These privileges included high interest rates, import permits, fiscal exemptions, and temporary control of state monopolies. Other example of this extraction of political and economic privileges from the state took place in 1881, when the state authorised a French-Egyptian company to establish the Banco Nacional de Mexico with several and special concessions. Among these privileges were: the right of issuing money and establishing branches throughout the country. In exchange the government obtained an annual credit line. This bank worked as the financial agent of the government consolidating its position within the Mexican financial system (Moore 1963: 18; White 1992: 12).

[4] President Díaz used extensively the coercive power of the state to repress opposition movements. Furthermore, the economic benefits produced by his policies were appropriated by a small elite and income distribution deteriorated rapidly during this period. The Mexican revolution was a response to his long-lasting presidency and harsh economic policies.

[5] The commission was integrated by three lawyers, two financiers, and a representative from Banco de Londres.

[6] Period of Mexican history dominated by the Presidency of Porfirio Díaz from 1874 to 1910.

A second attempt to reorganise the financial system took place in 1925 under President Plutarco Elías Calles (1924-1928). His government drafted a new LGIC, according to which the government through the Ministry of Finance became in charge of inspecting and regulating the financial system (White 1992:38). Later on, that same year, the government drafted the Organic Act of Banco de Mexico (Ley Orgánica del Banco de México, LOBdeM). This was the other major act regulating the organisation of the financial system. The LOBdeM (1995) regulates three important issues: the relationship between the central and commercial banks; the relationship between the central bank and other state agencies; and the money supply. These two acts provided the core of the legal framework for the financial system during most of the twentieth century.

Banco de Mexico (BdeM) and the Ministry of Finance

One of the most important events in the modern history of the Mexican financial system was the foundation of the central bank (Banco de Mexico, BdeM) in 1925. The actual commitment to create BdeM came from the first annual convention of the *Asociación de Banqueros de México* (Mexican Bankers Association, ABM) in 1924. Forty-one banks participated in this convention along with government representatives. Bankers and authorities discussed legal and practical problems facing the financial system and at the end, the state committed itself to the creation of a central bank and a banking commission. Shortly after the convention, in January 1925, the LGIC was enacted regulating and reorganising the financial system.

The consolidation of BdeM as one of the core organisations of the policy network for the sector took place only gradually. At the time of its foundation, President Calles was trying to resolve disputes with international creditors (Maxfield 1993: 236). At first, it was intended to signal a firm commitment towards price stabilisation and conservative monetary management. However, the functions performed by BdeM in its early days were more akin to commercial banking than to central banking. Private bankers themselves owned an important part of BdeM's voting stock and therefore their interests circumscribed the bank's operations in this early stage (Moore 1963: 52). Besides, BdeM did not have the monopoly of money issue and private banks were not required to associate with it. The lack of operational experience, financial resources and public

confidence combined with economic recession and political instability delayed the consolidation of BdeM as a central bank (White 1992: 39).

In 1932, however, the government reformed the LGIC in order to strengthen the position of BdeM. The reform included restrictions on the commercial operations of BdeM and new provisions to conduct central banking operations (White 1992: 44). The affiliation of commercial banks to BdeM became compulsory and in just one year, the associated banks increased from 14 to 62. The reorganisation of the monetary system between 1932 and 1940 provided BdeM with increasing control over financial policy. Since then, BdeM has provided the initiative and financial support for the creation and development of new private organisations and for the stability and institutional development of the system in general. William Glade (1968: 157) argues that BdeM is the organisation that best embodies the interests of the financial system as a whole.

Despite the fact that the reform formally strengthened BdeM vis-à-vis commercial banks, the reform subordinated BdeM to the Ministry of Finance at the same time. The ministers of finance crucially influenced the appointment of BdeM's directors during this period (Maxfield 1993: 239-245). In the 1930s President Cárdenas consulted Eduardo Suárez, minister of finance (1934-1952), before appointing Luis Montes de Oca as head of BdeM. Then in 1954, Antonio Carrillo Flores, minister of finance (1952-1958), played a decisive role in the designation of Rodrigo Gómez as BdeM's director.

While Presidents and ministers of finance wavered between the objectives of growth and stability, BdeM invariably took a stance in favour of stability, which is the main precondition for a healthy financial system (Thompson 1979: 59). Financial policy, consequently, oscillated between these two major and sometimes conflicting objectives: stability and growth (Maxfield 1993: 231). According to the first objective, as stated by the LOBdeM (1995: 151) and the Act for the National Banking and Securities Commission (LCNBV 1995: 424), the first priority of the financial policy is to secure the stability and development of the financial system. Economic growth is fostered only indirectly through efficient saving and investment decisions. However, according to the second objective, as stated by the political constitution (CPEUM 1997), the government's policy must be primarily concerned with economic development. Under

this perspective, when stability and growth are in conflict, financial policy must favour the latter.

The Mexican state embodied an ideological contradiction. This ambiguity was rooted on its historical origins from the Revolution, on the one hand, and on its function of promoting economic development, on the other (Hamilton 1982: 3; Basáñez 1991a: 56). Populism and capitalism coexisted as ruling principles of the state's ideology, in what Miguel Basáñez (1990a) called the 'contradictory state'. Very often, financial policy was the result of these ideological contradictions. In the 1920s, when stability was crucial to re-establish state credit-worthiness, the government founded BdeM and implemented 'orthodox' policies. Then in the 1930s, when economic expansion was necessary to engineer popular support for the regime, the state shifted the financial policy away from the relative orthodoxy of the 1920s to an active promotion of economic development. The minister of finance, Eduardo Suárez, between 1934 and 1946 originally advocated the 'heterodox' view. This view favoured state intervention in the financial markets in order to foster economic development. However, every time the government used financial policy with expansionist purposes a conflict developed between the Ministry of Finance and BdeM. At all other times these two organisations worked in close collaboration promoting the development of the financial system.

Commercial and Development Banks

Shortly after the revolution and as a result of a nationalist ideology, the government's policy led to a process of 'Mexicanisation' of the financial system.[7] The 1932 reform to the LGIC precluded the direct ownership of foreigners in Mexico's banks. Domestic investors acquired the old and formerly foreign-owned large banks. However, after their departure, the share of banking resources controlled by commercial banks dropped from 61 percent in 1932 to 42 percent in 1934. State banks throughout the 1930s predominantly controlled most assets in the system. BdeM, for instance, controlled

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[7] Late in the nineteenth century and early twentieth century, financial practices in Mexico were very similar to those in Europe since the financial system was dominated mainly by European immigrants. This foreign influence within the banking community was strengthened by new waves of immigrants after the Mexican revolution mainly refugees from Franco and Hitler in the late 1930s and early 1940s. Nevertheless, the institutions created by this generation of immigrants and their children began to acquire Mexican identity over this period (Vernon 1963: 156).

approximately 50 percent, other state banks handled an additional 10 to 20 percent, and the proportion controlled by private banks fluctuated around 35 percent (Hamilton 1982: 203).

The reform to the LGIC in 1932 laid the foundations for the modern financial system in Mexico. Most of the financial activity was structured around banks, both private and state-owned. However, throughout most of this period the state controlled financial policy-making without much intervention from private bankers. Commercial banks were relatively small compared to BdeM and other state-owned banks in terms of assets and capital. Furthermore, private bankers and state officials were in many cases the same persons. For instance, President Aberlardo Rodríguez (1932-1934) was one of the cofounders of Banco Mexicano. Maximino Avila Camacho, governor of Puebla under Cárdenas and brother of President Manuel Avila Camacho (1940-1946) controlled Banco de Comercio (BANCOMER) along with Manuel Espinoza Yglesias and William Jenkings. Manuel Gómez Morín, founder of the opposition party PAN, led the acquisition of Banco de Londres y México after the bank's liquidity crisis in 1934. Luis Montes de Oca, minister of finance (1927-1932) and BdeM's director (1935-1940), founded Banco Internacional along with Alfonso Cedillo. Eduardo Suárez, minister of finance (1935-1946), was President of Banco Comercial Mexicano (COMERMEX), for several years and subsequently deputy-President until his death in 1976 (Hamilton 1982: 131; White 1992: 46).

The ABM's annual convention dates from this period as well. It is one of the oldest and most important events in the calendar of the financial system. At the beginning, it represented more a statement of the government's financial policy rather than an effective mechanism of policy co-ordination. It was organised by the ABM, but the minister of finance actually chaired it. The Mexican President used to give the closing speech. According to John Thompson (1979: 57), the best statement of state economic policy was the annual speech by the minister of finance at this convention.

Another major development for the financial system during this period was the introduction of development banking as a parallel circuit to commercial banking. The explicit aim of these banks was to assist the incipient domestic productive apparatus and to attend the financial needs of peasants, small industrialists and local governments

(Maxfield 1993: 237). Commercial banks serviced the large and well-established manufacturing firms but neglected the less-profitable and riskier sectors. Despite the fact that development banks did not have policy-making power as BdeM or the Ministry of Finance they played a central role in the overall performance of the financial system. The size of their assets increased steadily over all this period; their share of the total grew from less than ten percent in 1935 to more than 25 percent in 1952 (NAFIN 1990: 477). Besides, the economic sectors attended by development banking, usually neglected by commercial banking, were not only politically important, but they were also strategic for the development of the whole economy.

Nacional Financiera (NAFIN), established in 1934, was the most important development bank in terms of assets and connections with domestic banks and multilateral financial organisations. Other important banks created during this period were: Banco Nacional de Comercio Exterior (BANCOMEXT), Banco Nacional de Crédito Rural (BANRURAL) and Banco Nacional de Obras Públicas (BANOBRAS). The creation of each bank was related to a particular set of political and economic circumstances (Glade 1968: 121). Development banks were created to satisfy the credit needs of politically significant sectors in a period of institution building. Peasants and workers, for instance, two of the benefited sectors with access to development finance through BANRURAL and Banco Obrero respectively, are two of the three corporatist pillars of the PRI.

Development banking, especially under President Cárdenas, suffered from the conflicting goals of securing bases of popular support for the regime and gaining a profitable return on their assets. Development banks yielded to political pressures very often and their financial soundness was constantly at risk. The emphasis placed on financial efficiency vis-à-vis political oriented goals varied across banks. For instance, NAFINSA was a highly efficient and influential participant in the financial markets with low political input in their internal policies. BANRURAL, in contrast, was regarded as a highly politicised bank with problems of financial efficiency. According to Sylvia Maxfield (1993: 242) President Cárdenas attempted to build a national political party supported by a wide base of favoured agents through the provision of credit. However, Presidents Manuel Avila Camacho (1940-1946) and Miguel Alemán

(1946-1952) departed from the development conception of President Cárdenas and promoted industrialisation taking away financial resources from agriculture.

4.2 Financial Management, 1952-1982

Robert Bennett (1965) found that Mexico's financial markets at the beginning of this period were small, non-diversified and unable to adopt a long-term perspective in their investment decisions. These characteristics motivated the state to participate directly in the management of the financial system (Haggard and Lee 1993: 6). Financial policy was characterised, according to Danby (1996: 22-23), by four main features. First, the state exercised greater control over the financial system by extending and tightening the existing programme of selective credit controls. Second, the state financed its deficit increasingly through reserve requirements. Third, the state increased foreign borrowing. Fourth, the state introduced credit incentives on capital investment.

This period, also, represented the consolidation of an institutional framework for the financial system along with a new configuration of organisations. The formation of financial groups was an important element in the process of economic development in Mexico. Given the context of a capitalist system, the state promoted the process of private accumulation, which strengthened the political and economic position of large financial groups (Hamilton 1982: 287). Their influence became institutionalised into policy consultations. Financial groups were represented by corporatist associations responsible to articulate their demands. The three main organisations were the ABM for banks, the AMCB for stock brokerage houses (SBHs) and the AMIS for insurance companies. These organisations included consulting staff of economic and financial specialists to study and develop policy initiatives in collaboration with the authorities. Financial corporatism differed substantially from popular corporatism in the sense that the state could not exert any visible influence on their internal affairs and external positions. The organisational strength and the independent financial resources of these associations secured them a great degree of autonomy (Camp 1989: 228).

According to Celso Garrido and Enrique Quintana (1987: 109), the ABM became the most important link between bankers and public officials in BdeM and the Ministry of Finance during the 1960s. Survey studies on the Mexican private sector's own

perception of their political influence, found that bankers were regarded consistently as the most influential group (see Derossi 1971; Story 1986b). Antonio Ortiz Mena, minister of finance (1958-1970), accepted that the bankers' views on public policies were always taken into account (quoted by Camp 1989: 191). Every year representatives from the state and the large financial groups met at the ABM's annual convention to discuss the most urgent policy issues for the financial system. Actors from both sectors, private and public, presented their positions through public speeches, and immediately afterwards negotiation took place in the discussion tables. The connection between the ABM and the state was reinforced by informal personal links. For instance, between 1928 and 1982, seven out of the forty-eight Presidents of the ABM were men involved directly in politics and banking (Camp 1989: 84).

It is possible, however, to distinguish two sub-periods. In the first sub-period (1952-1970) the financial policy produced an efficient framework that fostered the development of a domestic productive apparatus. In the second sub-period (1970-1982) these policies did not cope with the changing international context and produced a phenomenon known in the literature as 'financial repression' and ended up with the twin crises in 1976 and 1982.

The Golden Years, 1952-1970

In this period, the financial policy set up a stable financial system with strong and well-enforced institutions providing the required environment to boost the economy and develop the domestic productive apparatus. During these years, known as the 'stabilising development' period, the Mexican economy recorded average annual growth rates near to seven percent, which were among the highest in the world, and average inflation rates of three percent (INEGI 1994: 401-402, 959). The performance of the Mexican economy during this period became to be known as the 'Mexican miracle' (see Carmona 1973).

During the 1950s and 1960s the state moderated the policy of direct economic promotion. Stabilisation considerations came to the fore of the state agenda and the government shifted back to conservative financial policies. President Ruíz Cortines (1952-1958), for instance, brought down inflation, increased the authority of the

Ministry of Finance and BdeM dramatically, reversed the loose fiscal policy of President Miguel Alemán (1946-1952), took anticipatory devaluation in 1954 and raised reserve requirements to finance the public deficit (Haggard 1990: 176). Exchange and interest rates policies were rather conservative with emphasis on attracting foreign direct investment and the allocation of credit was directed to priority public and private investments (Kaufman 1989: 110).

The financial authorities made extensive use of selective credit controls and interest rate ceilings, essential features of the post-revolutionary Mexican financial system, to preserve price stability more than to direct credit to strategic economic sectors (See Brothers and Solís 1966). The programme of selective credit controls was carried out through four mechanisms: (1) development banks lending; (2) lending quotas to commercial banks; (3) preferential discount rates offered by BdeM to commercial banks lending to specific sectors; and (4) differential reserve requirements depending on the sectoral structure of the banks loan portfolio (Edwards 1995: 205). The government also created a series of trust funds in order to control the allocation of credit and the inflationary pressures from World War II. Selective credit controls were 'heterodox' because credit was allocated to productive investments in predetermined economic sectors, but at the same time, they were 'orthodox' since its major objective was to control inflation.[8] Colin Danby (1996: 29) described very well the double nature of the credit controls:

> '... the policy followed by the Mexican government was a sort of hybrid of the opposing sets of policy recommendations termed 'structuralist' and 'monetarist' in Latin America: on the one hand, resources were aimed at eliminating supply constraints, on the other hand, overall credit expansion was limited. Mexican authorities sought to avoid the demand-augmented effects of any credit expansion by targeting credit to desired uses, and severely constricting unchannelled credit, especially consumer credit.'

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[8] The 'orthodox' view of monetarism that advocated conservative monetary and credit policies in order to control inflation was advocated mainly by Rodrigo Gómez, director of BdeM (1952-1970), and Antonio Ortiz Mena, minister of finance (1958-1970).

Parameters like reserve requirements were very often the result of negotiations between financial authorities and commercial bankers rather than unilateral decisions of the state (Fitzgerald 1979; 1980). Credit controls, of which reserve requirements are only one variation, had to be negotiated. Otherwise, they were ineffective without the bankers' co-operation. Reserve requirements served mainly two purposes: secure financing for the state and conduct monetary policy. Printing money served both purposes as well, but at the expense of fostering inflation. Reserve requirements remained as a popular source of state financing for a long time thanks to their non-inflationary bias. These policies were expected to provide an inexpensive and non-inflationary source of financing for the state and the economy (Aspe 1993: 62). This framework worked well throughout this period, providing financing to the state while preserving macroeconomic stability and securing profitability to financial ventures.

At the end of this period, most of the studies on the Mexican financial system coincided that it was the best-developed in Latin America.[9] Despite the fact that the financial system had a good performance, it was very vulnerable to potential surges in inflation or potential policy mistakes. The weaknesses of the system were: (1) the development of the financial system depended completely on the dynamism of the banking sector while the other non-banking agents remained stagnant; (2) the banking deposits were very liquid and Banco de Mexico (BdeM) was responsible from backing them, hindering the ability of BdeM to conduct monetary policy; (3) the reserve requirements mainly used to finance the public deficit and to control the money supply required constant adjustments; and (4) the combination of interest rate controls, a fixed exchange rate regime and free exchange convertibility. This combination was potentially explosive in a changing environment, both political and international, and left the government with a very narrow margin for policy errors.

The Tragic Years, 1970-1982

The policy of financial controls, dominant in Latin America at the end of the 1960s, was challenged by the view that liberalisation was essential to encourage growth. According to this approach, pioneered by Ronald McKinnon (1973) and Edward Shaw (1973), a

growth-conducive financial policy required free interest rates, low reserve requirements on bank deposits and sophisticated financial intermediaries, including stock exchanges (Edwards 1995: 201). The advocates of financial liberalisation argued that the state intervention in finance produces a phenomenon called 'financial repression', where the state maintains artificially low interest rates inducing an excess demand for credit. In this framework the state is drawn into the process of rationing financial resources among competing uses (Haggard and Lee 1993: 5). The consequences for efficiency are twofold: first, interest rates below market clearing level inhibit savings; second, the allocation of credit is often imbued with political considerations.

The first wave of financial liberalisation in Latin America during the 1970s, took place in Chile, Uruguay, Brazil and Argentina where governments deregulated interest rates; eliminated selective credit controls; reduced and harmonised reserve requirements on banks' deposits; relaxed barriers to entry; encouraged securities markets and institutional investors; and created modern and efficient supervisory legislation (Edwards 1995: 208). The goal of financial deregulation in most Latin American countries was to withdraw the state from directly participating in the allocation of credit and the setting of interest rates. However, the outcomes from these policies in most of these countries were very disappointing. Chile and Argentina, for instance, experienced the collapse of their financial systems early in 1980s (see Díaz-Alejandro 1985).[10]

The Mexican government, in contrast, did not liberalise the financial system during this period and kept in place most of the controls introduced formerly. The major departure from the earlier period was the subordination of the financial policy to the explicit goal of income redistribution and economic expansion. The political crisis of 1968 forced the state to shift the emphasis on stability to a second place on the economic agenda. This period represented a return to the expansionist policies of the 1930s and 1940s. Foreign

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[9] See Brothers and Solís (1966), Goldsmith (1966), and Moore (1966).

[10] In the case of Chile, the then recently privatised banks went on a lending spree thanks to the looser regulation. The boom in domestic credit led to an expansion on the money supply with the corresponding surge in inflation. Differentials between domestic and external interest rates promoted capital flight and exerted pressure on the exchange rate, which eventually collapsed. Most of the banks' loan portfolios were denominated in dollars. The devaluation created a problem of non-performing assets that forced the government to step in and bail out the whole banking system.

lending was an important source of financing and it was mainly directed to investment in the parastatal sector and to the newly created *fideicomisos*.[11]

At the same time, the state displaced the private sector from the domestic credit markets and public investment replaced private investment. This situation became one of the focal points of the conflict between the state and the private sector during the 1970s. The dissociation of interests between the state and big business became increasingly evident as the state increased its stake on the economy. The break up between state and business increased the business' propensity to switch from productive to speculative investments and capital flight when the first signs of potential macroeconomic instability appeared. In fact, these propensities hastened the economic crises in 1976 and 1982.

In terms of policy management, President Luis Echeverría (1970-1976) weakened the position of the Ministry of Finance and BdeM by replacing personnel, creating new organisations and changing consultation hierarchies (Maxfield 1993: 248). The office of the presidency became the most important state agency in financial policy-making during his *sexenio*. Then, President José López Portillo (1976-1982) created the ministry for programming and budgeting (SPP), which further weakened the Ministry of Finance. SPP became a very powerful state organisation regarding economic policy, it took over the capacity to decide upon budgetary allocation, formerly attributed to the Ministry of Finance (see Torres 1997). Financial policy during these two *sexenios* was subordinated to the government's spending policy, which was under complete control of SPP.

In the mid-1970s inflation surged as a result of Echeverría's expansionist fiscal and monetary policies. The financial system remained, nevertheless, under tight controls. The state relied increasingly on reserve requirements to finance higher public deficits (see Table 4.1). The exchange rate remained fixed and the government stuck to its policy of free exchange convertibility.[12] A fixed exchange rate with free capital mobility means that domestic interest rates have to be aligned to those in the major financial

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[11] A *fideicomiso* is a trust fund set up by the state to promote a specific activity or to channel financial funds to a specific constituency. The *fideicomiso* is very similar to development banking.

[12] A fixed exchange rate and free convertibility have always been considered as primary policy goals by the financial authorities (Ortiz 1984: 44; Maxfield 1990: 74)

centres. However, the state kept artificially high real interest rates on deposits to promote savings and the rising reserve requirements pushed up the real interest rates on loans. High interest rates were not a problem as long as inflation was low. Nevertheless, as soon as inflation speeded up and nominal interest rates were kept fixed, real interest rates became negative and the financial system lost depth. Negative real returns on savings motivated capital flight and non-productive investments like gold and real estate (Mansell 1995: 7; Aspe 1993: 62; González 1993: 177). External borrowing palliated the problem temporally. The situation was non-sustainable and ended up with the peso devaluation on August 31 1976 after twenty-two years of a fixed parity to the dollar.

Table 4.1

Reserve Requirements, 1972-1976

Year	Total Reserves	Total Deposits	Rate of Reserve
1972	55.0	122.6	44.9
1973	65.2	138.5	47.1
1974	84.9	164.6	51.6
1975	118.4	203.9	58.1
1976	141.5	223.3	63.4

Source: BdeM, *Economic Indicators,* (Various years).
(1) Billions of pesos

The peso devaluation made evident that economic circumstances had changed and that the prevailing framework was no longer adequate. In order to introduce more flexibility to the financial system, the state attempted to create a market for state securities.[13] In 1978 the government issued treasury bills (CETES) for the first time (Aspe 1993: 78). However, in the early years of President López Portillo the revenue from oil exports and abundant foreign lending palliated the need for financial liberalisation and the emission of CETES remained relatively stagnant throughout this period.

Economic conditions, however, got worse once again towards the end of President López Portillo's *sexenio.* In 1981, the U.S. Federal Reserve increased interest rates and oil prices plummeted. The rise on external interest rates and the fall in oil prices

[13] When there is a developed market for government securities, state's borrowing and interest rates are freely determined by market forces. Besides, monetary policy can be conducted more effectively through open market operations. An open market operation is when the central bank either buys or sells government securities in the open market in order to reduce or increase the money supply.

produced a double squeeze on the public finances. External lending came to a halt in 1982 and the exchange rate was under increasing pressure throughout the first months of that year. Large domestic investors switched from productive to speculative investments and took their capital out of the country. Without access to new external lending, reduced revenues from oil exports, capital flight and substantially higher interest payments on the external debt, the financial crisis of the state in 1982 was far more severe than in 1976. The only sources of financing still available for the state were domestic credit and monetary expansion. The state was forced to complement the resources obtained through reserve requirements with increasing issues of state securities in the Mexican Stock Exchange (BMV). The increasing issues of these securities fostered the process of securitisation of Mexican financial system that progressed steadily throughout the 1980s.

Moreover, the 1982 economic crisis made explicit the tensions between the state and the private sector. Shortly before the collapse of the peso, in the XLVIII banking convention, the bankers discussed the government's intervention in banking operations, whereas the state referred to banks' social obligations (see White 1992). These subtle positions reflected a serious power struggle that was just beginning to become visible. Then after the peso devaluation President López Portillo blamed the private commercial banks of promoting speculative investments and capital flight for their own interest and at the expense of the national interest (see Maxfield 1992). In a desperate move to control capital outflows López Portillo nationalised the Mexican commercial banks and introduced exchange controls. The economic crisis broke the alliance between the state and the business elite temporarily. But the banks' nationalisation strengthened the bases of popular support for the regime also only temporarily.[14]

However, the crisis provided the right juncture for policy-makers with 'orthodox' views regarding financial policy to take over the most important positions within the state. In the last months of the sexenio a last clash developed over the expected role of the recently nationalised commercial banks: Jesus Silva Herzog, minister of finance, supported a commercial and profit-oriented operation for the banks, on the one hand;

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[14] President de la Madrid reversed both trends: re-established the alliance with business and weakened the bases of popular support.

and Carlos Tello, BdeM's director, advocated a stronger social role for the banks, on the other. President Miguel de la Madrid (1982-1988) solved this dispute in favour of a more 'orthodox' and profit-oriented management for the banks signalling the financial policy for the next six years.

4.3 Financial 'Securitisation', 1982-1988

The 1980s was characterised by the increasing globalisation of the financial markets. Two major trends fostered this process: securities operations replaced banking credit as the main instrument in the international financial markets, and banks operations were increasingly deregulated. The immediate outcome was the convergence towards universal banking, meaning that banks and SBHs offered similar financial services. The traditional boundary between commercial and investment banking was blurred. The debt crisis in the early 1980s triggered this process of *securitisation* of funds to a great extent. Large corporations and governments were forced to finance themselves increasingly through the securities markets (*Comercio Exterior*, February 1991: 10). Falling income from traditional banking operations, increasing operation costs and rising systemic risk led bankers to engage in non-traditional operations for which they earned commissions and fees. [15] The banks also increased their reliance on the securities markets to obtain financing and invest their own resources. At the same time, SBHs introduced new financial instruments that substituted traditional banking accounts. These trends showed some differences across regions. The integration of financial intermediaries into universal banks went further in Europe than in the US or Japan.

In Mexico, however, this period was dominated by the 'securitisation' of finance only. The deregulation of banking operations was delayed to the next presidential administration. The transformation of the Mexican financial system was a two-stage process. In the first one (1982-1988), the state policy promoted the securities market and strengthened the Mexican Stock Exchange (BMV). In the second stage (1988-1994), the government removed all the controls on banks' operations. The sequence of these two processes is crucial to understand the financial crisis resulting from the collapse of the

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[15] Systemic risk refers to the possibility of a generalised run against the whole banking system deposits. This risk increased during the 1980s as a result of deregulation in banks operations.

peso in December 1994 (see chapter eight). In 1982, in the midst of a financial crisis and when the technocrats opportunity for consolidating their political power depended precisely on their ability to provide financing for the state, the development of the securities market became a policy priority.

Politics of the Financial Policy

In Mexico, President de la Madrid started his government laying the foundations for a new alliance with the business elite and international capital. The shadow of the unexpected nationalisation of the commercial banks made this task especially difficult. However, President de la Madrid took decisive action in this direction: re-appointed Jesus Silva Herzog as minister of finance and Miguel Mancera as BdeM's director, made compensation payments to ex-bankers according to the banks' market value, and sold the non-banking concerns to their former owners (Maxfield 1992: 89, Vera 1991, Ramírez 1994). These measures facilitated the co-operation of ex-bankers after the nationalisation and the re-negotiations of the external debt with the international capital (Hamilton 1985: 166).

President de la Madrid appointed and empowered officials strongly committed to reform and liberalisation. These officials delivered a sophisticated, though ideologically biased, strategy to cope with the challenges and problems faced by the Mexican financial system at that time. Theoretical considerations and specific economic circumstances apart, political considerations were at work urging the deregulation of the banks' operations in the context of a power struggle to preserve the control of the state. Important groups from state and society alike were against economic reform. President Echeverría and López Portillo failed to implement fiscal reform and trade liberalisation respectively because of opposition from large business.

Far from having a antagonistic position towards business, President de la Madrid actively assisted the reorganisation of the private financial groups around the SBHs. For instance, the Legorreta family, former owners of BANAMEX, remained influential

actors.[16] In the late 1980s, Agustín Legorreta controlled a brokerage house (INVERLAT) and an insurance company (Seguros America). His brother, Eduardo Legorreta, controlled OBSA, another brokerage house. VISA group, former owners of Banca Serfin and current owners of BANCOMER, centred their financial operations in the stock and bond markets through Valores Monterrey and the insurance company, Seguros Monterrey. After this brief nationalist interlude, the former private banks became again the main political representatives of the private financial sector. Nonetheless, the leadership of the financial sector diversified and modernised. Traditional families like Espinoza Yglesias, Legorreta and Trouyet although still important are sharing this leadership with other families (Garrido and Quintana 1987: 122). Two of the most important newcomers were Carlos Slim and Roberto Hernández, both of them accumulated their capital during the 1980s in the booming stock exchange.

The AMCB became the most important organisation articulating the policy interests of the financial community. The CEMAI and the AMCB had a prominent presence in public affairs through their role in the CCE. The nomination of Agustín F. Legorreta, who had very strong economic and political interest in both organisations, as President of the CCE illustrated this new configuration of power within the private sector. The AMCB, created in 1980, substituted the former ABM as the organisation representing the financial fraction within the CCE. In 1984 the AMCB requested the support of the CCE to negotiate the coming reform to the financial legislation in which the notion of specialised financial system was introduced.

State Financing and Government Securities

The government's financial policy was constrained throughout this period by a double squeeze on its finances: higher interest payments, on the one hand, and lower revenues from oil exports, on the other. Without access to foreign lending, the only options available to the state were reserve requirements on banking deposits, securities issues in the stock market and monetary expansion. The elimination of reserve requirements was not likely in this juncture, given the above-mentioned fiscal imbalances. During the

[16] The Legorreta family acquired the control of Banco Inverlat as a result of the privatisation process. However, they lost control of this bank after the 1995 banking crisis when it went into severe financial

1980s, reserve requirements up to 50 percent were common, and in some cases they went up to 100 percent on marginal requirements crowding out credit to the private sector (Coorey 1992: 38).[17]

The state issued increasing amounts of CETES throughout the 1980s fostering the development of the market for state securities (see Table 4.2). The bonds market more than the equity market was highly favoured by these issues of CETES. At the same time, large private investors demanded more liquid and short term instruments, given the prevailing exchange rate volatility and high inflation (Katz 1990: 46). These instruments boosted SBHs operations and profitability. SBHs bought state securities and retailed them to the public as money market mutual funds.

Table 4.2

State securities Issues, * 1978-1988

Year	CETES	BONDES	Other	Total	Total (2)
1978	2.0	—	0.8	2.8	1.8
1979	5.5	—	5.5	11.0	4.7
1980	20.1	—	5.2	25.3	7.6
1981	16.9	—	-1.6	15.3	1.8
1982	176.5	—	13.3	189.8	11.5
1983	113.1	—	110.5	223.6	14.5
1984	314.3	—	-5.6	308.7	12.3
1985	281.9	—	379.2	661.1	14.5
1986	1,725.7	—	893.3	2,619.0	20.6
1987	8,105.1	358.4	2,459.9	10,923.4	35.2
1988	6,362.0	15,360.4	694.5	22,416.9	45.8

Source: Katz 1990: 47.
(1) In Millions of Mex. pesos.
(2) As a percentage of the public deficit.

In addition to CETES and PETROBONOS,[18] the state issued new securities towards the end of President de la Madrid's *sexenio* in order to lengthen the maturity structure of the public debt and secure financing for the state in a context of high macroeconomic instability. In 1986, PAGAFES, 28- to 365-day dollar-denominated bonds payable at a

difficulties.

[17] 100 percent marginal requirements meant that all deposits above a government-set level had to be put aside by commercial banks as reserves' deposits in BdeM.

[18] Three-year bonds with returns indexed to international oil prices, which were introduced almost simultaneously to CETES in 1977.

fixed interest rate, were introduced for the first time in order to hedge investors against exchange rate volatility and attract foreign capital. Then in 1987 longer-term BONDES were introduced to gradually replace short-term CETES and reduce the uncertainty engendered by a debt with very short maturity structure. Finally in 1989, the introduction of AJUSTABONOS[19] and TESOBONOS[20] completed the whole array of public instruments issued to finance the state in the context of high inflation and exchange rate volatility. The introduction and diversification of public debt increased the volume and value of transactions in the BMV becoming the major stimulus for its development.

The initial development of the market for state securities allowed the state to finance its increasing deficit during the 1980s. The stock of state securities traded in the BMV rose from $3.3 billion dollars in 1982 to $9.8 billion in 1988.[21] In fact, the state relied more heavily on this source of financing relative to monetary expansion and foreign lending, it increased from 11.5 percent of the public deficit to 45.8 percent during the same period.

Development of the Mexican Stock Exchange (BMV)

The nationalisation of commercial banks, an unexpected but crucial event for the liberalisation of the financial system, provided the right juncture to speed up the development of the securities market while preserving the banking system under the old financial controls. As mentioned before, President de la Madrid sought to re-establish the policy collaboration with the large financial groups. De la Madrid sold the firms owned by the nationalised banks to their former owners, only three months after he took office (Basáñez 1990: 96). Some large industrial concerns were among the sold firms but most importantly for the financial policy of this period was the sale of the SBHs; their sale was the first step to develop a parallel financial circuit free from state intervention (Maxfield 1992: 90; see also Márquez 1986).

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[19] Three- to five-year bonds with returns indexed to the consumer price index.

[20] One- to three-month bonds with returns indexed to the free exchange rate.

[21] Calculated from Katz (1990: 47) for the stock of state securities and INEGI (1994: 1006) for the exchange rate.

At the moment of the nationalisation, SBHs were minor banks' subsidiaries that could hardly be compared to the banks themselves in assets and capitalisation. Nonetheless, two institutional provisions furnished the conditions for the remarkable development of the SBHs and the BMV over this period (see Table 4.3). The first provision was the introduction of an upper limit to state borrowing through reserve requirements. The second was the exclusion of banks from operating in the BMV where an increasing share of the public debt was traded (Basáñez 1990: 98). Non-bank financing soared from one percent of the GDP in 1980 to 7.4 percent in 1988 (Maxfield 1992: 98). The BMV experienced a period of rapid expansion becoming one of the best performing markets in the world by 1986 (Maxfield 1990: 157). The BMV became a very profitable business opportunity for ex-bankers and some new individuals who capitalised the political and economic juncture.

Table 4.3

Securities Market Development, 1982-1987

Securities trading	1982	1987
Value in billions of pesos	2.3	296.8
Volume in millions of shares	913	19,089

Source: Mateos and Roman 1993.

Furthermore, the unstable macroeconomic conditions during this period favoured the development of the BMV. SBHs were the only financial organisations that could provide the instruments that investors demanded to hedge against inflation. In fact, the expansion of secondary markets[22] for CETES was a response to this increasing demand for liquid and short-term instruments (Sandoval 1994: 211). The recently nationalised banks lacked the flexibility to develop new products that could compete with the SBHs for new deposits. The BMV gained depth and became highly profitable at the same time. The increase in SBHs equity, from $52 million dollars in 1982 to $1.24 billion in 1988, illustrates the outrageous capital accumulation and concentration that took place over this period (González 1993: 187; INEGI 1994: 1006). Carlos Slim and Roberto Hernández accumulated their personal fortunes in this period.

[22] We refer by secondary markets to those markets where securities that have already been issued in the primary markets but have not reached their maturity date are traded.

Throughout the 1980s the state-owned banks lost competitiveness vis-à-vis SBHs; the latter offered financial instruments more flexible and liquid and with higher returns.[23] Securities as a share of financial savings went from 13.4 percent in 1982 to 48.2 percent in 1989 (*Comercio Exterior*, February 1991: 15). During this period the booming SBHs increased substantially the volume of their operations and became strongly capitalised, meanwhile the banks remained relatively stagnant in terms of capitalisation and assets (see Table 4.4). The higher yields on mutual funds and investment societies pulled deposits away from still-regulated bank deposits. During the preceding eighteen months to the stock market crash in October 1987, the state delayed correcting a drift toward negative real interest rates causing a shift of funds from bank deposits to portfolio investments in the BMV and a speculative boom.

Table 4.4

Securities vs. Banks' Deposits*, 1980-1989

			Capitalisation		
Year	**Banks' deposits**	**Securities market value**	**Total**	**SBHs (%)**	**Banks (%)**
1980	1,323	100	—	—	—
1981	1,925	119	—	—	—
1982	3,263	154	53	5.6	94.4
1983	5,231	353	89	7.0	93.0
1984	8,749	1,049	128	11.0	89.0
1985	12,619	4,873	129	14.8	85.2
1986	23,017	17,175	568	24.0	76.0
1987	56,893	63,008	2,341	60.4	39.6
1988	50,679	137,077	5,249	40.2	59.8
1989	97,897	213,367	9,472	30.1	69.9

Source: González 1993: 187
(1) Millions of Mex. pesos

Towards the end of President de la Madrid's *sexenio*, the government partially privatised the banks by selling 34 percent of their equity through public offerings in the BMV. This move provided valuable resources to the state in a moment of financial distress, but also set forth the stock market boom that went bust in October that year (International Reports 1990: 14). The index of the BMV increased 600 percent in the 13

[23] However, the banks, though operating under very restrictive regulation, remained profitable at the expense of retail banking users.

months prior to the crash (Bienen and Waterbury 1989: 620). The stock market crash was a severe set back to the strategy based on the BMV for the transformation of the financial system. In fact, both the stock market crash and a massive new round of capital flight occurred within days of the designation of Carlos Salinas as next President (Kaufman, Bazdresch and Heredia 1994: 374).

Table 4.5

Financial Stability, 1980-1989

Year	Exchange rate (1)	Inflation (2)	Interest rates (3)
1980	22.95	29.8	27.94
1981	24.51	28.7	33.34
1982	57.18	98.8	57.86
1983	150.29	80.8	53.95
1984	185.19	59.2	49.32
1985	310.28	63.7	74.80
1986	637.87	105.7	105.98
1987	1 405.80	159.2	131.10
1988	2 289.58	51.6	51.47
1989	2 483.35	19.7	40.19

Source: Aspe 1993; and INEGI 1994
(1) Mex. pesos for US dollar quoted on the last day of the year for banking operations
(2) Yearly increase on the National Consumer Price Index (January to January)
(3) 3 months treasury bills (CETES)

Regarding stability, most of the policies introduced under President de la Madrid were evidently insufficient to attain any degree of stability for the financial system, less so for the rest of the economy. Throughout most of his *sexenio*, the Mexican economy experienced a period of rising inflation, negative real interest rates and the constant devaluation of the peso (see Table 4.5). However, in December 1987 the government implemented a broad stabilisation plan that included both 'orthodox' and 'heterodox' policies. The programme was 'orthodox' because it was committed to restrictive fiscal and credits policies, and was 'heterodox' because it included crawling-peg exchange regime and income policies.[24] Income policies were institutionalised into a three-party agreement, known as the Pacto of Solidaridad Económica (PSE). The parties that signed the agreement were the government, the largest labour union, and the most important

[24] The crawling-peg exchange rate regime means that the currency is devaluated daily at a pre-determined rate. Income policies refer to those agreements where business agree on price increases, workers agree on wage raises and the government agree on price increments for public services.

business organisations (Edwards 1995: 39). This programme was largely successful. Inflation was brought down from 159 percent in 1987 to 51 percent in 1988.

The collapse of the stock market in 1987 and the signing of the PSE influenced the policy agenda of the incoming President Carlos Salinas (1988-1994). Financial policy clearly favoured price stability over economic expansion during all of Salinas's *sexenio*. Financial policy was also harnessed to the financial needs of the state and to the international trends in finance urging for further liberalisation.

4.4 Financial Liberalisation, 1988-1994

The international trend in the 1980s regarding financial liberalisation was the replacement of the traditional mechanisms of financial management (i.e. reserve requirements, selective credit controls and interest rate ceilings) by stronger capital requirements and more effective prudential regulation. Derived from the Basle Agreement signed in July 1988, the Bank for International Settlements introduced a minimum capital requirement—8 percent of banks' risk weighted assets—for commercial banks operating in the member countries (*Comercio Exterior*, February 1991: 11). The minimum capital requirement intended to provide stability and flexibility to the international banking system.

The specific financial circumstances of the Mexican state during the 1980s, however, delayed the deregulation of banking operations until 1989. The renegotiation of the external debt and the proceeds from the privatisation programme reduced the pressure on the state finances. Healthier public finances and a deeper market for state securities created the right conditions for the elimination of the reserve requirements. President Salinas decreased gradually the importance of BdeM's credit for state funding, from 40 percent in 1988 to virtually nil in 1991. By the end of President Salinas's term, all domestic borrowing was done through the securities market; the value of state securities outstanding at the end of 1994 reached almost $50 billion dollars.[25]

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[25] Calculated from Zedillo (1995: 55) for the size of state securities, and Zedillo (1995: 77) for the exchange rate.

Politics of Liberalisation

One of the most prominent features of the politics of economic policy-making under President Salinas was the concentration of decision-making power in a small circle of pro-market *technocrats*. This team was made up by a generation of economists born in the 1940s and early 1950s who studied abroad and entered the state at the same time. According to Stephanie Golob (1997: 108) the members of this team sought political advancement and reached high levels in the bureaucracy, acted in teams and organised their political networks in informal ways that were congruent with their advancement in a camarilla based system. Furthermore, cosmopolitan attitudes prevail among them, being skilled and confident negotiating partners with bankers, foreign states and MFOs. This team agreed on the need to reform both the private and the public sector and the desirability of a leaner, more efficient state. Top officials in the Ministry of Finance and BdeM under President Salinas were characterised by their ideological homogeneity that favours free market and conservative financial policies.

During the 1980s technical advice became increasingly important in decision making. Consequently, technocrats in staff areas and in the economic cabinet increased their influence. Information, analyses and options presented by staff officers, often imbued with ideological content, were increasingly decisive for financial policy-making as the 1980s progressed (Grindle and Thomas 1991: 97-99). The team in the Ministry of Finance designed and implemented the policies for some of the most difficult problems facing the government when Salinas took office (i.e. tackling inflation, tax reform, external debt, public-sector deficits, the privatisation of state enterprises and of course the implementation of the financial reform).

Pedro Aspe, minister of finance (1988-1994) and Guillermo Ortiz, deputy-minister of finance (1988-1994), were the two major financial reformers, both with a clear background favouring liberalisation (see Table 4.6).[26] Pedro Aspe was mainly involved with the stabilisation programme and external debt renegotiation while Guillermo Ortiz was responsible for the financial system reform including the banks' privatisation. Both

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[26] Guillermo Ortiz received a PhD degree in economics from Stanford University for his thesis "Capital Accumulation and Economic Growth: A Financial Perspective on Mexico."

of them were part of a generation that embodied a secular faith in economic and financial liberalisation. Pedro Aspe was somewhat of an 'outsider' to the inner circle of friends and allies of President Salinas. However, several of his strengths (i.e. economic expertise, international connections and leadership abilities) earned him a place in President Salinas's economic team. When international capital was still hesitant to trust Mexico again, Aspe's personal abilities were crucial to gain their confidence (Golob 1997: 127). The other key figure in the reform was Miguel Mancera Aguayo, governor of the BdeM, who had strong links with Leopoldo Solís, one of the most influential individuals in the state's financial circuit (see chapter three). Mancera's unwavering commitment to financial stability represented a safeguard against the constant temptation to boost the economy through looser monetary policies.

Table 4.6

Profile of Major Financial Reformers

	Pedro Aspe	**Guillermo Ortiz**
Position	Minister of Finance	Deputy-minister of Finance
Career	ITAM, Ministry of Finance and Ministry of Programming	ITAM, Banco de Mexico, IMF and Ministry of Finance
Degree (University)	PhD (MIT)	PhD (Stanford)
Thesis	International Transmission Mechanisms	Capital Accumulation and Economic Growth
Academic tutors	Rudiger Dornbusch	Ronald I. McKinnon

Source: Camp 1995; Golob 1997; and Ortiz 1984.

President Salinas's economic team argued that the current controls on the banking sector discouraged savings and produced an inefficient allocation of credit (Aspe 1993: 62; Ortiz 1994: 41-55). Their ideas were influenced by academic work done early in the 1970s by Ronald I. McKinnon (1973) and Edward S. Shaw (1973), who claimed that repressed financial systems in developing countries were hindering their own economic

development.[27] Aspe and Ortiz advocated financial liberalisation because it was consistent with their own beliefs, but also because the reform appealed to international capital and to the domestic financial elite. The deregulation of banking operations in 1989 illustrated how the interests of the state and large financial groups were articulated into mutually beneficial policies.

The institutional links between the most prominent financiers and government officials were crucial for the introduction of the reforms and for the day-to-day management of the financial system. Permanent policy consultations and co-ordination took place between representatives from business organisations and the government commissions for the financial system. For instance, Juan Ignacio Gil, President of the CNSF, used to meet once a week with executives from the Mexican Association of Insurance Institutions (AMIS) to discuss the policy initiatives for the insurance industry (Interview: Mexico City, September 1st 1995). The reform to the pension system created a new strand of collaboration between the private and public sector regarding finance. The new framework for pension created two committees, one for supervision and other for consultations, where representatives from workers, business and financial organisations met every two months to discuss the state of the system (Interview with Fernando Solís: Mexico City, September 1st 1995). BdeM had a consulting body also, known as the Advisory Management Council, where public officials and private executives were represented. The main function of the council's board was to provide a permanent institutional space to solve disputes over policy issues and to co-ordinate their actions. A similar body was created as a result of the reform in 1993 to the Securities Market Act, known as the Committee for the Securities Market Modernisation. The committee was constituted by state representatives from the Ministry of Finance, BdeM and CNBV on the one side of the government and by private representatives from the BMV and the AMCB on the side of the SBHs (Ortiz 1994: 112).

Personal connections were also important to preserve the collaboration between the main actors in the financial system. Alonso Ríos, chief economist at BANAMEX,

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[27] Ronald I. McKinnon was the academic tutor of Guillermo Ortiz while he was studying at Stanford University. Guillermo Ortiz was, in turn, the main official responsible of the financial policy within the

provides an illustrative example of this personal interlocking between public and private agents:

> '...the relationship between Pablo Aveleira, head of division for social and economic studies of BANAMEX and Miguel Mancera, head of BdeM (1982-1997), dates back to their school days at the Instituto Tecnológico Autónomo de Mexico (ITAM). They hold a monthly lunch in which authorities and financial executives meet in an informal atmosphere. Among the participants to these meetings are: Miguel de la Madrid, former President of Mexico, Francisco Gil, deputy-minister of finance, Ismael Maidón, executive from BdeM, Alberto Gómez, deputy-director of BANAMEX and Roberto Hernández, chairman of BANAMEX's board of directors' (Interview: Mexico City, September 14th 1995).

Deregulation of banks operations

The programme of financial reform under President Salinas was the most comprehensive set of reforms implemented so far. Salinas's programme started in 1989, when the government made fundamental amendments to the LGIC and concluded in 1994, when the reform to the LOBdeM, which grants the autonomy to BdeM, was enacted. Jose Cordoba (1994: 252-253), chief of staff under President Salinas, classified the financial reform during this period into two broad themes: deregulation of banks' operations and institutional changes. Regarding deregulation, the government eliminated the interest rate ceilings and the selective credit controls and substituted the reserve requirements by a 'liquidity coefficient'.[28] As regards institutional changes, the state reformed development banking (see chapter five), privatised the state-owned commercial banks (see chapter six) and granted full autonomy to BdeM (see chapter seven).

At the moment when the process of banking deregulation was initiated, the most important feature of the Mexican financial system was the existence of two separate

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Ministry of Finance.

[28] The liquidity coefficient was a requirement for the commercial banks to hold a pre-specified amount of their assets in government securities. This requirement was also eliminated eventually.

circuits. The first circuit was organised around the banking sector, which was over-regulated and controlled by the state through direct ownership.[29] The second circuit was organised around the BMV and SBHs, which was virtually free from state regulations and controlled by a new financial bourgeoisie integrated by ex-bankers and new stock brokers. Despite the crash in October 1987, the BMV was one of the most profitable emerging markets again in 1991. By September 1992 the IPC (main index of the BMV) had increased 120 times its value since the banks nationalisation ten years earlier (*The Economist,* February 13th 1993). SBHs were financial enterprises relatively free of state intervention; the banks, in sharp contrast, were extremely regulated. The unequal competition between SBHs and banks was crucial to reduce the importance of the banks as financial intermediaries. Yet it provided the rationale for deregulating banks' operations.

In 1988, when the stabilisation programme seemed to control inflation, investors increased their demand for credit. However, the programme reduced the supply of credit in order to contract aggregate demand at the same time. The result was the development of an informal credit market, where SBHs brokered bonds among large firms. In response to the lack of competitiveness of banking deposits, the authorities lifted controls on interest rates for banking deposits and on maturity terms in October 1988. More significantly, in November 1988 the authorities allowed the banks to offer similar accounts to those offered by the SBHs.[30] These accounts were operated off the balance sheets and hence were not subject to the onerous reserve requirements for normal deposits (Danby 1996: 42). The banks started to compete successfully against SBHs by offering these instruments, which were bonds with a bank guarantee basically. Furthermore, banks were allowed to issue *acceptances* on their own account in order to finance their own lending (Katz 1990: 50). Not surprisingly, banks and their customers rapidly moved funds from traditional deposits to these *banker's acceptances*. The

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[29] President de la Madrid interfered little with the operations of the commercial banks while under state's ownership, apart from continuing to use high reserve requirements to finance fiscal deficits. Adolfo Ríos, Chief Economist at BANAMEX, considered that "... despite the fact that bankers during that period were politicians, they were also officials well acquainted with the financial system and with independent positions regarding the state policy (Interview, Mexico City, 14/09/95)."

[30] These decisions were taken by the outgoing government when Carlos Salinas was already elected-President. The fact that important decisions were not postponed until the new government was in office illustrate that financial liberalisation was an ongoing process in which both Presidents, de la Madrid and Salinas had the same stance.

resulting competition between commercial banks and SBHs created an apparently ineluctable cascade of reforms.

In January 1989, as the traditional deposit base dwindled and most of the banks' operations were conducted off the balance sheet, the authorities scrapped first the selective credit controls and interest rate ceilings paid on deposits.[31] Then, in April, the reserve requirement for all deposits was lowered to 30 percent and renamed a liquidity coefficient. The reserves could be invested in specified state securities (mainly CETES and BONDES), interest-bearing deposits in BdeM or cash deposits in BdeM's vaults (Danby 1996: 44). At this point, the old complex framework based on reserve requirements, selective credit controls and interest rate ceilings was almost completely abolished. The only element from this framework that remained in place was the liquidity coefficient on banks deposits. In December 1989 a modest pack of regulatory changes was also enacted; they were aimed to strengthen bank prudential regulation and supervision by giving greater power to the CNB, CNV and CNSF.[32] Additional reforms in July 1990 established procedures for classifying overdue loans and for putting aside loan-loss reserves. Capital requirements as a percentage of risk-adjusted assets were also established at six percent and gradually increased until reaching 8 percent in 1993 (Ortiz 1994: 61). Finally, in September 1991 the coefficient was also eliminated because banks were facing increasing difficulties to secure enough CETES or cash to meet the requirement (Danby 1996: 46).

Despite the deregulation of banks operations the segmentation of the financial markets did not decline.[33] Financing through the securities market was an option for the state and large corporations but not for medium and small firms who remained dependent on the more expensive banking credit. In fact, only 200 companies could raise funds through the BMV at a cost up to 20 percent lower than banking credit (Maxfield 1990). Trading in state securities between 1988 and 1993 accounted for over 90 percent of the total

[31] The lending quotas and the interest rates ceilings were calculated on banks deposits. However, as most of the banks operations move off the balance sheet, away from traditional deposits and into *bankers acceptances*, these controls became increasingly irrelevant.

[32] At this point, the National Banking and Securities Commission (CNBV) was split into two: National Banking Commission (CNB) and the National Securities Commission (CNV).

[33] Market segmentation is the feature of financial systems, where economic agents pay different interest rates.

volume of trading in the BMV (Coorey 1992: 39). The development of the bond market far exceeded the development of the equity market, which only accounted for slightly more than two percent of total trading in the BMV (Mexico Company Handbook 1993: 13). Only 190 firms were listed in the BMV in 1993 compared to 550 firms listed in the Sao Paulo stock exchange or to the much smaller in terms of capitalisation, Peruvian stock exchange, that listed 233 firms (Holden 1995: 63).

Conclusions

The development of the financial system in post-revolutionary Mexico can be divided into four different periods (see Table 4.7). Each period is characterised by a specific process driven by the government's financial policy that has, in turn, oscillated between two major objectives: growth and stability. Those policies that favoured growth over stability were label as 'heterodox' whereas the policies that emphasised stability over growth were identified as 'orthodox'. Every time policy-makers with 'orthodox' views dominate the state, financial policy pursue three goals: satisfy the financial needs of the state, secure macroeconomic stability and provide profitable business opportunities to the large financial groups. The government's financial policy and the businesses of large financial groups were closely intertwined all the time. Financial groups conducted the day-to-day operation of the financial system, while the government controlled regulation and policy-making (Camp 1989: 244).[34] In this symbiotic relationship, the state induced the allocation of credit according to its political concerns, whereas financial groups influenced policy decisions according to their economic ends. The large financial groups used their economic leverage to extract political and economic privileges from the state at certain historical junctures. The state, however, preserved its autonomy thanks to a strong and efficient policy network dominated by the Ministry of Finance and BdeM.

Between 1952 and 1982, banks operations and monetary policy in Mexico were tightly regulated through interests rates ceilings, reserve requirements on banking deposits and

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[34] Isaac Katz reasserted that the political power of the large financial organisations stems from "...their control over money and their knowledge that an efficient economy depends on the financial system. Bankers know that the financial system is the most important sector in the economy (Interview, Mexico City, 13/09/1995)."

selective credit controls. This framework worked well in Mexico during the stabilising development period when the economy grew at annual rates above six percent and annual inflation remained below five percent. Yet, once inflation accelerated in the 1970s, and interest and exchange rates remained fixed, the financial system discouraged savings and promoted speculative investments and capital flight. This framework produced negative real interest rates and real exchange rate overvaluation that, in combination with higher external interest rates, fuelled devaluation expectations. The lack of flexibility of this framework led to the first financial crisis in the history of post-revolutionary Mexico. The peso devaluation in August 1976 ended a twenty-two year period of exchange rate stability (Aspe 1993: 68).

Table 4.7

Summary of Mexico's Financial Policy, 1925-1994

Period	Process	Main Policies
1925-1952	Institutionalisation	• Foundation of BdeM • Introduction of development banking • Creation of business 'corporativism'
1952-1982	Management	• Introduction of credit controls, reserve requirements on banks' deposits and interest rates controls • Introduction of financial groups
1982-1988	Securitisation	• Bank's nationalisation • Separation of banks and SBHs • Development of the securities markets
1988-1994	Liberalisation	• Elimination of financial controls • Development banking reform • Banks' privatisation and reintroduction of universal banking • BdeM's Autonomy

The first attempt to introduce flexibility to the system took place in 1978 when the government introduced CETES. Nonetheless, the oil boom and massive foreign lending delayed the need for further changes. Interest and exchanged rates remained fixed by BdeM. In 1982, however, external shocks on American interest rates and oil prices placed the state finances under intense stress once more. Inflation speeded up again, the financial system still lacked flexibility to adjust and therefore real interest rates became negative. A new wave of capital flight developed and forced the government to devalue

the peso in February 1982. This time the consequences of the crisis were far more severe given the size of external indebtedness. Servicing the accumulated external debt limited the growth possibilities of the Mexican economy throughout most of the 1980s.

The transformation of the financial system, although initiated as early as 1978, speeded up only after 1982, when President de la Madrid took office and empowered a group of policy-makers with 'orthodox' views regarding the financial system. However, the lack of a developed market for state securities foreclosed the elimination of interest rate controls and reserve requirements. President de la Madrid's economic team set itself the task to foster a market for government securities without removing the tight controls on banking operations. By the time de la Madrid left office, the financial system was characterised by the presence of two parallel circuits: one of them was organised around the banks, over-regulated and under the control of the state; the other was organised around the SBHs, virtually free of regulation and under the control of the large financial groups. Financial operations were increasingly conducted through the stock exchange at the expense of the banks.

President Salinas completed the process of financial liberalisation as part of his agenda of policy reform. When Salinas took office in 1982, the securities market was deep enough to provide stable and secure source of funds for the state. Also, the public deficit was under control. Consequently, the deregulation of banks operations became the next important task for the state. In 1988, under better economic circumstances, the state liberalised the banks operations. The three most important decisions in this direction were deregulation of interest rates; elimination of the selective credit controls; and substitution of the reserve requirements by a liquidity coefficient, eventually also abolished. Most of the financial liberalisation took place in the late 1988 and early 1989, with some follow-up measures in subsequent years.

The transformation of the financial system in Mexico during the 1980s illustrates how the financial needs of the state influence the balance of power between rival policy coalitions. The political influence of the Ministry of Finance and BdeM stems from their strategic function providing funding for the state. However, this influence has fluctuated over time depending on the personal agenda of the President (see Maxfield 1990). During the period of stabilising development, the Ministry of Finance enjoyed a great

degree of autonomy because the Presidents placed great emphasis on stability. However, in the 1970s, political pressures shifted the emphasis on the President agenda towards income distribution, abridging the political leverage of this organisation. The consolidation of policy-makers with 'orthodox' views as the dominant group within the state in 1982 was favoured by the state's financial distress resulting from the debt crisis. The transformation of the financial system, initiated as a response to the economic crisis in 1976, became a top priority of the economic agenda of the state only after this group came to power. During the 1980s, the state's main concern was to secure its own financing under very adverse external circumstances.

Finally, the deregulation of banking operations, in combination with other important institutional changes (see chapters five, six and seven), transformed the financial sector. The old framework based on interest rate ceilings, legal reserve requirements and credit controls was completely replaced by a new framework centred on a new concept known as 'universal banking', where brokerage and banking services, among others, are provided by integrated financial groups. The financial system went from a highly regulated and very rigid system dominated by banks to a two-tier system emphasising market forces. In the new framework, where the compulsory sources of finance for the state were eliminated, the investment climate became of paramount importance. At present, the state has to comply with all the implicit policy demands from international capital and domestic business groups in order to secure financing for itself and for the economy. The reform to the financial system has somewhat institutionalised economic policy in Mexico.

The next three chapters are case studies where decisions regarding the financial system were part of a broader political strategy to secure legitimacy for the regime and reassert the President's political leadership. Each one of these chapters are intended to show how the simultaneous processes of economic globalisation and political democratisation pushed President Salinas to change the institutional framework for the financial system according to the dominant policy consensus at international level.

Chapter 5

Development Banking Reform

This chapter shows how the reform of development banking was mainly aimed at improving state capacity, on the one hand, and how the economic institutions that emerged from the reform failed to induce public and private organisations to behave efficiently. The state policy for development banking conformed to the 'neoclassical' postulates of economic liberalisation. Development banking reform was, however, a special case because there was not an explicit attempt of reform, yet the state policy for the sector changed its traditional role in the Mexican political economy fundamentally; development banking is one of the institutional arrangements where economic and politics are more tightly interwoven. This case also introduces an additional element to the analysis: interest groups closely linked to development banking but outside the financial system, like small entrepreneurs, workers and peasants organisations, were also relegated from the decision making process.

There are already some studies about this institutional feature of the Mexican political system. Blanca Heredia (1993) argues that each policy coalition within the state is aligned with different organised interest groups. Sylvia Maxfield (1990), in contrast, identifies two main competing coalitions: financial and developmentalist, already discussed in chapter three. This chapter argues that the limited influence of non-financial interest groups in the reform of development banking, despite having big stakes in the reform, was caused by the reconfiguration of power within the state in favour of the financial coalition.

This chapter follows the structure set for all the case studies included in the second part of the thesis. The first part introduces the ideas underlying the reform. The second part presents a historical overview of the economic and political significance of development banking. The third part is a description of the specific changes implemented under President Salinas. Finally, the fourth part is a discussion of the outcomes from the reform in three specific areas: political control, competition and allocation of credit.

5.1. The Ideas

The reform to development banking had two different and essentially contradictory strands: the need to preserve organisations conducting directed lending with development purposes, on the one hand, and the need of financial liberalisation, on the other. Expressed in a different way, the reform to development banking intended to preserve and liberalise organisations that were essentially designed to carry out state intervention. I argue that the inherent contradiction in this approach was the main cause of the reform's failure.

Development banking in Mexico was profoundly influenced by 'keynesian' ideas during the 1930s (Suárez 1994b: 42). The state under President Lázaro Cárdenas (1934-1940) promoted economic development very actively but more important, also created a financial circuit of state development banks alternative to the private banking dominated system. Around this time, Joseph Schumpeter [1934] published 'The Theory of Economic Development', a seminal study on the role of the financial system on economic development. As a result, development banking was considered as the orthodoxy on the subject for very long time. Alexander Gerschenkron (1962), for instance, showed that successful late developers, including Germany and Japan, manipulated their financial system to achieve goals of industrialisation.[1]

The pioneering work of Joseph Schumpeter (1983) is build upon the premise that the main challenge in economic development is 'detaching productive means (already employed somewhere) from the circular flow and allotting them to new combinations' (Schumpeter 1983: 71).[2] Innovation is the essence of development but in order to introduce new forms of production it is necessary to destroy the old ones such that

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[1] South Korea, represent a more recent example of active state intervention in the financial system with development purposes. The state in South Korea relied heavily on financial policy tools to induce private investment in strategic sectors (see Sakong 1993). Consequently, financial policy strongly influenced Korea's investment allocation, more so than the fiscal policy measures that were also used. The main instrument of the monetary authorities was the policy loan, usually earmarked for certain sectors or even specific industries. The policy loans in most cases had preferential interest rates when compared with ordinary loans.

[2] By circular flow, Schumpeter means the economic process by which existing resources, labour and capital, are employed in combinations to produce commodities for the consumption of labour and capital. Savings represent withdrawals from this cycle, whereas population growth and capital accumulation are influx to the cycle. These influx produce marginal growth but not economic development in the Schumpeterian sense.

resources are freed and can be transferred from old to new uses. This is what Schumpeter calls 'creative destruction'. However this process is not automatic since those who are usually willing to try new combinations are not the same as those who are actually employing the existing resources at a given time. A mechanism is, thus, required to shift resources from old combinations to new ones. Schumpeter (1983) stresses the role of banks as institutions making possible this shift by creating a market for the existing resources. In this way banks ensure that resources are allocated to their most valuable uses by making possible the process of creative destruction.

For Albert Hirschman (1958) development does not depend so much on finding optimal combinations for given resources but on having a financial system able to call forth and enlist for development purposes, resources and abilities that are hidden, scattered, or badly utilised. The state has a role to play in development as an entrepreneur. For Albert Hirschman (1958: 25), economic 'backwardness is due to insufficient number and speed of development decisions and to inadequate performance of development tasks.' Therefore the fundamental problem of development consists in inducing and directing individual action in certain direction.

According to Hirschman (1958), there is a process in which an initial decision in a specific economic sector creates imbalances in other interconnected sectors. These imbalances in turn call for further development decisions in order to re-establish equilibrium but by doing so they create new imbalances in some other sectors. Hirschman (1958) calls this process 'imbalance growth' and state initiatives usually enables a country to set out on this path by creating the initial imbalances. Development banks often unleash economic processes that bring to light shortcomings and bottlenecks in developing economies, inducing in this way new decisions aimed to overcome these overlooked deficiencies. The role of development banking in this framework is thus to set forth this domino effect in which once the first action is taken then a institutionalised process of decision making ensues inducing new development actions. The state has a very active role in this process of imbalance growth by consciously initiating it or simply by securing that decision making takes place smoothly without major obstacles.

The phenomenon of 'credit rationing' is also directly relevant to the theoretical underpinnings of development banking. The institutional function of development banking is to allocate credit at interest rates below clearing market levels, inducing an excess demand for credit and consequently drawing the state into the process of rationing financial resources among competing uses (Haggard and Lee 1993: 5). In some cases the criteria used by development banking to allot credit are strongly imbued with political considerations and therefore economically inefficient. In order to improve the efficiency on the allocation process of development banking funds, the reform intended to rely more heavily on the market while preserving their assisting nature for development. In a very simple microeconomic analysis, development banks under the new scheme are supposed to promote specific sectors or activities by supplying additional funds to the credit markets and therefore reduce equilibrium interest rates and increase credit availability to these sectors. This analysis relies on the neoclassical assumption of efficient and competitive financial markets. Commercial banks are drawn into the allocation of development credit under competitive conditions and therefore are expected to conduct it more efficiently than development banks under political pressure.

5.2. An Overview

The reform of development banking under President Salinas responded to the convergence of two major historical events that have been already analysed extensively in chapters two and three. These events were a trend towards financial liberalisation at the international level and the reconfiguration of political power in favour of the financial coalition. Instead of going back to these events, this part elaborates on the role that development banking has played in the Mexican political economy.

Origins

Development banking was an important strand in the institutional reconstruction of the Mexican political system after the Revolution. President Plutarco Elías Calles (1924-1928), in a first stage of political and economic institutionalisation, made significant progress towards the reorganisation of the state. President Calles founded two of the

most important institutions of the post-revolutionary Mexican state: the *Partido Nacional Revolucionario* (PNR)[3] and *Banco de Mexico* (BdeM). Then, President Lázaro Cárdenas (1934-1940), in a second state stage of institution-building during the 1930s, reformed the official party and created the most important development banks (see Table 5.1).[4]

Table 5.1

Large Development Banks

Development Bank	Acronyms	Foundation	Sectors
Banco Nacional de Crédito Agrícola / National Bank of Agricultural Credit	BANRURAL	1926	Agriculture
Banco Nacional de Obras y Servicios Públicos / National Bank of Public Works and Services	BANOBRAS	1933	Public works
Nacional Financiera / National Investment Bank	NAFIN	1933	Industry
Banco Nacional de Comercio Exterior / National Bank of External Trade	BANCOMEXT	1937	Foreign trade

Source: Maxfield 1990: 62; and Ramírez 1986: 156.

Since then, the supply of subsidised credit to promote industrialisation and agriculture has been an important mechanism of economic promotion and political control. Using this simple and accepted notion, the state created similar organisations targeting different social groups and economic activities. Development banking proved to be a very useful idea to attend demands from very different interest groups. The creation of other minor development banks like the *Banco del Transporte* (Transport Bank), *Banco del Pequeño Comercio* (BANPECO/Small Merchant's Bank),[5] and *Banco del Ejército*

[3]In 1929 the Partido Nacional Revolucionario (PNR) changed its name to Partido de la Revolución Mexicana (PRM) and then in 1935 the name was changed again to Partido Revolucionario Institutional (PRI), the way it is known nowadays.

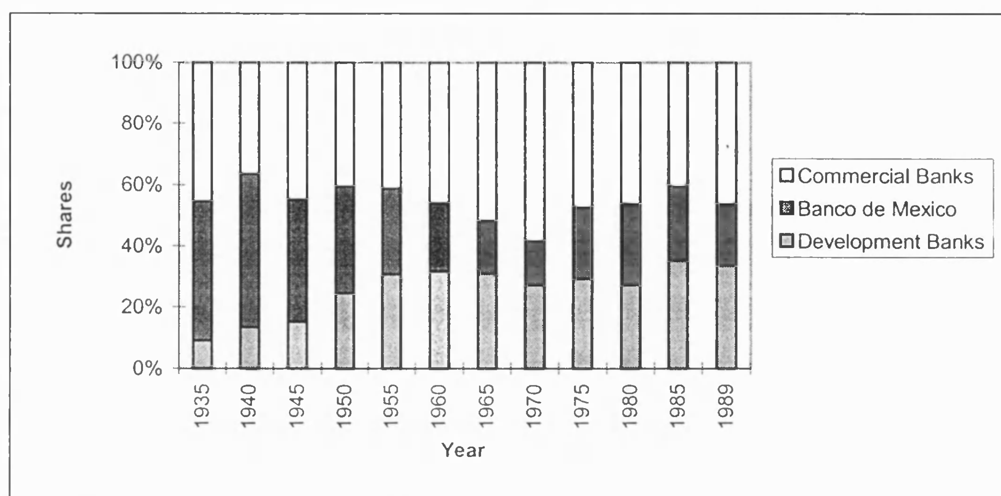
[4]Around the same time, similar financial organisations were created in the United States like the Reconstruction Finance Corporation and the Federal Housing Authority providing an additional source of support to the newly created development banks in Mexico (Anderson 1968: 119).

[5] BANPECO was restructured under the reform of development banking and changed its name to Banco de Comercio Interior (BNCI).

(BANEJERCITO/Armed Forces Bank) responded to demands from very specific groups within the society and the state.

Figure 5.1

Assets of the Mexican Financial System, 1935-1989



Source: NAFIN 1990: 477

The large size of development banking is one of the distinguishing features of the Mexican financial system. From 1945 until 1955 development banks experienced a great expansion in terms of their assets; their share in the system's total assets increased from 15.3 percent in 1945 to 30.7 percent in 1955 (see Figure 5.1). At the same time that their financial significance increased so did their political importance. Development banks became organisations controlling large amounts of resources and delivering subsidised credit to politically sensitive groups within society. However their relative importance remained relatively stagnant throughout the 1960s and 1970s, despite the fact that when the parastatal sector grew substantially again in the 1970s, development banks financed their expansion and their operational losses at the expense of the private sector. In the 1980s development banking share of total assets in the financial system increased again reaching almost 40 percent in 1987 (NAFIN 1990: 477-488; Presidencia de la República 1995: 60-61).

Economics

Development banking is essentially an economic institution aimed to, as can be inferred from its label, promote economic development in a broad sense. Imperfections present

in the financial markets provided the economic rationale for development banking. A gap between social and private returns in specific economic activities meant that socially profitable investment projects were not undertaken because they were not privately profitable; development banks were created to bridge this gap. Private banks trying to maximise profits and minimise risks concentrated on large enterprises financing, rich borrowers and short-term loans; and left small firms, poor borrowers and medium- and long-term investment projects without enough access to credit. Development banking was expected to attend these segments of the market.[6]

In Mexico, development banks are powerful organisations used by the state to steer the economy. Their operations in three major economic sectors —finance, agriculture and industry— were crucial in the early stages of Mexico's economic development; they served tree main economic purposes: (1) promote industrialisation and agricultural production; (2) promote the development of the financial system; and (3) secure alternative sources of financing for the state.

Development banking was a key element in the early stages of Mexico's industrialisation process. Back in the 1930s, as a result of the agenda of the post-revolutionary state, development banks extended credit to small and medium entrepreneurs. President Cárdenas, for instance, created the *Banco Nacional Obrero y de Fomento Industrial* (Workers and Industrial Promotion National Bank) in 1939 in order to foster grass-roots industrial and trade development (Anderson 1968: 123). Subsequently, in the 1940s, new groups of entrepreneurs, organised in chambers like CANACINTRA, CONCANACO and CONCAMIN, sought the support of the state (Anderson 1968: 124). As a response, NAFIN, the largest development bank, expanded its financial activities to attend this emerging political clientele. NAFIN became not only a source of financing for large projects, investing in infrastructure and heavy industry, but also a strong promoter of small and medium entrepreneurial initiatives during the 1950s and 1960s, when the Mexican drive towards industrialisation was at its

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[6] States in industrialised countries have also used development banks to direct credit to investment projects neglected by private banks because of their high risk, long term, and low private returns. Two notable examples are the Japan Development Bank and the German Kreditanstalt für Wiederaufau (see Alide 1994: 393). Their operations are very similar to those of any other development bank, namely: providing access to long term financing closely linked to state objectives, complementing the private financial sector. The only major difference is that they are profitable.

highest point. During this period NAFIN was a 'supply-leading' development bank (see Ramírez 1986).[7] Development banks targeting industry, as opposed to those targeting agriculture, were relatively more successful boosting a rapid process of industrialisation while preserving financial soundness. Credits from these banks were still subsidised but their allocation was undertaken under quasi-commercial criteria.

In agriculture, one of the most important political symbols that emerged from the Revolution was the agrarian reform. In the new semi-collective scheme of production, the state was responsible to provide land to communities of heretofore land-less peasants. However, in order to make these new units of production economically viable, they required additional inputs like machinery and credit. A whole array of development banks were created to finance those small farmers working *ejidos*, plots distributed under the agrarian reform, who could not legally mortgage their land and thus had difficulty obtaining commercial financing (Danby 1996: 19). As early as 1926 the state under President Calles established the *Banco Nacional de Crédito Agrícola* (BANRURAL/National Bank of Agrarian Credit) in order to support and control groups in rural areas.[8] In 1935 Cárdenas further boosted the agrarian reform with the creation of the *Banco de Crédito Ejidal* (BANJIDAL/Ejido Bank). However these banks have been always under continuous financial difficulties requiring continuous bailouts. In fact, they became one of the most important the institutional mechanisms to manage the subsidy scheme for agriculture in Mexico.

Development banking played also a very important role in the promotion of the financial system in general and the securities market in particular. NAFIN, the most important development bank in this respect, was created, among other things, to restore the banking system's liquidity and to develop the securities market. NAFIN made possible the development of new *financieras* (investment banks), private financial firms that emerged to meet the financial needs of specific industrial sectors, by providing them with liquidity (Ramírez 1986: 83). According to Raymond Goldsmith (1966: 16)

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[7] Miguel Ramírez (1986) uses the term *supply-leading* bank to describe the role of NAFIN as guarantor for loans extended by third parties to small entrepreneurs. NAFIN was not the lender all the time, in some cases it just provided the collateral to make financially viable some investment projects that would not be otherwise.

[8] Banco Nacional de Crédito Agrícola changed its name to the current Banco Nacional de Crédito Rural.

NAFIN is 'probably the most original contribution made by Mexico to the types of financial institutions participating in financing economic development and promoting economic growth.'

The creation of a securities market in Mexico was also to a great extent promoted by NAFIN. According to its Organic Act, NAFIN was responsible for the supervision and regulation of the securities and long-term credit markets. But most significantly, as a participant, NAFIN own issues of bonds were crucial to the development of the incipient securities market in Mexico. These bonds, known as *Certificados de Participación* were liquid; NAFIN was always ready to repurchase its outstanding securities at par value. Furthermore, NAFIN purchased securities issued by all sorts of firms, both public and private, arranged for guaranteed loans, and acted as a large-scale industrial promotes. It guaranteed liquidity to the securities market by standing ready to repurchase them at par value (Danby 1996: 18). This excessive liquidity was instrumental for the securities market development but also led to situations of extreme volatility and speculation under macroeconomic instability like in the 1976 and 1982 crises.

Another function of development banks with important implications for the economy and the power of the state, not extensively explored though, is their ability to raise funds for the state in international financial markets without involving the Ministry of Finance. In the 1950s President Miguel Alemán (1952-1958) turned NAFIN into the sole financial agent for medium- and long-term foreign credits requiring government guarantee. NAFIN was also the only organisation authorised to handle issues of state securities. Furthermore all public agencies and enterprises required to obtain NAFIN's approval before borrowing abroad (Ramírez 1986: 73). Still late in the 1980s it was a key organisation to secure medium- and long-term loans from international agencies (Ramírez 1986: 56). Other cases in Latin America like CORFO in Chile and COFIDE in Peru illustrates how development banks are key state organisations to channel credit from international markets to the domestic economy (Alide 1994).[9]

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[9]Development banking in Chile underwent a process of transformation similar to the one introduced in Mexico. From 1990, the Chilean government eliminated CORFO's 1st-floor operations arguing deficiencies in the allocation of credit by state agencies in combination with a greater development of commercial banks. CORFO is now restricted to act as a financial agent of the state for long-term

Loans to development banks have state guarantees and therefore are contracted at very similar interest rates than any other state loan. Yet the organisational infrastructure of development banks increases the capacity of the state to borrow in the international financial markets. There is, however, a distinction in the use of external financing depending on the agency that places the debt in the international markets: the financing contracted abroad by the Ministry of Finance is generally allocated to financing core activities of the state such as health, education, infrastructure and current spending; in contrast, external funds borrowed by development banks are usually directed to capital spending through financing both state owned enterprises and private ventures. This distinction was blurred though, during the stabilising development period when NAFIN resources, along with the resources of the banking system through reserve requirements, were directed to finance the public deficit; BdeM stopped being the most important source of funding in an attempt to curve down inflation.

Politics

Charles W. Anderson (1968: 44) illustrated very well the multiple political nature of development banking in Mexico. According to him, development banks have three essential political functions: management of politically predetermined public credit policies; provision of financial services to specific clienteles; and centres of power where managers carry out policies within a self-defined sphere of competence. Despite the fact that development banks enjoy certain autonomy and have powerful clienteles, their most important political role is to carry out presidential policies. In a political system where political power is highly centralised in the President, state organisations have little autonomy to pursue their own individual agendas and social groups are unlikely to capture them. Yet, the political role of development banks is far more complex than simply carrying out credit policies. As a consequence of their financial activity and economic influence, development banks strengthen regime legitimacy and control and mobilise interest groups.

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development projects, getting funds from international financial organisations like IBD and BIRD and then allocating them through commercial banks or other private financial firms (Alide 1994: 162-163).

In the early stages of economic reconstruction after the Revolution, these agencies were very useful to lay the foundations of a capitalist economy but also to fulfil fundamental demands of the Revolution as in the case of the agrarian reform; they were central to consolidate the legitimacy of the post-revolutionary regime at the first level of political organisation.

Development banking is an administrative instrument of political leadership of the state, 'a carrot and stick to bring about behaviour deemed appropriate to certain public purposes' (Anderson 1968: 169). For instance, BANRURAL and BANJIDAL are organisations channelling the efforts of small landholders toward an over-all agrarian policy; BANOBRAS is a bank enforcing compliance to national policy by local and municipal governments; and NAFIN serves to direct investment capital towards projects consistent with economic development. Jesus Villaseñor (1991: 1173) argues, however, that development banking has been more effective to perform the tasks that the state demands but have failed to promote economic development.

Development banks are powerful organisations with the ability to influence the behaviour of important economic and political organisations—e.g. commercial banks, local governments, associations of small and medium entrepreneurs and peasants' organisations. For instance, development banks given their control over a substantial share of the financial resources have effectively counterbalanced the economic power of the financial elite; they also exercise political control over their clienteles. In fact, according to Charles Anderson (1968: 168), the nature of the relationship between development banks and their clienteles is more tutelary than responsive despite the political importance of the clienteles.

The main sources of political power of development banking are the size of the financial resources they control and the terms and conditions under which they are prepared to lend. Nonetheless they also derive great influence from their continuous communication with key political and economic actors at the second and third level of political organisation. Development banks provide an organisational space for the interaction between state and society where policy co-ordination and collaboration regarding capital accumulation can take place (Ramírez 1986).

This organisational infrastructure for policy co-ordination is also very important at the third level; each bank has continuous communication with the set of state organisations related both to the financial system and to the specific sector the bank is servicing. For instance, the minister of agriculture, the minister of the agrarian reform, the minister of finance, the head of BdeM, all have a seat in the board of directors of BANRURAL. This institutional feature places them at the core of the power struggle between policy coalitions within the state. Development banking was consolidated under President Cárdenas, a member of the developmentalist coalition and therefore they represent to a great extent the policy preferences of this coalition. However, when the financial coalition is dominant within the state their political influence is mediated by the continuous intervention of the conservative BdeM.

President Cárdenas, by changing the heads of the Ministry of Finance, the CNBV and BdeM, empowered a group of economic advisers advocating Keynesian policies (Suárez 1994: 41). A conflict between this new group and the conservative economists from BdeM emerged as a consequence of this cabinet reshuffle that has continued to the present day (Anderson 1968: 121; see also Maxfield 1990).[10] The dual nature, political and economic, of development banking made it a normal arena of conflict between these two groups. The financial nature of development banking involves BdeM advising conservative policies regarding the allocation of credit, on the one hand; and the parastatal nature of the banks involves agencies like the ministry of National Properties, the ministry of Agriculture, the ministry of Fisheries, where economic advisors advocate stronger involvement of the state to allocate credit to targeted groups, on the other. Development banking has been historically at the core of the political struggle for the control of the state between the developmentalist and financial coalitions.

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[10]Maxfield (1990) explains swings in economic policy in terms of the conflict between two policy coalitions, one advocating neoliberal type of policies and centred on BdeM and another supporting Keynesian policies centred on the Ministry of National Properties.

5.3. The Reform

The reform to development banking under President Salinas was made up of three main changes: (1) specialisation of development banks in second-floor operations;[11] (2) reduction on state funding for these banks; and (3) replace the public for the private sector as the main recipient of development funds. In contrast to other economic reforms where changes were swift and radical, the reform to development banking took place only gradually with marginal changes to the existing institutional framework. Second-floor operations, decreasing credit subsidies and increasing financing to the private sector were trends already present in development banking prior to the reform. The merger between trust funds and large development banks, the privatisation of parastatal enterprises and the rationalisation of public finances were all decisions made in the context of economic transformation that, nevertheless, impinged upon the new scheme of development banking.

President Salinas and his inner circle of economic advisers established the general guidelines for the reform along with those for the structural transformation of the economy. However, in this case, the gradual nature of the changes allowed for greater resistance to the reform from some of the development banks, on the one hand; and required the co-operation from private bankers, on the other. For instance, smaller banks like BANRURAL and BNCI opposed the reform and defended their 'first-floor' operations and their programmes of guarantees (Maydón 1994: 169). Private financial groups, meanwhile, conditioned their participation in the new scheme on a minimum of profitability on the allocation of development banking credit (Maydón 1994: 150). Next section shows how the resistance from some development banks and the lack of co-operation from private bankers left development funds unallocated.

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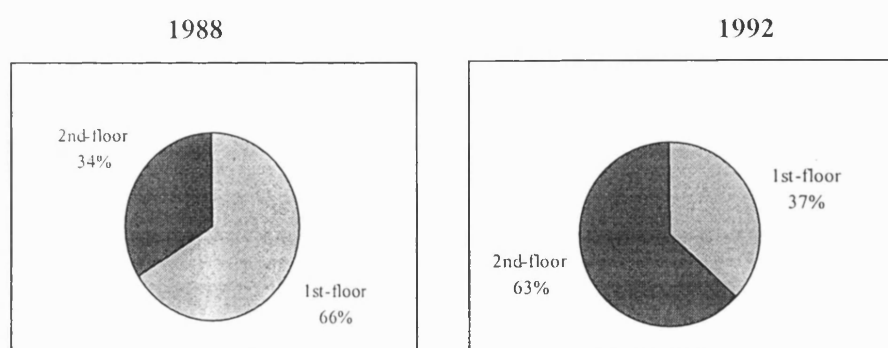
[11] *Second-floor* banking means that banks do not operate at the level of retail operations. On the passive side of their operations, means that development banks typically raise funds by issuing securities in domestic and international financial markets and by contracting large loans with international financial organisations. On the active side, means that development banks do not allocate credit directly to the final borrower but to other financial firms who have already extended credits and need additional funds to continue lending.

Shift to Second-floor Banking

Development banks, as any other financial firm, have passive (funding) and active (lending) operations. On the side of passive operations, the most important are: get direct budgetary allocations, borrow from international financial organisations, and issue their own securities. On the side of the active operations, they provide medium- and long-term loans, rediscount loans from other financial firms, and provide guarantees and collateral for third parties. The reforms to development banking changed their *modus operandi* from first-floor to second-floor operations regarding their active operations (see Figure 5.2).[12] *Second-floor* operations consist mainly on rediscounting commercial banks loans and contract funding through securities issues in financial markets, both international and domestic. Development banks reduced their first-floor operations, i.e. stopped choosing winners and restricted themselves to increase the liquidity (and consequently reduce interest rates) for loans to specific sectors.

Figure 5.2

Development Banks' second-floor Operations



Source: Ortiz 1994: 152

The concrete actions taken in this direction were: merging trust funds with development banks, closing down or merging specialised first-floor banks, and gradually eliminating the first-floor operations from major development banks. The closure of BANPESCA illustrates the elimination of specialised first-floor development banks and their

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[12] Regarding their funding, Mexican development banks have never operated on the *first-floor*, that is to say they have not taken deposits from the public (Danby 1996: 19). Most of the Mexican development banks have funded themselves from foreign borrowing, issuing bonds in the domestic market, and budgetary transfers.

replacement by programmes and trust funds handled by major development banks. In the same line, the merger of BANCOMEXT with FOMEX, the largest second-floor bank and the merger of NAFIN with industrial promotion funds like FONEI and FOGAIN, were directed to consolidate these organisations as second-floor banks (Maydón 1994: 56). BdeM used to be the most important second-floor development bank in Mexico through its management of trust funds and development programmes. However with the reform, BdeM lost its stake in this sector by transferring the control of trust funds to NAFIN, BANCOMEXT and BANOBRAS mainly. Yet BdeM keeps its prominent position in the design of development baking credit policy.[13]

At present, development banks financial activity is concentrated on rediscounting loans extended by commercial banks and *Asociaciones de Crédito* (Credit Associations)[14] to specific clients like small farmers, small- and medium-industrial and merchant firms, and exporters; they supply additional funds to commercial banks lending to those sectors where investments have long-term maturity and offer low returns combined with high risk, development banks changed fundamentally the way they perform their operations. The reform transformed development banks from active lenders to passive wholesale suppliers of funds to the actual lenders, e.g. commercial banks and *Asociaciones de Crédito*. Development banks, however, set the criteria to determine what sectors are liable to be rediscounted and then commercial banks actually extend the loans under this new scheme.[15]

An increasing specialisation of development banks in second-floor operations was expected to improve the allocation of credit and eliminate the need of state subsidies. *Second-floor* banking means that development banks use the infrastructure of commercial banks, supposedly with better risk management systems and operating under market conditions, to allocate development funds more efficiently. At the same time, development banks can use the credit rating of the state to channel funds, raised in international markets, into domestic credit markets and hence reduce interest rates

[13]The Governor of BdeM has a seat in every development bank Board of Directors.

[14] *Asociaciones de Crédito* are small organisations integrated by small entrepreneurs in the same line of business with the explicit purpose of borrowing from development banks.

[15] BANRURAL is the only major exemption to this scheme since it still keeps its network of branches and extends credits directly to small landholders.

charged on loans to specific sectors. This trend towards second-floor development banking is present all over Latin America, large financial corporations controlled by the state like CORFO in Chile, COFIDE in Peru and NAFIN in Mexico are all reducing their participation in the direct allocation of credit (see Alide 1994). NAFIN, for instance, allocated 72 percent of its loans through commercial banks in 1992 (Aspe 1994: 1046).

Declining Budgetary Funding

A central part in the economic transformation promoted by President Salinas and his economic team was the rationalisation of public finances. The scheme of state subsidies was radically reformed in order to improve its transparency and efficiency. Most of the subsidies were managed by a single programme, namely the Programa Nacional de Solidaridad (PRONASOL/National Programme of Solidarity). Financial subsidies were among those targeted for cuts back and therefore the Ministry of Finance cut down the budgetary allocations to those banks operating with financial losses. The gradual elimination of state subsidies to development banks was central on the new model of economic development with a downsized state. Regardless of the political significance of this measure, that shall be discussed later, it had important implications for the cost and availability of credit to those sectors considered as of public interest. Besides, development banks were no longer essential organisations in the new scheme of state subsidies.[16]

Declining budgetary funding forced development banks to become self-financing organisations, and consequently to eliminate all kinds of transfers to their clienteles. Banks in the first cluster, dealing with sophisticated clienteles, are already independent of budgetary allocations. However, banks in the second cluster, especially BANRURAL and BNCI, attending clienteles in more traditional economic sectors, have loan portfolios with problems of non-performing assets; political pressures force them to extend credits with very low probabilities of being repaid. At present, these two banks

[16]At this point, BANRURAL and some other trust funds are still deficit organisations, relying on budgetary allocations for their operation. However, they are supposed to move gradually towards financial independence by eliminating subsidies to interest rates and improving the re-payment of their loans.

still rely on budgetary allocations for their operation. However, they are also expected to improve their loan-recoverability ratio and eventually become self-financing organisations. The challenge they face at this point is to change their lending policies, highly sensitive to political pressures, and the financial culture of their clienteles used to the subsidiary role of the state.

The elimination of state subsidies, means that the interest rate charged on the funds supplied by development banks cannot be lower than the financial cost of raising those funds plus the administrative costs of the banks. This interest rate is, however, different to the one charged to the final borrowers because commissions and fees of commercial banks have to be added on top. Furthermore if the credit programme is also funded with commercial banks funds, which are usually more expensive, then the average cost of the pool of funds available in the programme is higher than the original cost of the funds provided by development banks only. In sum, interest rates charged on loans under programmes sponsored by development banks are the weighted average of the pre-determined interest rate on the funds provided by development banks and the marked-determined interest rate on the commercial banks' own funds (Maydón 1994: 184). Development banks have no longer control on the interest rate charged on the loans extended under their own programmes.

Increasing Private Sector Financing

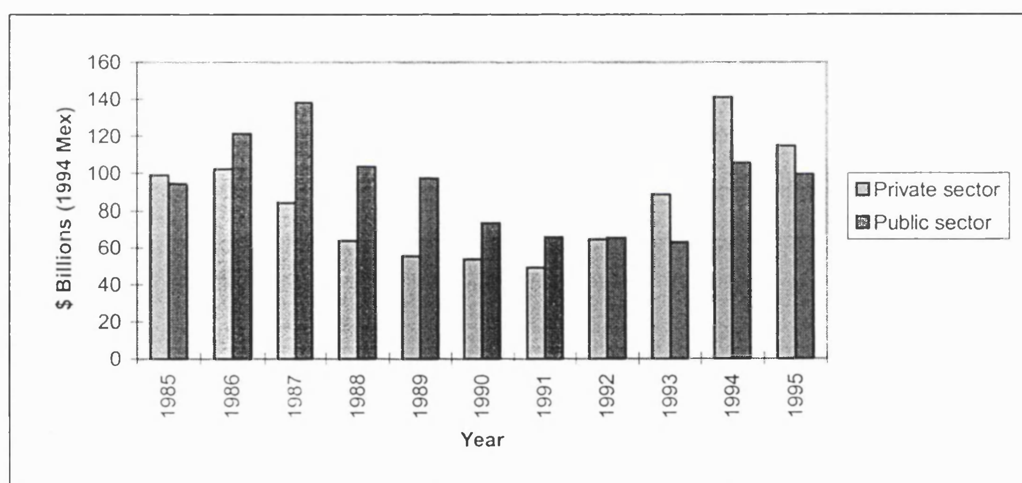
The third major component of the reform was the redefinition of the sectors to be sponsored by development banking: the private sector replaced the public sector as the main recipient of development funds, and new criteria were introduced for the selection of beneficiaries within the private sector, specifically: (1) potential for growth and expansion; and (2) potential contribution to national development. Micro, small and medium firms regardless of their activities fell under the first category, whereas infrastructure and export projects fell in the second category.

During the 1970s and 1980s, the credit from development banks was mainly directed to finance parastatal enterprises. This was a common trend all over Latin America where development banks experienced patrimonial losses because of political pressures to ease off their loan re-payment requirements. Transfers between agencies within the state

were the result of their relative influence rather than operational efficiency or financial transparency. Development banks allocated most of their funds to parastatal enterprises providing services, employment and exploiting natural resources. However, as a consequence of the privatisation programme the relative economic importance of the parastatal sector decreased and hence its financial requirements; privatisation meant a fundamental transformation of development banking. A shrinking parastatal sector forced development banks to redirect their credit towards the private sector (see Figure 5.3). In this respect development banking reform was essentially linked to the privatisation programme of the state.

Figure 5.3

Public vs. Private Sector Financing, 1985-1995



Source: Presidencia de la República 1995: 64

The share of total financing going to the private sector rose from 38.2 percent in 1988 to 57.2 percent in 1994 (Presidencia de la República 1995: 64). Despite the steady decline in development banks financing between 1987 and 1991 to both public and private sectors, in the second half of President Salinas's term, between 1991 and 1994, this figure increased more than the original decline and by the end of the period reached an all-time high. It is remarkable that, in 1994, a year of presidential elections, development banks financing had its major increase in the last ten years.

5.4. The Outcomes

From the intended changes described in the last section it is possible to draw some conclusions on the relevant actors for economic reform under President Salinas. The content of the reform conformed to the guidelines of the programme of structural transformation advocated by the financial coalition. This reform aimed to introduce market forces to the allocation of the large amount of resources handled by development banks. Extending and reinforcing the general goal of transforming the Mexican economy into an increasingly market economy.

However, the reform to development banking delivered many unforeseen outcomes and, at the end, some changes had to be reversed. The outcomes, despite of being far from those intended, transformed development banking in a fundamental way. From these observed outcomes, to be discussed next, it is possible to draw some conclusions on the failure of the reform to induce efficient economic behaviour.

State Politics

The outcomes of the reform at the third level, can be broadly grouped into two: (1) reconfiguration of political power between policy coalitions within the state; and (2) the undermining of development banking as an institutional mechanism for political control. The reform to development banking along with the reform to BdeM are arguably the changes with most important consequences for the reconfiguration of power within the state. However, in the case of development banking did not receive much public attention.

President Salinas reduced the economic and consequently their political significance of those banks where the political input is stronger. These banks had been important mechanisms to secure the popular support for the regime. However, in President Salinas's strategy they were replaced by PRONASOL under the direct control of the executive. The appointment of Oscar Espinoza as head of NAFIN, regardless of his links to the strongest contender for the presidency in opposition to Salinas, Alfredo del

Mazo, is somewhat puzzling.[17] However, Espinoza shared the President's views on economic policy despite the fact that they were members of different *camarillas*. President Salinas continuous attempts to form alliances with rival political groups sharing similar economic policies may explain why he did leave the most important position of development banking in the hands of a political rival.

The state abandoned the use of development banking as an instrument for political control. By turning development banks into second-floor banks, they became alienated from their traditional clienteles.[18] However, the government still used development banks with expansionist purposes during the year prior to the presidential elections. Development credit jumped from 16.1 percent of the GDP in 1993 to 24.7 percent the year after (Presidencia de la República 1995: 61). In 1993, the government removed the balance of these banks from the public accounts and therefore this increase went unnoticed at that time.

At present, retail banking is completely controlled by commercial banks and other minor organisations; they have taken over the role, formerly performed by development banks, of intermediaries between interest groups and the state. As long as there is preferential resources to be allocated there is potential for clientelist relationships. In the new scheme commercial banks have strengthened their political and economic position within the Mexican political economy. Development banks used to provide the institutional space where their clienteles, usually influential societal groups like non-elite entrepreneurs or peasants, would interact with the state. However, the reform reduced this space of co-ordination between the state and non-financial interest groups.

There are already some signals of discomfort with the new institutional arrangement. For instance, CANACINTRA, an organisation grouping small and medium entrepreneurs, demanded that development banks and not commercial banks should assess the financial viability of the investment projects, arguing that development banks

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[17]Oscar Espinoza, himself, acknowledges that he was not expecting to be called to collaborate with the new President Carlos Salinas given his links to Alfredo del Mazo (*La Jornada*, June 25th 1995).

[18]The only major exception is BANRURAL that still has its own network of branches through which it allocates most of the credit to small farmers.

have a long term horizon whereas commercial banks having shorter term horizons demand immediate benefits from investments (*El Economista*, February 14th 1997).[19]

Structure of Development Banking

Prior to the reform it was possible to distinguish three different clusters of development banks in Mexico. The first cluster comprises NAFIN, BANCOMEXT and BANOBRAS. These banks attend a sophisticated clientele that in some cases is also served by commercial banks, operate on the basis of responsible banking and financial soundness, have a centralised administration, and are relatively free of corruption problems. The second cluster includes BANRURAL, BANPECO and BANPESCA.[20] These banks supply credit to socially and politically sensitive sectors with limited access to other sources of financing, rely to a great extent on budgetary allocations for their operation, have a decentralised administration, and operate a high volume of small transactions and face problems of corruption. Finally, the third cluster is made up of *fideicomisos* (trust funds) that perform the same function of development banking but with simplified organisational structures. They manage large funds for very specific projects and activities in which the state has a special interest (see Table 5.2). The specificity in the destination of these funds makes them politically and economically significant.

Trust funds were created to secure credit to strategic economic projects or to politically well-organised groups. The most important at present are: *Fondo Bancario de Protección al Ahorro* (FOBAPROA/Banking Fund for Savings Protection), *Fideicomisos Instituidos en Relación a la Agricultura* (FIRA/Trust Fund Instituted Regarding Agriculture), *Fondo Operativo y de Financiamiento a la Vivienda* (FOVI/Operational Fund for Housing Financing), *Fideicomiso para el Desarrollo Comercial* (FIDEC/ Trust Fund for Trade Development) and *Fondo Nacional de Fomento al Turismo* (FONATUR/National Fund for Tourism Promotion).

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[19]Other organisations like CONACEX also demanded that BANCOMEXT should operate in the first floor in order to expand the number of exporting firms with access to the bank's financing (*La Jornada*, March 30th 1995).

[20] The National Bank for Internal Trade (BNCI) was the result of the merger between BANPECO and BANPESCA.

Table 5.2

Main Funds and Trust Funds

Fund Manager	Acronym	Funds and Trust Funds
BdeM	FIRA	*Fideicomisos Instituidos en Relación con la Agricultura*
	FOVI	*Fondo de Operación y Descuento Bancario a la Vivienda*
	FONEI	*Fondo de Equipamiento Industrial*
NAFIN	PAI	*Programa de Apoyo Integral a la Industria Mediana y Pequeña*
	FOGAIN	*Fondo de Garantía y Fomento a la Industria Mediana y Pequeña*
	FOMIN	*Fondo de Fomento Industrial*
	FIDEIN	*Fideicomiso de Conjuntos, Parques, Ciudades Industriales y Centros Comerciales*
	FONEP	*Fondo Nacional de Estudios y Proyectos*
	INFOTEC	*Fondo de Información y Documentación para la Industria*
	FONATUR	*Fondo Nacional de Fomento al Turismo*
	FONACOT	*Fondo de Fomento y Garantía para el Consumo de los Trabajadores*
	FONAFE	*Fondo Nacional de Fomento Ejidal*
	FONART	*Fondo Nacional para el Fomento de las Artesanías*
	MINOMET	*Fideicomiso Minerales no Metálicos*
BANRURAL	FICART	*Fideicomiso para Crédito en Areas de Riego y Temporal*
	FIRCO	*Fideicomiso de Riezgo Compartido*
	FFG	*Fideicomiso Fondo Ganadero*
	FOIR	*Fondo para Obras de Infraestructura Rural*
	PRODEL	*Fondo del Programa de Descentralización de las Explotaciones Lecheras del D.F.*
BANOBRAS	FOMUN	*Fondo Fiduciario Federal de Fomento Municipal*

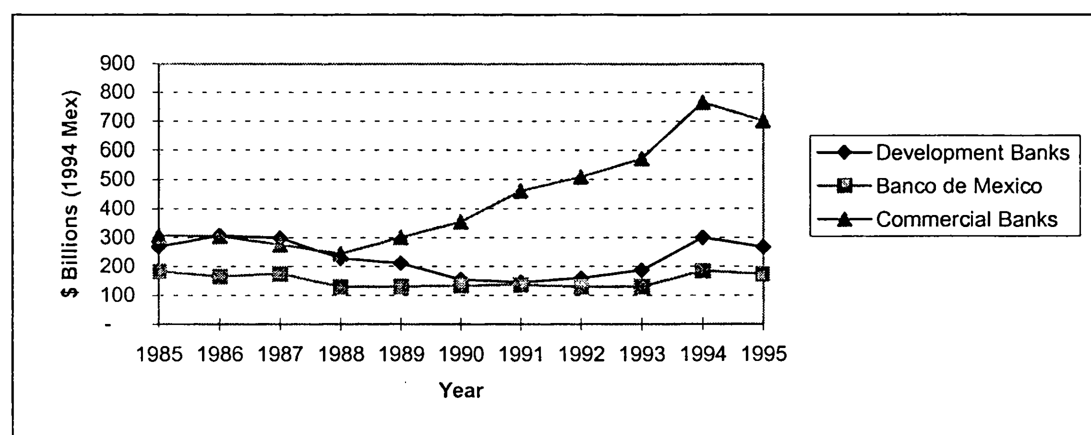
Source: *Mercado de Valores*, October 5th 1987.

This structure remained essentially unchanged with one important exception; most of the funds and trust funds in the third cluster merged with the banks in the first cluster, i.e. NAFIN, BANCOMEXT and BANOBRAS. The banks in this major cluster, the only financially significant ones after the reform, concentrated on second-floor operations mainly, remained relatively isolated from political pressures and relatively financially sound despite the crisis in December 1995. The second cluster—BANRURAL and BNCI—continued their first-floor operations, facing problems of non-performing assets and subject to strong political pressures from their clienteles. At this point BANCOMEXT has greater dynamism than NAFIN, extending a larger amount of funds in the form of new loans. Nevertheless NAFIN is still the largest development bank in terms of assets and size of loan portfolio.

As recent as 1987 development banks financing was larger than commercial banks financing. However, as a result of the reform, the relative financial importance of development banking decreased steadily and by 1991 its share of total assets of the system was barely 19.6 percent, the lowest in the last fifty years. In contrast, commercial banking increased its size very rapidly leading to a substantial change in the structure of the Mexican financial system. This lending boom was sparked by financial liberalisation and banks' privatisation. In 1991, the share of total financing allocated by development banks was only 21.9 percent (see Figure 5.4). Afterwards it partially recuperated and reached 26.7 percent of the total in 1995 (Presidencia de la República 1995: 62).

Figure 5.4

Assets of the Mexican Financial System, 1985-1995



Source: Presidencia de la República 1995: 62

Along with the change in the relative importance of development vis-à-vis commercial banks, the relationship between them also changed dramatically because of the introduction of second-floor banking. Development banks are supposed to induce commercial banks to channel credit to priority sectors. However, their position to do so is jeopardised by the new scheme in which they depend on a concentrated commercial banking sector.[21] The control of development banking resources is concentrated in NAFIN, BANCOMEXT and BANOBRAS in the same fashion that the allocation of credit is concentrated in BANAMEX, BANCOMER and Banca Serfín. Fees and

[21]In order to avoid the concentration of development banks funds in a few commercial banks some ceilings were introduced according to Carlos Sales, head of NAFIN (*El Economista*, March 6th 1997).

commissions for rediscounting credits with development banks are supposed to be determined by market forces.

However, the fact that there are only a small number of relevant banks operating in this segment poses a serious doubt on this contention. It is more likely that the spread on the interest rate, along with fees and commissions are determined by the bargaining power of the banks. The co-operation between them has not been, nevertheless, smooth and completely effective. In 1995, commercial banks allocated their resources first, leaving development banking funds unallocated. The relationship between development and commercial banks is still dominated by mistrust and continuous tension despite the continuous efforts to improve this relationship and to create new business opportunities for the private financial groups.[22]

Early in the 1990s when consumer credit was so profitable it was difficult and very costly to induce commercial banks to participate in development credit programmes. This situation was aggravated by the banking crisis that followed the December 1994 devaluation in which commercial banks were more concerned to capitalise themselves than to allocate development banks funds. This problem illustrated the potential problem to development banks that arises from relying completely on other financial firms for the allocation of their own funds. For instance, BANCOMEXT did not allocate the entire amount of funds it had planned in 1996 and therefore towards the end of the year restarted its first-floor operations in 1996 to allocate its own funds. BANCOMEXT also decided to increase its stake in the loans risk from 50 to 70 percent in order to further induce commercial banks to give away loans (*El Economista*, November 7th 1996).

Economic and Operational Efficiency

Under the managerial perspective, the reform of development banking was intended to bring about: reduced fiscal transfers, increased efficiency and better selective criteria in

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[22] Commercial banks protested when FIRA demanded, before paying guarantees, to try all the possibilities to re-negotiate the debt in order to avoid the further accumulation of non-performing assets (Maydón 1994: 168). Carlos Sales, the newly appointed chief executive officer of NAFIN, called for the solution to differences between development and commercial banks in the context of the new scheme of co-operation (*El Economista*, March 10th 1997).

the allocation of credit (Maydón 1994: 14). The group pressing for responsible banking also stressed the need to insulate the process of credit allocation from political pressures and place technical and economic considerations at the top. In the same line of structural adjustment policies, the major guideline for the reform was less state intervention in the allocation of credit to those sectors regarded as of public interest. The attempt to eliminate fiscal transfers to development banks meant the triumph of responsible banking over the subsidiary role of the state. However in practice this was not always the case. In fact, by 1996 after a few years of gradual reductions, budgetary allocations to development banks increased by 85 percent in real terms respect a year before. The banks most benefited were BANRURAL with 27 percent, FIRA with 22 percent, FONHAPO with 25 percent and FOVI with 12 percent (*El Economista*, February 12th 1997). Furthermore, NAFIN was the only bank that improved its profitability over capital from 1988 to 1992 (see Table 5.3); and not even in this case it is possible to claim an increase in operational efficiency. Gilberto Borja, head of NAFIN, declared that 50 percent of the 470 000 loans extended by the bank between 1988 and 1994 were not financially sound (*El Economista*, September 13th 1996).

Table 5.3

Development Banks Profitability (1)

Bank	1988	1992
Nacional Financiera	10.51	18.93
Bancomext	10.71	6.29
Banobras	4.85	2.27
Other	-25.7	-35.6

Source: Ortiz 1994: 159
(1) Profits / capital

Nevertheless, credit markets in Mexico are still far from being competitive. Almost 50 percent of the total assets and total branches of the banking system are controlled by the two major commercial banks. By handing to commercial banks the final responsibility of allocating credit, the state officials implicitly assumed that commercial banks were essentially more efficient than development banks. They grounded this assumption on theoretical claims that the market delivers more efficient outcomes. However, the lack of empirical evidence supporting these claims is noteworthy. Profitability and operational efficiency in NAFIN and BANCOMEXT has been historically as high as that of any large commercial bank. In fact, the banking crisis in 1995 made evident the

opposite, commercial banks lending policies were defective with catastrophic consequences for the system.

Commercial banks were not more efficient necessarily than development banks and *second-floor* operations did not eliminate the problems of corruption associated to political pressures either. There was a case of corruption in the allocation of rediscounted credit from NAFIN by three credit unions. Gilberto Borja, head of the bank, attributed the cause of the problem to NAFIN's by-laws that allowed a great degree of discretion in the behaviour of its executives. Without blaming Oscar Espinoza, former head of the bank, he disapproved the way credit was allocated under his administration (*La Jornada*, July 5th 1995). In the haste to allocate credit in 1994, the year of presidential elections, NAFIN did not create controls to rediscount the credits on a solid basis. Financial groups like Grupo Havre were also involved in cases of corruption related to the allocation of development banks funds. Other banks—Banco Union and Banpaís—although not directly related with development banking funds, were also involved in cases of corruption. In sum, second-floor banking did not eliminate the problem of corruption neither improved the allocation of development banks funds.

An essential element in finance is uncertainty. In every loan there is an implicit risk of not being re-paid. This type of risk has traditionally kept commercial banks away from extending credit to small entrepreneurs and therefore development banks stepped in to cover that segment of the market. Under the new scheme, risk is shared between commercial and development banks though allocation is mostly in the hands of commercial banks. Then the original problem has reappeared, though under different circumstances. Commercial banks will not lend to those sectors that they still find too risky despite of sharing the risk with development banks. Risk adjusted profitability in operations with development banks' programmes has to be as least as high as that in any other business of commercial banks. Under this new scheme, some sectors are having reduced access to credit because of a lack of interest by commercial banks whereas other more attractive sectors offering better returns have improved their access to credit.

In the end the reform of development banking did not succeed in placing economic considerations at the top and remained highly influenced by the electoral cycle despite

continuous attempts to insulate it from political factors. In 1994, the election year, the increase in development banking credit was the highest in the last 10 years. This time the main recipient was the private sector. In the midst of a haste to allocate this increased financing, development banks, especially NAFIN as latter became evident, overlooked responsible banking and sound financial practices.

Summary

The reform of development banking in Mexico supports the claim that the state behaves strategically as an organisation with well-defined objectives. In the context of a severe economic crisis and with the society demanding bold economic measures, the state came out with a whole new development strategy based on a market economy. By introducing market elements to the allocation of development credit, the state intended to advance its goal of transforming the Mexican economy into an economy increasingly market oriented. Development banks were not eliminated but their operations are now not only mediated by the market but also narrower in their scope.

Structural adjustment policies urging for a greater reliance on market forces and less state intervention triggered the debate on the role of development banking in a liberalised economy. In the new scheme of reduced state involvement in the economy, development banking became an awkward issue for the state. The state acknowledges that in the absence of these organisations, imperfections in the financial markets may leave important groups and regions short of credit. However, development banking is subject to political pressure distorting the financial activity of these organisations. The debate revolved around two main positions: responsible banking and financial soundness vis-à-vis greater access to subsidised credit for those groups unattended by the financial system.

The reorganisation of development banking entailed changes in three areas mainly: (1) redefinition of development banks *modus operandi*; (2) rationalisation of state funding for these banks; and (3) redefinition of economic sectors or activities that required the assistance from development banking (Alide 1994: 212). However, at the end, the reform lacked a clear direction as to where the state wanted to take it in the new context of an increasingly liberalised economy despite the strong leadership of President

Salinas. Introducing market elements to one of the symbols of state intervention in the economy would signal the commitment and determination of the state to transform the Mexican economy. However the state could not afford to neglect the political dimension of the reform.[23] The allocation of subsidised credit has always been a major mechanism of state control over the society (Villaseñor 1991: 1172). It creates networks of collaboration between groups within the society and the state who profit from the existing scheme and therefore have a vested interest to preserve it. The dual nature of development banking involving economics and politics jeopardised the attempt to improve its economic efficiency by using market mechanisms.

The outcomes of the reform of development banking were very mild compared to other reforms to the financial sector. The structure existing prior to the reform of a two-tier development banking system remained essentially the same after the reform. By 1995 some development banks had to go back to their first-floor operations in order to allocate their own resources since the schemes intended to induce commercial banks to participate in the allocation of development banks funds did not work. Scandals of corruption in Nacional Financial, supposedly the bank less susceptible to this type of problems, showed that the reform did not isolated the banks from political pressures. Despite that increasing funds are allocated to the private sector, the public sector is still very significant as a recipient of these funds. The elimination of subsidies went down but not significantly and by 1996 the budgetary allocations to some banks increased again. Banks like NAFIN and BANCOMEXT were operating without budgetary

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[23]The underlying concept of development banking is as much about political values like social justice and equality as it is about economic efficiency. Development banking in the form of fiscal transfers through subsidised credit from the whole society to specific groups is a political issue as much as it is economic.

allocations even prior to the reform, and the banks that were dependent on them are still so, like BANRURAL, BNCI and some development funds.

Chapter 6

Commercial Banks Privatisation

Among all the reforms to the financial system implemented under President Salinas, the privatisation of the commercial banks is the most representative case of a state-engineered change. The state deployed its institutional capacity to bring about swift and fundamental change to, arguably, the most important sector in the Mexican political economy. This reform was pivotal to move forward the economic and political agenda of President Salinas for two main reasons. First, the privatisation improved the investment climate in Mexico more than any other single policy —capital inflows sky-rocketed during the second part of the *sexenio*, economic growth, though slow, was regained and inflation was brought down. Second, the privatisation consolidated Salinas's political and economic leadership by securing the support of the business elite and providing liquidity to finance the social spending programme that, in turn, secured grass-roots support.

Part of the more general financial reform, the banks' privatisation changed fundamentally the configuration of the Mexican financial system. It is not possible, however, to show on theoretical or empirical grounds that the transfer of banks ownership improved the internal efficiency of the banks or the stability of the financial system. As the 1994 crisis served to establish, the Mexican banks' privatisation was not primarily intended to ensure the stability of the financial system. Furthermore, new financial practices and universal banking, both outcomes of the privatisation, were instrumental in triggering the current banking crisis. This chapter looks at the political economy of the privatisation process and the resulting institutional changes in order to explain the inefficient behaviour of the economic agents preceding the crisis.

There is a vast literature that tries to identify the main drives behind the privatisation programmes implemented all over the world since the late 1970s.[1] Most of these studies agree on three very clear economic goals pursued by any privatisation programme, namely: increase economic efficiency, reduce public deficits and improve the investment climate. Likewise, there are several political studies of privatisation as a public policy.[2] At a political level, any privatisation programme causes a massive redistribution of wealth and power, and therefore has important implications for the political behaviour of the state and interest groups. In the Mexican case, political considerations outweighed economic goals in the decision to privatise the banks, as I shall argue in the third and fourth sections.

This chapter is organised according to the structure already discussed. The first section is a review of the dominant ideas on ownership and privatisation. The second section addresses the political and economic circumstances that surrounded the banks' privatisation. The third section analyses the implementation of this decision in order to illustrate the capacity the state to bring about institutional change. Finally, the fourth section presents a retrospective analysis of the decision in order to assess the economic consequences of the privatisation.

6.1. The Ideas

This section is concentrated on the dominant ideas underlying the widespread trend towards privatisation. They are grouped into two main categories: ownership and economic efficiency and public finances. I assume that the basic principles of these arguments apply to the case of the banks, and therefore they are presented at a very abstract level. The discussion about the specific conditions of the Mexican banks' privatisation is left for subsequent sections. The discussion, however, acknowledges the fact that the financial system usually has a strategic role in the process of capital accumulation and is especially sensitive to imperfections. The analysis uses the notions

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[1] See, for instance, Vickers and Yarrow 1988; Bienen and Waterbury 1989; Van De Walle 1989; Suleiman and Waterbury 1990; Starr 1990; Glade 1991; Lieberman 1993; Castelar-Pinheiro and Schneider 1994; Gil 1994; Jameson 1994; Manzetti 1994; and Holden and Rajapatirana 1995.

[2] In this case, see Schneider 1989; Schneider 1990; Waterbury 1990; Vera 1991; Lieberman 1993; Mateos and Román 1993; Ramírez 1994.

of market imperfections, asymmetric information and economies of scale in order to assess the economic pertinence of the privatisation of the banking sector. Private ownership in the context of increasing financial integration has additional effects on capital flight, speculative investment and assets performance.

Ownership and Economic Efficiency

In an ideal world, where markets are of the type described by the perfect competition paradigm, it does not matter who owns the productive assets. Unfortunately markets, especially in developing economies, are better described by imperfect competition, information asymmetries and economies of scale. Under these conditions, who own the assets does matter for goals of efficiency and equality. Public ownership is considered to be the best option in the presence of market imperfections that cannot be removed by pure regulation. These imperfections are reputedly more common in the early stages of development. However, as economies develop, competition increases, economic institutions become stronger and, therefore, the need for state-owned enterprise decreases.

The literature of industrial organisation and new political economy argues that public ownership introduces additional distortions to the markets (Jones 1982; Van de Walle 1989). Likewise, the literature of mainstream economics has developed many arguments in favour of privatising state-owned companies. As regards efficient behaviour, they argue that the political process, through which top executives at public enterprises are appointed, distort management incentives, induce inefficient decisions and corrupts the character of public enterprise.

John Vickers and George Yarrow (1988) produced the most important and comprehensive economic study of privatisation. They approached the issue of ownership through the notion of the agency problem.[3] In this framework, the internal efficiency of the firm and the industry depends on the incentive structure. This structure is determined, in turn, by ownership, degree of competition within the industry and the

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[3] Fundamentally, what this concept says is that owners (principal) and managers (agent) are different players and therefore have different sets of objectives and information. The principal wants to induce the agent through an incentive structure such that agents' actions favour principals' objectives.

existing regulation. Privatisation, understood as a change in ownership, means a shift in the owners' objectives and, consequently, on the incentive structure for the managers. Changes in ownership lead to different managerial behaviour and company performance. However, the effects of privatisation upon efficiency cannot be assessed in isolation from the competitive structure of the industry and the regulatory constraints. At this level of abstraction, all that can be said is that efficiency depends on a complex set of interactions among factors that include: type of ownership, market structure and institutional framework (Vickers and Yarrow 1988: 44).

Public Finances

Privatisation is often encouraged on the basis of a more efficient management of the state and the economy. According to this line of arguments, privatisation programmes release financial and human resources for alternative uses, reduce the pressure on the state finances and improve economic management. Public deficits are often a source of economic instability. According to 'monetarist' thinking, running public deficits systematically will eventually require an increase on the money supply with a corresponding rise on inflation (Sargent and Wallace 1981). Through privatisation, the state improves the public finances in two ways. First, the state reduces the flow of interest payments in the future by using the proceeds from the sales to pay off debt and, as a result, secures permanent benefits. Second, The state reduces public spending by writing off the subsidies accounts of inefficient public enterprises from the budget.

The macroeconomic effects of privatisation programmes have been vastly more studied than the microeconomic relationship between efficiency and ownership.[4] Most of these studies assert that public deficits were the major drive for privatisation in developing countries. Preoccupied with economic stabilisation, policy makers were more concerned with the proceeds from the sale of public enterprises than with the uncertain efficiency improvements to be attained at some time in the future (Van De Walle 1989, Manzetti 1994).

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[4] See Bienen and Waterbury 1989; Van De Walle 1989; Starr 1990; Glade 1991; Barnes 1994; Castelar-Pinheiro and Schneider 1994; Manzetti 1994; Jameson 1994.

Politicians have short time horizons and thus have strong incentives to maximise immediate receipts (Castelar-Pinheiro and Schneider 1994). However, some authors also argue that privatisation does not help to reduce the public deficit (Waterbury 1990; 1994). In theory, privatisation has a positive effect on public finances only in the case that it improves economic efficiency, otherwise the simple exchange of assets only foreclose a future stream of income. Furthermore, the evidence shows that revenues from privatisation did not come at the right time and in the right magnitude to contribute much to fiscal adjustment in Chile, Mexico and Brazil (Castelar-Pinheiro and Schneider 1994). Dionisio Meade, Managing Director of Banco Mexicanò (1988-1991), believes that the decision to privatise the commercial banks was unrelated to macroeconomic considerations (Interview: Mexico City, January 22nd 1998). The state did not intend to solve the problem of the increasing current account deficit with this action. Notwithstanding, privatisation remained valuable to political leaders as a credible signal of the state's commitment for economic stability. The privatisation was more a decision of political economy.

6.2. The Context

The level of abstraction of the theoretical arguments presented above forecloses any conclusion on the economic pertinence of the specific decision to privatise the Mexican banks. This section, however, addresses the concrete circumstances under which the decision was taken. I argue that the issue of commercial banks' ownership was ultimately political. The argument is presented in two parts: how political events surrounded the nationalisation of the banks in 1982, and less than ten years later, also their privatisation; and how the financial performance of the banks under state ownership do not endorse the need for their privatisation. The privatisation of commercial banks conforms the original claim that international policy trends and domestic politics brought about policy change under President Salinas.

The Politics of the Banks Nationalisation

The nationalisation of the commercial banks back in 1982 was the response of President López Portillo to the lack of co-operation from the business elite to overcome the increasing financial difficulties of the state. According to Sylvia Maxfield (1990: 1),

'the bank nationalisation was the most dramatic move against the Mexican private sector since Mexico's 1938 oil nationalisation'.[5] However, less than ten years later, President Salinas reversed this, once considered, popular decision without major political opposition. This swing in state policy illustrates very clearly the role of coalition politics in policy change. The nationalisation, first, and the privatisation, only ten years later, correspond to the shift in the balance of power between policy coalitions within the state.

President López Portillo can be identified with the developmentalist coalition, especially towards the end of his term, when the nationalisation of the banks took place. Some members of the financial coalition, who disagreed with the decision resigned as a consequence of the power struggle taking place within the state, including: Miguel Mancera, governor of BdeM and Adrián Lajous, head of BANCOMEXT. Carlos Tello, the main promoter of the nationalisation, took the position as governor of BdeM. During the last months of President López Portillo's term a clash developed between Carlos Tello in BdeM and Jesus Silva Herzog in the Ministry of Finance. They represented two alternative coalitions with conflicting positions regarding state economic policy. The ideological dispute materialised in the new role to be played by the state-owned banks in the economic development. Jesus Silva Herzog supported orthodox management for the banks, whereas Carlos Tello advocated a stronger social role for the banks. The outgoing President López Portillo, endorsed Carlos Tello; and the incoming President de la Madrid supported Jesus Silva Herzog.

When President de la Madrid took office, he solved this dispute in favour of a more orthodox and profit oriented philosophy for the banks; this view persisted until their privatisation early in the 1990s. The economic project advocated by the coalition centring on Carlos Tello was discontinued as a result of the financial coalition take-over. Back in 1982, at the moment of the commercial banks nationalisation, this coalition had already strategic positions in the executive bureaucracy. In fact, the limited reach of this

[5] Despite the initial statements against the decision, the response of the financial elite was very mild. One possible explanation is that the financial situation of the banks was very precarious at the moment of their nationalisation. At the moment of the devaluation in February 1982, commercial banks had large amounts of dollar-denominated debt in their balances; state intervention was just a matter of time. The banks nationalisation can be interpreted as a bailout of the sector.

decision is explained to a great extent by the opposition of Jesús Silva Herzog, minister of finance (1982-1986) (see Maxfield 1992). The President designated ex-state officials with financial experience as chief executive officers of the larger banks in the system. Most of these officials were trained at BdeM or NAFIN; former ministers of finance, Antonio Carrillo Flores (1952-1958), David Ibarra Muñoz (1977-1982) were appointed as chief executive officers of BANCOMER, BANAMEX respectively and José Juan de Olloqui, also with financial experience, was entrusted Banca Serfin (Hamilton 1985: 163).

President de la Madrid, member of the financial coalition, consolidated the new configuration of power dominated by technocrats positioned in the financial division of the executive bureaucracy, ministry of Budget and Planning, Ministry of Finance and BdeM. The points at the top of this agenda were economic stabilisation and structural change, including privatisation, deregulation and opening-up domestic markets to foreign competition. In 1982, President de la Madrid re-appointed Jesus Silva Herzog as minister of finance and Miguel Mancera as governor of BdeM in order to move forward the negotiations and policy co-operation with the ex-bankers and international capital (Hamilton 1985: 166).

The Politics of the Banks Privatisation

The banks' privatisation was a state engineered change motivated by the new international consensus and implemented by President Salinas's economic team. There are two essential political elements in the Mexican banks' privatisation: (1) the economic agenda for liberalisation; and (2) the political control of the financial coalition over the state. International policy networks of the type described in chapter two share a common background all over the world; are very well interconnected and communicated; and consequently are very aware of the changes and trends occurring in the international context at any time (see Ikenberry 1990). Their decisions not only respond to domestic forces but also they copy successful policies implemented in other countries largely. Those that capture the attention and recognition of global investors secure an important source of funds to finance the development of their countries and strengthen their political positions.

In Mexico, most top state officials in the finance division of the executive bureaucracy at the moment of the banks' privatisation were trained in major US universities which endorse analytical developments in favour of economic liberalisation. Some of them worked for international financial organisations such as Guillermo Ortiz, deputy minister of finance (1988-1994) and person responsible for the banks' privatisation; he also worked for the IMF from 1984 to 1988 (Diccionario Biográfico de la Administración Pública 1992: 273). It is easy to understand why these state officials were strong advocates for economic liberalisation and privatisation. The case of the banks' privatisation was a matter of economic, political and ideological consistency of the Mexican policy elite. Guillermo Barnes asserted that having state-owned commercial banks was inconsistent in a general equilibrium perspective under an integrated economy (Interview: Mexico City, February 9th 1998).

In the case of the banks' privatisation only political actors at the top level of the state hierarchy ever got involved in the process. The only political opposition to the banks' privatisation came from senators of the left wing Partido de la Revolución Democrática (PRD), Ifigenia Martínez and Porfirio Muñoz Ledo, who accused the state of '...fighting openly and without pretence for its true constituents—the financial group' (International Reports 1991: 7). It remains true that some political capital had to be spent in order to carry the banks' privatisation through. The PRI, for the first time in its history, did not have the required majority to change the constitution and therefore formed a coalition with the *Partido Acción Nacional* (PAN). However, not a single public demonstration against the decision was mounted. Peak labour organisations reserved their organisational efforts for policies relating more directly to their interests. The banks' privatisation was not a politically costly decision that, nevertheless, paid important political and economic dividends for the state.

Banks Financial Performance, 1982-1990

The economic basis of the privatisation is very weak at best in the concrete case of the Mexican commercial banks; the empirical evidence is not conclusive as regards to the relationship between internal efficiency and ownership. For instance, Carlos Tello, the main architect of the banks' nationalisation, admitted that simply changing ownership did not guarantee that their operations, practices and uses would change (Maxfield

1992: 86). In like manner, eight years latter, the main promoters of the privatisation did not raise the issue of banks internal efficiency as a major motivating factor. In fact, Pedro Aspe (1990: 18), minister of finance (1988-1994), stated that the banks were not on sale because they were financially troubled; they were on sale because it was not acceptable to have resources of the state in the form of banks capital when there were pressing needs in Mexican society.

The banks' profitability while under public ownership was remarkable despite the shock of the nationalisation, strong competition from the SBHs, macroeconomic difficulties and the departure of many senior management teams (Hanley et. al. 1991: 3). The internal efficiency of the banks measured by the ratio profits/income improved substantially while the banks were publicly owned (see Table 6.1). Moreover, steady earnings recovery and absence of dividend payoffs bolstered their capitalisation. The financial strength of the banks based on a sustained increase in capital to risky assets ratios was in line with the international standards set by the Basle agreement. Banks remained outside the public sector budget and were allowed to reinvest profits; the state capitalised dividends in order to strengthen the financial position of the banks (Danby 1996: 40). In addition, though partly because of a concentration of lending to state-owned borrowers, domestic asset quality improved sharply as well.

Isaac Katz, an expert on Mexico's financial system, pointed out that the banks profitability was linked, at least to certain extent, to limited competition in the retail banking business (Interview: Mexico City, September 13th 1995). The high spread between active and passive interest rates was the result of both limited competition and the nature of retail banking itself. Whatever the cause, the result was a stable and specialised banking system with efficient and profitable banks while under public ownership. Despite the good performance of the banks with respect to retail banking operations, they lost competitiveness in the area of corporate finance. Institutional constraints on the type of financial services banks could provide in combination with a context of high inflation left them disadvantaged vis-à-vis stock brokerage houses (SBHs) to compete for the large corporate clients. A phenomenon of securitisation at the level of corporate finance took place during this period. Banks credit stopped being the most important source of financing for the private sector.

Table 6.1

Financial Indicators of the Nationalised Banking System: 1982-1993

Ratios(1)	1982	1984	1988	1991	1993
Profits / Income	1.86	2.24	4.92	5.49	7.83
Profits / Capital	21.61	40.23	49.81	32.54	34.11
Capital / Assets	2.01	1.65	3.73	3.06	4.20
Past due loans / Total loans	3.61	2.33	0.89	3.15	7.27

Source: CNBV (1994)
(1) As percentages

From a managerial perspective the banks did not have the required flexibility to cope with the challenges of international finance. According to Dionisio Meade, executive at Banco Mexicano, the banks under public ownership operated under exceedingly rigid management schemes, which hindered the efficient and aggressive decision-making already present in other parts of the world (Interview: Mexico City, January 22nd 1998). The following figures illustrate the relative stagnation of the banking sector: during 10 years of banks public ownership only forty new branches were opened; the number of accounts went down from 32 million at the moment of the nationalisation to 21 million ten years latter (CNBV 1994: 7); financing by selling equity or commercial paper was as much as 20 percent less expensive than through the banking system; total banks deposits fell from 25 percent of the GDP in 1980 to 15 percent in 1988; banking credit accounted for 70 percent of total financing in 1982 and by 1987 they accounted only for 40 percent (Maxfield 1992: 98-100).

In sum, President Salinas was not mainly interested in the banks internal efficiency when he decided to privatise them. Salinas intended to attract new investment in order to expand banking services and to incorporate them into new financial conglomerates that could provide financial services both for retail and corporate segments. In 1987 President de la Madrid took a first step towards the eventual re-privatisation by selling shares worth a third of the banks' value, which helped to capitalise these institutions. The SBHs undertook the sale of these shares to the public, and acquired many of them themselves paving the road for their eventual acquisition (Danby 1996: 43).

6.3. The Reform

It is possible to distinguish the decision-making stage from the implementation stage of the policy-making process. The former is induced by external pressures to secure good investment conditions for international capital and by legitimacy requirements in the form of popular support. In the Mexican institutional context, the President is the actor that usually mediates these pressures and translates them into policy decisions. The implementation stage, by contrast, is shaped more by practical and administrative considerations in which state and business organisations are the relevant actors.[6] Usually the interaction between state and interest groups takes place at this stage of the policy process; the interaction between the bureaucracy and the private sector is crucial for the final outcomes of the policies.

In the specific case of the banks' privatisation, the implementation process is illustrative of the main factors behind the decision and the corresponding outcomes. The following two sections of this chapter provide some facts on the implementation and the outcomes that followed the banks' privatisation under President Salinas. In the present section issues of timing, the special *Comité de Desincorporación Bancaria* (CDB/Banking Divestiture Committee) and sale mechanisms will be analysed. Then, in the last section, some direct consequences of the banks' privatisation will be addressed: public debt reduction, universal banking, market structure and new configuration of the private sector.

Timing

On May 2nd 1990 President Salinas sent to the Congress the initiative for amendments to Articles 28 and 123 of the Constitution; required to privatise the banks. This decision, though anticipated, was not expected before the midterm congressional elections in July 1991 (International Reports 1990: 12).[7] The timing of the decision was exclusively

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[6] For the implementation of state policies regarding the financial system in Mexico see the discussion presented in chapter five.

[7] According to Dionisio Meade, Managing Director of Banco Mexicano (1988-1991), the decision to privatise the banks was completely unexpected, "...the issue of the privatisation was not under discussion; nobody was taking about it. Only the President had it in mind (Interview, Mexico City, 22/01/1998)."

driven by three major considerations: (1) the electoral calendar;[8] (2) the economic reform schedule; and (3) the expected proceeds from the sale. The timing was not driven by considerations regarding banks internal efficiency or the financial system stability; it would not have made any difference when the decision was taken and implemented. However, there were important issues of timing relating to the congressional elections, the economic reform, and the expected revenues from the sale of the banks.

Under the shadow of the disputed results in the 1988 presidential elections, President Salinas was determined to legitimise the regime in the 1991 congressional elections (Centeno 1994). Under effective electoral competition, economic growth and price stability became very sensitive issues in the public opinion and their trends were expected to influence the voting preferences. President Salinas and his economic team intended to have the programme of economic reform well underway before the elections in July 1991 in order to attract enough capital to boost the economy and hence secure popular support (International Reports 1990: 12). Despite the fact that the banks' privatisation is a politically sensitive issue, the banks' privatisation did not lead to any major public debate. At the end, the privatisation substantially improved Mexico's economic perspectives; some signs of economic recovery started to become visible. In 1990 most of the macroeconomic indicators showed a noticeable improvement. Economic growth was 4.4 percent, the highest since 1981; the inflation rate was 26.6 percent, down from 114.2 percent in 1988 (Presidencia de la República 1995: 41); and employment increased by 7.4 percent in 1990 (Presidencia de la República 1995: 27). The electoral triumph of the PRI in the 1991 congressional elections made evident the feel good factor among investors and voters.

Maximising expected proceeds from the sale were another major consideration. Its importance was twofold: in terms of public finances, massive resources were still required to relieve the debt burden, on the one hand; and a boost in the economy was expected to result from the capital inflows associated with better economic perspectives, on the other. This would compensate for the recessive pressures of a restrictive monetary policy, part of the stabilisation programme underway. In this context, the right

[8] An alternative view states that the timing of the decision was not influenced by electoral considerations; it just responded to the fact that President Salinas had already consolidated his political power to

time to sell the banks came with the improving macroeconomic conditions generated from the external debt restructuring. Selling the banks within a period of almost two years after the signing of a debt relief agreement cashed in on the rapidly improving economic outlook (Volj and Draaisma 1993: 130).

It is clear that privatisation conditions are directly related to the general performance of the economy (Barnes 1994: 238). In Mexico the privatisation and the macroeconomic stabilisation programmes were well underway before the sale of the banks. For instance, the parastatal sector had 1,155 entities in 1982 and by 1991 this figure was only 239 (Aspe 1993: 216). By sequencing and packaging reform policies properly, the programme became self-reinforcing. For instance, linking privatisation to the simple and popular goal of deficit reduction, the state generated popular support for both policies (Castelar-Pinheiro and Schneider 1994). Furthermore, valuable experience was gained as the reform was implemented. In the privatisation programme the smaller enterprises were sold first in order to avoid any costly mistake due to lack of experience. The sale of larger enterprises did not take place before 1989.

Following a similar logic and taking advantage of the accumulated experience, the privatisation programme of the banks started by selling the smaller banks. In this way the expectations of the financial community heated up for what was regarded as an unprecedented and unique opportunity to get a bank. In the substantially improved economic context, the banks were sold at more than twice their originally estimated price. Obviously there was no shortage of capital among the financial community and the final revenues from the sale of the 18 banks were $12.9 billion dollars. As it is now clear, this timing was an example of perfect policy engineering. It avoided any political opposition to the decision at any level of political organisation; contributed to the political victory of the PRI in the 1991 congressional elections; yielded huge revenues to the state; and further improved the investment climate.

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implement a decision of this nature (Dionisio Meade, Interview, Mexico City, 22/01/1998).

Banking Divestiture Committee (CDB)

At the onset of the privatisation process it was acknowledged that its success would depend to a great extent on its credibility and transparency (Barnes 1994: 238). In order to attain this goal, the process was centralised, first, by the advisory staff of the minister of finance and, subsequently, by a special unit also within the Ministry of Finance. This unit was responsible for organising and co-ordinating all divestiture operations regardless of the sector in which the enterprises operated. The banks' privatisation was, however, the only case not carried over by this unit. The Ministry of Finance created a new committee, headed by the deputy minister Guillermo Ortiz. The fact that a special committee handled the banks' privatisation isolated the process from any possible interference from groups outside the Ministry of Finance. Furthermore, it minimised the possibility of corruption and mismanagement during the process.[9] *The Economist* (March 9th 1991) characterised the scheme for selling the banks as transparent and likely to prevent 'string-pulling, favour-swapping and pre-arranged deals' despite the government's tradition of corruption.

The composition of the CDB is interesting as it further signals the dominance of the financial coalition. The CDB was integrated, with the exception of two private sector representatives, by public officials from the financial division of the executive bureaucracy exclusively (see Table 6.2). As members of the financial coalition they share similar academic backgrounds and professional careers making their co-ordination very effective.

Responsibilities of the CDB were: (1) to establish general criteria for the process and formulate a specific strategy for the sale of each bank; (2) ensure the transparency of the process through continuous communication with the public at large; (3) hire external advisors and benefit from their international experience (Barnes 1994: 246). But more important, the CDB was responsible for certifying the managerial skills of the potential buyers and to determine the winners in case of technical draw. The CDB took significant decisions for the future stability of the banking system on these matters. For

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[9] According to Dionisio Meade, not even the banks directors were consulted regarding the convenience of the privatisation (Interview, Mexico City, 22/01/1998).

instance in the case of Banpaís, which is under state management at present because of corruption, the CDB authorised the merger of two investment groups just two weeks before the date of the auction; the group represented by Angel Rodríguez did not participate in the financial assessment of the bank (Ortiz 1994: 271). Notwithstanding, it obtained the control of the bank after internal disputes within the other investment group. A similar case occurred with Banco Union when a technical draw took place and the CDB decided to sell the bank to an investment group without financial experience. Banco Union is also under state management for corruption.

Table 6.2

Banking Divestiture Committee

Member	Position	Background	Career
Guillermo Ortiz Martínez	Under-minister of Finance	PhD Economics (Stanford)	Banco de Mexico, IMF and Ministry of Finance
Miguel Mancera Aguayo	Governor of Banco de Mexico	MA Economics (Yale)	Banco de Mexico
Guillermo Prieto Fortun	Head of the Banking Commission	BA Economics (UNAM)	Ministries of Finance, of Industry, of Labour, Comermex and CNB
Oscar Espinoza Villareal	Head of the Securities Commission	BA Management (UNAM)	CNV, Ministry of Finance, and NAFIN
Carlos Ruíz Sacristan	General Director of Public Credit	MA Finance (Northwester)	Banco de Mexico and Ministry of Finance
Victor Miguel Fernández	General Director of Commercial Banking	PhD Law (UNAM)	Ministry of Finance
Jacques Rogozinski	Head of the public enterprises divestiture unit	PhD Finance (Colorado)	Indeval, Ministries of Finance, of Budget and Banobras
Rogelio Casas Alatriste	Head of an accounting firm		
Sergio Ghigliazza García	Private expert in finance		

Source: Ortiz 1994: 224; and Diccionario Biográfico de la Administración Pública 1992.

Guillermo Barnes, chief of staff of the deputy-minister of finance (1989-1992), conceded that it was not possible to discriminate between good and bad investment groups (interview: Mexico City, February 9th 1998). The evidence suggests that the

CDB was unable to assess the management qualifications of the investment groups that acquired the control of the banks with important consequences for the present instability of the banking sector.

Sale Mechanism

The selection of the sale mechanism was a major determinant for the final outcomes of the banks' privatisation process. However, it is also one that has barely been addressed. The decision on that mechanism posed an economic dilemma to the state. This dilemma was between diversified ownership and deeper equity markets by selling the banks through stock flotations in the BMV vis-à-vis obtaining the highest possible price for the banks and being able to discriminate among the possible bidders by selling them through direct auctions. At the end, the CDB decided to sell the banks through direct auctions instead of public offerings in the equity market. Table 6.3 presents the largest cases of privatisation through, both public offerings and direct auctions.

Table 6.3

Privatisation by Sale Mechanism

Public Offerings				**Direct Auctions**			
Company	**Country**	**Year**	**Value (1)**	**Company**	**Country**	**Year**	**Value (1)**
NTT	Japan	1986	12.4	Procordia	Sweden	1989	3.8
BP	Britain	1987	9.5	**BANAMEX**	**Mexico**	**1991**	**3.2**
British Gas	Britain	1986	7.8	Gas del Estado	Argentina	1992	3.2
BT	Britain	1984	4.9	**BANCOMER**	**Mexico**	**1991**	**2.6**
British Steel	Britain	1988	4.5	Telecom	New Zealand	1990	2.5
Scottish Power	Britain	1991	3.7	CANTV	Venezuela	1991	1.9
YPF	Argentina	1993	3.0	TELMEX	Mexico	1990	1.8
National Power	Britain	1991	2.3	Usiminas	Brazil	1991	1.5
TELMEX	Mexico	1991	2.2	Nacobre	Mexico	1988	1.4
				ENTel	Argentina	1990	1.3

Source: *The Economist*, August 21st 1993
$billion dollars

This decision responded both to practical considerations and to the economic and political priorities of the state. The sale through stock flotations implied practical difficulties. One of the most important was the under-capitalisation of the equity market in Mexico. This market is shallow and underdeveloped specially compared to the

market value of the whole banking system. The capitalisation of the equity sector of the Mexican stock exchange at the end of 1989 was only $24 billion dollars and the valuation of the 15 Mexican banks traded in the stock exchange was a significant $7 billion (Hanley 1991 et. al.: 19).[10] However, selling the banks through public offerings in the equity market would have enhanced important stated objectives such as financial system development and ownership diversification. When the banks were partially privatised in 1987 though this mechanism, the stocks exchange gained depth and liquidity, although not stability. In contrast, in 1991 the banks' privatisation did not make any significant contribution to the development of the securities markets in Mexico.

Regarding ownership diversification, or ownership democratisation as it was called by state officials, much was achieved; at the end of the privatisation, the number of investors with stakes in the banks, more than 130 000, was substantially higher than the pre-nationalisation case, when only 8 000 investors owned 59 banks (Aspe 1992: 785). Nevertheless, the number is still very small compared to the number that could have been attained if the sale mechanism would have been stock flotations. Jamaica and Chile privatised their banking systems using this sale mechanism in which both public at large and institutional investors participated (Zank 1991: 57). These cases, along with the privatisation programme in the UK, also done mainly through stock flotation, became to be known as 'popular capitalism' for the large number of investors with share-holdings in the newly privatised financial firms. In this way, ownership democratisation eliminated any possible popular opposition to the programme ensuring its political success (Zank 1991: 57). In Mexico, however, the institutional arrangements of the political system make popular support for these decisions non-essential.

An additional consideration for selecting direct auctions over stock flotation was the possibility to clearly identify the investment groups with controlling stakes in the banks (Dionisio Meade, Interview, Mexico City, January 22nd 1998). This served the double purpose of discriminating among potential bidders according to their managerial skills and financial experience, on the one hand, and making possible an alliance with those

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[10] The valuation was calculated from the quoted value in the market for the Certificados de Aportación Patrimonial (CAPs/Certificates of Patrimonial Contribution). CAPs were shares of state-owned banks

winning the auctions, on the other. Nonetheless, as mentioned above, the state failed to identify the best investment groups and some banks fell into the control of either inexperienced or corrupt managers.[11] In terms of the alliance with the new owners of the banks, the bidding process opened a communication channel between public officials at the Ministry of Finance and the most prominent investors of the private sector. There were several meetings with stock brokers and major industrialists held in order to establish the value of the banks prior to the date of the auctions (Ortiz 1994: 343).

Table 6.4

Shares Valuation of Selected Mexican Banks: 1990(1)

Banks	Price / Earnings	Price / Book value
Banamex	10.9	1.76
Bancomer	7.8	1.38
Serfin	4.3	1.30
Comermex (Inverlat)	5.9	1.58
Internacional	6.8	1.42
Mexicano	8.0	1.10
Composite (Five banks)	6.8	1.57

Source: Hanley et al 1991:25
(1) Valuation made in 1990 based on the latest twelve months available

The final, but also the most important consideration for selling the banks through direct auctions was the maximisation of revenues from the banks' privatisation. According to Dionisio Meade, the sale of the banks was purely decided on the price (Interview, Mexico City, January 22nd 1998). The Ministry of Finance estimated the value of the state share-holdings in the banking system somewhere around $4.4 billion dollars (International Reports 1990: 9). At the beginning of the process, early in 1991, analysts were projecting the prices for the banks to be along the standard valuation parameters at which the shares of the Mexican banks (CAPs) were traded. These valuation parameters were price/earnings multiples of 6 to 7 times and price/book ratios of about 1.5 times (see Table 6.4). The anticipated prices through stock flotations in the equity markets were close to those prices at which the shares were already traded. Had this sale

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susceptible of acquisition by private investors up to one third of the total bank's equity.

[11] Two of the banks that eventually felt into financial or corruption problems were sold to investors without financial experience. Angel Rodríguez, for instance, used the acquisition of Banpaís as a signal of his creditworthiness and hence have access to other lines of business; and Carlos Cabal, was virtually unknown in the financial circles in Mexico (Dionisio Meade, Interview, Mexico City, 22/01/1998).

mechanism been chosen, with valuations between 1.5 and 2 times book value, the state would have received between $6 billion dollars and $8 billion for its stake in the banking system.

Table 6.5

Revenues and Prices from the Banks' Privatisation

Banks	Percentage sold	Price (1)	Price / Book value
Multibanco Mercantil de México	77.19%	611.20	2.66
Banpaís	100.00%	544.99	3.02
Banca Cremi	66.70%	748.29	3.40
Banca Confía	78.68%	892.26	3.73
Banco de Oriente	66.00%	223.22	4.04
Banco de Crédito y Servicios	100.00%	425.13	2.60
Banco Nacional de México	70.72%	9,744.98	2.62
Bancomer	56.00%	8,564.21	2.99
Banco BCH	100.00%	878.36	2.67
Banca Serfín	51.00%	2,827.80	2.69
Multibanco Comermex	66.54%	2,706.01	3.73
Banco Mexicano Somex	81.62%	1,876.53	3.31
Banco del Atlántico	68.48%	1,469.16	5.33
Banca Promex	66.00%	1,074.47	4.25
Banoro	66.03%	1,137.81	3.95
Banco Mercantil del Norte	66.00%	1,775.78	4.25
Banco Internacional	51.00%	1,486.92	2.95
Banco del Centro	66.31%	869.38	4.65
Total		**37,856.45**	

Source: Barnes 1994: 249-250
(1) Millions of pesos

Nevertheless, the dynamics unleashed by a sale through direct auctions led to a weighted price/book value of 3.08 and total revenues of $13.5 billion dollars (Barnes 1994: 247). The financial community perceived as a unique and historic opportunity to control a bank in the clearly under-banked Mexican financial system. Price premiums paid in the bank auctions reflected confidence in the Mexican process of privatisation and recognition of potential growth for the banking services (Jameson 1994: 126). Since the very first auction high prices were paid for the banks. Jose Madariaga initiated the rally by buying Multibanco Mercantil de Mexico at 2.66 times the book value (Ortiz 1994: 241). In order to increase the competition by attracting more bidders for the larger banks (BANAMEX, BANCOMER and SERFIN) the initial auction was limited to a controlling equity stake complemented with the option for the winning group to buy the

remaining share-holdings from the state (Ortiz 1994: 282). In fact, the revenues from the sale of these two banks accounted for almost half of total revenues (see Table 6.5).

6.4. The Outcomes

On August 13 1990 at the VI National Banking Convention the minister of finance Pedro Aspe announced the rules and the official objectives for the banks' privatisation. These stated objectives were the following (Aspe 1990: 20-21, Ortiz 1994: 216-217): (1) create a more efficient and competitive financial system; (2) ensure diversified participation in banks ownership to promote investment in the financial sector and prevent ownership concentration; (3) ensure high ethical standards and competence of bank management and obtain adequate capitalisation levels; (4) ensure Mexican nationals control of the banking system without excluding foreign involvement; (5) promote decentralisation and regional participation in the banking institutions; (6) obtain a fair price for the banks; (7) promote a balanced financial system; (8) promote fair and healthy financial and banking practices. This list includes only those stated objectives related to the financial system but has to be complemented with the undeclared motivations of the agents contending for political power and economic rents. The purpose of this section is to disclose the real forces leading to the Mexican banks' privatisation.

On July 16th 1992, President Salinas met with representatives of the more than 130000 investors that acquired a stake in the banks. In that meeting, he assessed the process and concluded that it was a success in every respect. The sale through public auctions was transparent and honest, based on a strict observance of the law. The interests of the nation were preserved at all time, raising revenues of $13.5 billion dollars translated into permanent benefits by writing off public debt. The banks ownership became democratised, by increasing the number of stockholders from 8 000 in 1982 to 130 000 after the privatisation, geographically decentralised, and preserved under Mexican nationals (Aspe 1992: 784-786; Salinas 1992: 782-784).

These facts are impressive but barely related to the efficiency and stability of the new configuration of the financial system that emerged as a result of the banks' privatisation. This section outlines the major economic, financial and political outcomes of this

policy. Former sections argued that this decision was consistent with the wider economic agenda of President Salinas. In addition, the privatisation was effective to consolidate his political leadership by releasing fiscal resources for social expenditure, securing an alliance with the new business elite and boosting the economy thanks to large capital inflows. Last but not least, the banks' privatisation radically changed the configuration of the Mexican financial system with important institutional implications for the long term growth and stability of the economy.

State Financing and Capital Inflows

The Mexican banks' privatisation was a clear economic success at least in two dimensions. In the first place all the banks were sold at higher prices than predicted which translated into healthier public finances. And secondly, the investment climate improved in line with the Mexican economic outlook attracting massive capital inflows. The proceeds obtained from the sale of the banks were fully directed to write off internal debt, which as a percentage of GDP was reduced from 24.4 in December 1990 to 17 percent in December 1991 (Barnes 1994: 248). By doing this, the one-off revenue from the privatisation was translated into a permanent reduction in interest payments. The reduction came from two sources: the amount of outstanding debt for which interest payments had to be made was substantially less, on the one hand; and the interest rates also decreased as a result of the government's reduced borrowing requirements, on the other.

Despite the fact that the public deficit was no longer a problem for economic stabilisation, the high prices paid for the banks reduced significantly the public sector debt burden releasing fiscal resources for social expenditure. In this way macroeconomic improvements were translated into social programmes which was a major component of the political strategy of the financial coalition. In fact, it paid extraordinary dividends in the 1991 and 1994 federal elections when the PRI recuperated its political hegemony and the bases of popular support were fully restored.

On another front, the banks' privatisation also contributed to boost the economy for the second part of President Salinas's term. However, the boost did not come from the capital paid for the banks, instead it came from better economic conditions and

increasing confidence from international capital.[12] The changes to the financial system contributed to restoring positive capital flows for the first time since the 1982 crisis (Jameson 1994: 126-128). At the same time that flight capital was repatriated in order to buy the banks and other large public enterprises. Mexico re-entered the voluntary international financial markets thanks to the improved investment climate. In fact, the newly privatised banks faced a favourable moment in which the Mexican blue chip companies were returning to the international capital markets. The largest banks placed new issues of debt and equity in these markets in order to bring capital adequacy in line with international standards. Nevertheless, the margins achieved in those issues were still very high: BANAMEX's Euromarket issue in the spring of 1993 was priced 350 basis points over US Treasuries; and a latter placement of GF BANCOMER achieved a slightly narrower margin of 282 basis points over US Treasuries (*The banker*, August 1993: 52).

However, it was not only Mexican companies going to the international capital markets that brought massive capital inflows but, more significant, foreign investors were coming to the BMV. Foreign investment in the stock exchange increased from $2.9 billion dollars in 1991 to $10.7 billion in 1994 (*Mercado de Valores*, August 1994: 67). As a further side effect of these capital inflows the Mexican currency was kept overvalued leading to a consumption boom that also contributed to the electoral success of the PRI in the presidential elections in 1994.

New Alliance for Economic Management

As mentioned before, the privatisation programme as a whole was a great act of state engineered change. This programme meant a deep transformation on the Mexican political economy. In this context, the banks' privatisation further activated the alliance between the economic elite and the financial coalition, which has been a permanent feature of Mexican political system, sometimes active and sometimes latent. The state, controlled by the technocrats, needed the support of large business for the whole programme of economic transformation. Their co-operation was essential to control

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[12] Officials in the Ministry of Finance were aware that much of the capital to buy the banks were credits from the banks themselves. They were not very careful with the sources of the capital (Guillermo Barnes,

inflation, bring back flight capital to buy the public enterprises, and increase the productive capacity of the economy in the context of free trade. In exchange, the state restricted itself to act as 'watchdog' leaving the management of the economy to the economic elite (Garrido 1994: 167).

The banks' privatisation alone transferred the control of $160 billion dollars in banking assets to 18 investment groups (CNBV 1994a: 16). Rodolfo de la Torre, researcher at ITAM, pointed out that 'bank ownership has been pulverised, but this has not necessarily produced a democratisation of control in the financial sector' (quoted by *Business Mexico*, January 1995). At the end of 1993, the assets of the industrial groups and the banks where the same principal shareholder dominate added up to $258 billion dollars, equivalent to 61.5 percent of the GDP in that year. According to Miguel Ramírez (1994: 34) this concentration of political and economic power in a relatively small and close group poses serious questions about Mexico's future stability and development.

It is suggested by Ben R. Schneider (1989) that the ruling coalition within the state, by privatising public enterprises gave up some political power to the economic elite, changing the existing balance of power between the public and the private sector. In the case of the banking system this is only partially true. Commercial banks were managed as a business concern in which patronage networks at the political level never developed while under public ownership. Furthermore, internal decision making within the banks was very much privatised. In fact, the autonomy in the internal operation of the banks was further enhanced with the elimination of the under-ministry for banking in June 1986 (International Reports 1990: 3). The political constraints on the operation of market forces were kept to a minimum (Glade 1989). For instance, in the case of BANAMEX, David Ibarra, Fernando Solana and Antonio Ortiz Mena as chief executives always acted in the best interest of the bank despite their having political backgrounds (Alonso Ríos, Interview, Mexico City, 14/09/1995). Regarding the allocation of credit, it was not directed, as originally intended, to politically sensitive sectors such as housing and agriculture (Márquez 1986). On top of all of these

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Interview, Mexico City, 09/02/1998).

considerations, the banks came under mixed ownership in 1987, which further limited any possible discretionary management with political ends.

However, the banks' privatisation changed the balance of power between the state and the business elite to the extent that new industrial-financial groups consolidated and concentrated the control of the financial system and some strategic economic sectors. The separation of concerns and ownership between banking and industry was not achieved despite the fact that it was a major strategic objective at the onset of the privatisation. With the exception of BANAMEX, the other major banks were acquired by investment groups with majority stakes in leading industrial and services corporations (see Table 6.6).[13]

Table 6.6

New Industrial-financial groups

Groups	Chairman	Financial division	Industrial division
BANACCI	Roberto Hernández	Banamex-Accival	Telecommunications
VISA	Eugenio Garza Lagüera	Bancomer	Beer
VITRO	Adrian Sada González	Serfín-Obsa	Glass
DESC	Fernando Senderos	Mexicano-Invermexico	Conglomerate
PRIME	Antonio del Valle	Prime	Beer
CARSO	Carlos Slim Helú	Inbursa	Conglomerate
HERMES	Carlos Hank Rhon	Interacciones	Car manufacturing

Source: Garrido 1994

The five largest banks alone controlled 67 percent of the banking system's total assets in December 1994 (CNBV 1995). This trend was further enhanced when the state authorised new banking licenses to those important new industrial groups that were originally excluded from the purchase of a bank. This was the case of Carlos Slim's Grupo Carso and Carlos Hank Rhon's Grupo Hermes (Garrido 1994). The already alarming concentration of economic power in a few groups was strengthened with the banks' privatisation, consolidating, in this way, the alliance of the economic elite with the financial coalition. The economic elite is a close and compact group with perfectly identified members that enhance the communication and policy collaboration with the state.

Corruption

Corruption scandals further support the view that the economic goals of the banks' privatisation were subordinated to political and personal ambitions. According to Felipe Díaz Garza (quoted by *Proceso*, December 12th 1995), as soon as the privatisation was announced, Raul Salinas, the President's brother, went to Monterrey in order to persuade investors to participate in the banks' privatisation. At the end of the process, four banks were under the control of investors from Monterrey. These four banks represented 41.8 percent of the total assets of the system. Eugenio Garza Lagüera (VISA) acquired BANCOMER; Ricardo Margain Berlanga bought Banco de Oriente; Jorge Lankenau acquired Banca CONFIA; and Adrian Sada purchased SERFIN. Once their new owners ran the banks, Raul Salinas received large credits from them. In August 1992, SERFIN extended him a loan for half million dollars to buy and refurbish a country house in the *Barrio Antiguo* of Monterrey; and BANCOMER extended a loan for $2.5 million dollars to buy a house in *Colonia Obispado* (*Proceso*, December 12th 1995).

Cross lending between bankers also became a common practice. According to *The Times* (July 24th 1998) Angel Rodríguez (BANAPAIS) lent to Jorge Lankenau (CONFIA) and to Carlos Cabal (CREMI-UNION). All of them are facing criminal charges for corruption. Jorge Lankenau and Carlos Cabal also received loans from each other's banks (*La Jornada*, August 28th 1998). By the end of 1998, the CNBV had brought to trial under criminal charges 162 bank executives and employees (*El Excelsior*, September 14th 1998). Among them, the Presidents of five financial groups: Eduardo Mariscal (HAVRE); Carlos Cabal (UNION); Angel Rodríguez (BANPAIS); Marcelo Margain (BANORTE); and Jorge Lankenau (CONFIA).

Some of the scandals involved bankers linked to important members of the political elite. For instance, Oscar Espinoza Villareal, the PRI's treasurer and Jose Angel Gurría, the PRI's director for international affairs, were involved in the financial scandal of

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[13] Nonetheless GF BANACCI is also developing its industrial branch by starting a telecommunications company.

Grupo Financiero HAVRE. Both of them authorised credit lines to the group while in NAFIN and BANCOMEXT respectively (*Proceso*, February 5th 1996).

On March 3rd 1995 authorities from the CNVB and CNSF took over the management of ASEMEX, the largest non-life insurance company in Latin America, and its parent bank BANPAIS, amid allegations of irregularities (*World Corporate Insurance Reports*, March 10th 1995).[14] According to *The Times* (July 24th 1998), Angel Rodríguez, former President of BANPAIS, lent himself and his family $400 million dollars, which they never paid back, leaving the state to buy their debts. In response to the charges brought up by the financial authorities, Angel Rodríguez, declared publicly that officials in BdeM and the CNBV were aware of the loans he received from its own bank. In fact they authorised a loan of $250 million dollars in order to buy ASEMEX from the government (quoted by *La Jornada*, August 28th 1998).[15]

Angel Rodríguez had close links to the political elite in Mexico: Guillermo Ortiz, deputy minister of finance (1988-1994), used to advise him on a 'friendly basis' on the management of BANPAIS. Both travelled together to New York in order to promote the economic plan of President Salinas where he met with Pedro Aspe and Guillermo Ortiz and signed a memo of understanding on the management of BANPAIS (*La Jornada*, August 28th 1998). His father Isidoro Rodríguez, known as the 'transport czar', participated in the PRI's presidential campaigns, providing transport, since 1958 when the candidate was Adolfo López Mateos (1958-1964). Angel Rodríguez argued that it was not corruption or mismanagement that caused the legal action taken against him but 'personal differences' with Eduardo Fernández, President of the CNBV (quoted in *La Jornada*, August 28th 1998). Rodríguez ignored Guillermo Ortiz and Eduardo Fernández's recommendations to appoint Juan Díaz Cañedo as executive director of Grupo Financiero ASEMEX-BANPAIS and to include Adolfo Lagos in the group of investors owning the bank.

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[14] Angel Rodríguez, the President of the financial group, made no comment and left the country three hours latter.

[15] The CNBV, in response to "El Divino" high profile defence campaign, paid for some advertisements in the national press saying that Angel Rodríguez, his father, and other BANPAIS executives received $900 million dollars in loans from the bank (*The Times*, July 24th 1998).

Another major case of corruption was Carlos Cabal's mismanagement of Grupo Financiero CREMI-UNION. The government took over the management of this financial group on September 5th 1995 because of illegal operations and under-capitalisation (*La Jornada*, November 11th 1998). Carlos Cabal Peniche was business partner with Federico de la Madrid, son of former President Miguel de la Madrid. When Cabal participated in the auction for UNION, he represented more than 250 businessmen and politicians. Among them were: Jorge Salomón Azar, former governor of Campeche; Mario Trujillo, former governor of Tabasco, David Gustavo Gutierrez former governor of Quintana Roo; and Salvador Neme Castillo former governor of Tabasco; and Patrocinio González Garrido former governor of Chiapas and former minister of Government (*La Jornada*, November 11th 1998). According to Aristides Prats Salazar, ex-board member of Banco UNION, Carlos Cabal openly accepted that making contributions to the presidential campaign was a 'political investment' (quoted by *La Jornada*, August 27th 1998).

None of the supposed checks on the banks' management —board of directors, external auditors and the CNBV— spotted the illegal operations at the time. This is an institutional problem that may go even further into the very nature of Mexico's business and political culture. Most of the members from the board of directors in the banks under government management because of corruption claimed that the chairman misled them. However, these same members were also involved in loans without the required guarantees, paying lower than market-interest rates and soft repayment conditions (*El Economista*, September 25th 1997). In any of the cases of financial scandal, external auditors, required once a year to conduct thorough inspections to banks' operations, detected the illegal operations going on. They claim that if they issue any recommendations against the management, they are either fired or replaced by another firm.

Universal Banking

Apart from the economic and political dimensions of the banks' privatisation, there is the obvious, and no less important, financial dimension itself. The privatisation changed the configuration of the Mexican financial system with important implications for the 1995 banking crisis and the long-term performance of the economy. The most important

provisions in this direction were mainly three: (1) the introduction of universal banking in the form of financial groups;[16] (2) the separation of ownership between financial groups and other business concerns; and (3) exclusive control of the financial groups by Mexican nationals.[17]

Of these three provisions, the introduction of universal banking has ever more important efficiency implications for the Mexican financial system. This is also the only one that has remained unchanged. Universal banking is supposed to increase the competitiveness of the financial system through the supply of complementary financial products and services by the same firm. According to Juan Ignacio Gil, Head of the CNSF, the banks' privatisation provided a business opportunity for the insurance companies integrated to financial groups (Interview, Mexico City, September 1st 1995). Insurance companies and other financial firms could access new clients by using branch network of the privatised banks. In fact, banking, stock brokerage and insurance under the same ownership is the existing configuration in most European countries, and was the configuration that existed in Mexico prior to the banks' nationalisation. However, most countries with universal banking built their system around the banks. In contrast, Mexico, as a result of the privatisation, universal banking emerged from SBHs buying commercial banks. Despite the fact that banks were far more important than SBHs,[18] the brokerage culture prevailed in the new financial groups with obvious consequences for their business strategies. Lending was far more aggressive than it would have been otherwise under traditional banking practices. Stockbrokers are acknowledged more prone to risk-taking than are bankers.

Between 1982 and 1991, when the banks were under public ownership, SBHs and banks competed for the segment of corporate finance through products that were close

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[16] Commercial banks cannot own a SBH or vice-versa but both can be owned by a financial holding company.

[17] The equity structure for the banks proposed by the state after the privatisation in order to institutionalise the new configuration was divided into three types of shares. "A" shares (minimum 51 percent) available to domestic individuals and state agencies only; "B" shares (maximum 49 percent) available to any domestic entity; and "C" shares (maximum 30 percent) eligible for sale to foreigners (Hanley et. al. 1991: 15-18). However, this structure was substantially altered as a consequence of the banking crisis in 1995.

[18] For instance, ACCIVAL, who bought Banamex, has only 31 thousand employees compared to 330 thousand of Banamex.

substitutes. Retail banking, however, remained under complete control from the banks. This segment is not only highly profitable, but also complementary to other segments of the financial business; the banks' network of branches can be used to sell securities and insurance products to the public. The publicly owned banks were relatively protected at this level from any kind of competition and therefore financial groups were eager to include this profitable and extremely useful segment of the industry within their operations.

In fact, analysts anticipated at the onset of the privatisation process that the most likely bidders for the banks were the owners of the recently created financial groups (International Reports 1990: 9-10). As expected, 13 out of 18 banks were sold to financial groups centred on SBHs, which also reflects the personal fortunes accumulated in the stock exchange during the 1980s. Nevertheless, the owners of these financial groups also have important equity stakes in other major business concerns. Therefore, as mentioned above, important links between financial groups and industrial firms were established despite the fact that only individuals could bid for the banks. These links increase the routes by which financial instability is transmitted and magnified to the real sector of the economy (see Jameson 1994). Furthermore, the incentive structure they create is conducive to vicious financial practices. In fact, in the cases of corruption of Banco UNION and BANPAIS there were conflicts of interest between the financial group and the other business concerns of the same owners.

Market structure and degree of competition

Last but not least, the privatisation of the commercial banks had important implications upon the market structure and the degree of competition in the Mexican financial system. The banks' privatisation did not substantially increase the degree of competition, although this was an explicit purpose of the state. Early in the 1990s it was expected that a more competitive financial system would arise from existing forces rather than from the privatisation of the banks themselves (Hanley et. al. 1991: 22). At that time there were already important forces shaping the competitive environment for the coming years: the competition between SBHs and banks at the level of corporate finance, and strategic decisions adopted by the banks to face this type of competition. Sophisticated information technology, training, and product development already

existed in Mexico prior to privatisation (Hanley et. al. 1991: 22). However, these competitive trends contrast sharply with the high prices paid for the banks that can only be explained by expected profits above competitive levels. Banks profits during the years immediately after the privatisation were still higher relative to those in Canada and the US, notwithstanding their high operation costs. Furthermore, the privatisation produced non-competitive pricing in which the interest rate spread has widened considerably (McComb et. al. 1994).[19]

An additional element that constrained competition just after the banks' privatisation was protection against foreign financial firms. Since the beginning of the banking divestiture process the state assured potential buyers that the domestic financial system was to be opened to foreign investment only gradually (Ortiz 1990: 44). According to Isaac Katz, the prices paid for the banks were very high because the bidders expected the system to remain protected from external competition, and therefore could earn extra economic rents (interview: Mexico City, September 13th 1995). Foreign banks barred from owning more than 30 percent of any bank, were not interested in entering the Mexican market, with the notable exceptions, according to *the Economist* (March 9th 1991), of Societe Generale and BNP from France and Banco Santander of Spain. Furthermore, according to Isaac Katz, the liberalisation scheme negotiated under NAFTA was very restricted and mainly intended to protect the market share of the three largest banks, namely BANAMEX, BANCOMER and SERFIN (Interview, Mexico City, 13/09/1995).[20]

This situation, however, changed radically after the banking crisis in 1995, when the Ministry of Finance removed most of the constraints on foreign investment in the banking sector. The original limit of 30 percent foreign participation in the groups' equity was removed as a consequence of this crisis; some banks, smaller and medium only, were allowed to be under complete foreign control completely in order to improve their capitalisation levels. This is the case of GF Probursa acquired by the Spanish bank

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[19] The interest rate spread is the difference between the interest rate the banks pay for the deposits they receive.

[20] In the original liberalisation scheme, total operations of foreign banks could not exceed eight percent of the total capitalisation of the system, and any single bank can exceed 1.5 percent before the year 2000. However, this scheme was radically changed as a consequence of the banking crisis ensuing the peso devaluation in December 1994.

Banco Bilbao Vizcaya and GF Inverlat now controlled by Bank of Nova Scotia from Canada. Despite the arrival of these foreign banks is an additional source of competition, the market for banking services is still dominated by the three largest financial groups: BANACCI, GF BANCOMER and GF Serfin. In June 1995 the banks of these three financial groups controlled half of the total assets of the banking system, slightly more than half of total income and almost half of the total branches (CNBV 1995). The market structure, characterised by high concentration, did not change as a result of the banks' privatisation.

Nevertheless, the degree of competition does not only depend on the observable structure of the market. Institutional arrangements like anti-trust legislation or barriers to entry also determine the banks' competitive behaviour. In the case of anti-trust legislation the experienced was mixed after the privatisation. The government introduced a comprehensive act to regulate competition. However, collusive behaviour was only mildly penalised, if at all. Although Santiago Levy, President of the Commission for Competition, found that some of the largest financial groups, including BANCOMER and SERFIN, manipulated the auctions of CETES, he imposed fines of just $60,000 dollars (*The Economist*, July 9th 1994).

Barriers to entry into the relevant business segments were also significant (McComb et. al. 1994). Under the 1990 LGIC the state introduced the possibility of issuing new banking licences subject to a minimum capital requirement of 0.5 percent to the system's total, at that time $17.6 million dollars (Hanley et. al. 1991: 18). The size of this capital requirement is an important barrier to entry, especially compared to the $8 million dollars required in Canada or the $5 million in the US. However, recently, new banks in Mexico have typically capitalised at levels in the $40 million dollars range. Thus, while minimum regulatory capital requirements are relatively high in Mexico, market conditions require *de facto* capitalisation well above that level (McComb et. al. 1994). In sum, the degree of competition is still very low and the market concentration is still very high in the Mexican financial system. However, the changes to the market structure and the increase in the degree of competition are more related to the responses to the 1995 banking crisis than to the banks' privatisation itself.

As a result of the lack of competition interest rates spread rose from average of around 6.5 percent in 1991 to 8 percent in 1993. Though inflation fell to 8 percent in 1993, borrowers are paying, according to *the Economist* (January 29th 1994), 30 percent on mortgages or car loans, 40 percent on credit cards and around 25 percent for business loans. In Mexico, banks made easy money just by arbitrating the differential between American and Mexican interest rates. Banks borrowed cheap abroad at low interest rates and lent expensive in Mexico at high interest rates. Their only risk, which they judged to be remote, was a devaluation of the peso.

Summary

Economic problems became the most sensitive political issue at the beginning of the 1980s. In this context, the financial coalition centred on the financial division of the executive took control of the Mexican state. In order to consolidate their dominant position they launched a far-reaching programme of economic transformation. The financial reform altogether with the banks' privatisation was an essential part of this wider strategy of structural adjustment. By privatising the banks, the state, commanded by the financial coalition, improved the investment climate and brought back massive capital inflows that translated into good economic performance and consolidated their dominant position within the Mexican political system. At the economic level, universal banking, new financial practices and a new configuration of the private sector are direct consequences of the banks' privatisation. These outcomes changed essentially the institutional framework of the economy with strong implications for the stability of the financial system as shall be discussed in chapter eight.

Chapter 7

Banco de Mexico's Autonomy

This chapter uses the case of the reform to the legal status of Banco de Mexico (BdeM),[1] to show how the state's strategy to rebuild the bases of popular support for the regime was shaped by the new international consensus on economic policy, on the one hand, and the Mexican political institutions, on the other. International trends in economic policy were incorporated to Mexico's development strategy in order to increase capital inflows and secure financing to the state. Late in the 1980s and early 1990s, Central Bank Autonomy (CBA) ranked very high in the new international economic consensus and the change to the legal status of BdeM in 1993 responded to this trend. In fact, this reform was motivated more by the need to improve investment conditions and not so much by the goal of achieving price stability in the long run, as it is claimed by economic theory.[2] Capital inflows, increasingly guided by signals of future macroeconomic stability, were critical for the success of the economic transformation pursued by the state under President Carlos Salinas.

This chapter is also organised according to the standard four-section format set at the beginning of the thesis for the case studies: ideas, context, reform and outcomes. The first section introduces the theoretical and institutional issues of CBA. The second section shows how changes to BdeM's relative autonomy have been historically related to the financial requirements of the state. This section also introduces the international context in which the reform to central banking gained momentum. The third section discusses the links of the financial coalition with BdeM, the upcoming presidential relay in 1994 and the end-of-sexenio economic scenario. Inflation and public finances

[1] The reform to the legal status of BdeM comprised changes to Articles 28, 73 and 123 of the Constitution and the issue of a new Organic Law for BdeM. The reform to the Constitution was published in the Official Newspaper of the Federation on August 20th 1993 and the new Organic Law of BdeM was enacted in April 1st 1994.

[2] Price stability in the long run is obviously an important component of the investment climate. However, it is more relevant for long-term investment. In the case of Mexico, we argue that the state was more concerned with portfolio investment, i.e. short-run investment in the securities market, for which is more important the current rate of inflation and policy signals.

indicators were under control, but problems in the balance of payments were increasing the risk of a major economic disruption towards the end of President Salinas's term. Finally, the fourth section illustrates how the main changes brought about by the reform did not alter the *modus operandi* of BdeM in any fundamental way, but they did contribute to improve international capital perception of Mexico's economic prospects.

7.1 The Ideas

The inflationary experience from the late 1960s to the late 1980s, when the world for the first time in a peaceful period adopted fiat money,[3] brought to the attention of policy makers the relationship between CBA and inflation. The view developed that where central banks were less susceptible to state pressure they delivered sounder monetary policy and therefore lower inflation (Bowles and White 1994: 236; Capie, Goodhart, Fischer and Schnadt 1994: 55). Under this perspective policy makers intended to bring about price stability by granting greater autonomy to their central banks as a mean of insulating monetary policy-making from the short run interests of the state (Alberti 1995: 475).

Price Stability: The Theory

During the 1980s one of the main theoretical debates in economics was about the role of monetary policy embedded in the Philips curve, i.e. a presumed trade-off between inflation and employment in the short run bestow on monetary policy the capacity to influence the level of economic activity. At present there is a clear and well-established relationship between surprise inflation and short-term growth and it is commonly agreed that monetary policy can be used to stabilise the business cycle when it cannot be anticipated by the economic agents. However, a new problem, known in the economic literature as 'time inconsistency', arises when the state handles monetary policy.[4] In this

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[3] Fiat money was the result of the collapse of the Bretton-Woods system when the gold standard was abandoned, and consequently money stopped being backed by gold reserves. Since then, economic agents hold money because it is a generalised accepted medium of exchange.

[4] Dynamic inconsistency or time consistency problem is the discrepancy between the optimal policies that a policy authority would announce if its announcements were believed by the public, and the policies the authority would carry out once the public had acted on the basis of these expectations (Fischer 1991: 287).

case, economic agents know that the state has the incentive to deviate from pre-announced monetary policy leading to inefficient outcomes characterised by higher interest rates.

In order to eliminate the uncertainty produced by this continuous incentive to deviate from pre-announced policies, two alternatives were considered: fixed rules and greater autonomy of the central bank. Fixed monetary rules means that the state and the central bank have to give up the possibility of using monetary policy with stabilisation purposes when unexpected shocks occur; and therefore it was rejected. As an alternative, some authors proposed appointing a conservative governor to the central bank, who is more averse to inflation than the state, in order to retain flexibility in monetary policy and deal with the inflationary bias of discretionary policy at the same time (Rogoff 1985; Grilli, Maschiandaro and Tabellini 1991; Alesina and Summers 1993).[5] By delegating monetary policy to those who value more price stability, policy makers can guarantee conservative decisions regarding money supply and interest rates improving their own welfare.

Officials at the central bank shape their policy preferences in a very different way to their counterparts in state. In terms of backgrounds, central bank's officials have training usually in economics or in related fields whereas state officials have much more diversified backgrounds. Therefore it is easier for the officials at the central bank to support price stability as an institutional goal. In the case of politicians, they are usually motivated by their desire to keep power and advance their own political preferences making very difficult to have coherent institutional goals. This explains why central banks have unified positions compared to those multiple positions almost always present in state (Alberti 1995: 478).

Another reason why the central bank tends to favour price stability more than the state is the length of their planning horizon. States have short run objectives, usually determined by the electoral cycle, and therefore use monetary policy either to attend the demands of important interest groups or to boost the economy just before the elections.

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[5] The inflationary bias of discretionary policy refers to the benefits of surprise inflation in terms of the stabilisation power of monetary policy over the business cycle.

Among the most common uses of credit expansions are: bailing out insolvent firms, financing development projects, or simply keeping interest rates artificially low. Central banks in contrast have long run objectives making their decisions usually guided by the natural business cycles of any market economy. Officials at the central bank are mainly concerned with price stability and the efficiency of the financial system (Cukierman, Webb and Neyapti 1992: 354; Alberti 1995: 477).

Politicians often try to influence central bank decisions in order to get re-elected or advance their own economic and political agendas (Alberti 1995: 478). Financing the public deficit is usually the most important locus of conflict between the central bank and the state. An autonomous central bank is expected to reduce the public deficit by forcing the state to meet its own budgetary constraints (Persson and Tabellini 1990; Alberti 1995: 480). It is important to mention that developed more than developing countries tried to exploit this trade-off between inflation and unemployment during the 1970s.[6] In the case of developing countries the inflationary bias of monetary policy was caused more by the continuous 'monetisation' of the budget deficit than by the attempt to stabilise the business cycle (Fry, Goodhart and Almeida 1996: 27; Lippi 1997).[7]

Price Stability: The Evidence

The empirical evidence for the relationship between CBA and lower inflation is by no means conclusively mainly due to a measurement problem. Real autonomy, the relevant variable in the analysis, cannot be objectively measured and therefore is proxied by legal or statutory autonomy (Bowles and White 1994: 238). The usual method is by constructing indexes from legal provisions regarding methods of appointing and dismissing top bank officials, length of their tenure and limits on financing to the state (Alesina and Summers 1993).[8] However, these indexes are good proxies for real autonomy only in the case of industrialised countries where the rule of law is stronger.

[6] Simple bi-variate regressions, cross section and pooled time-series indicate negative relationships between inflation and growth in the long and short run for 44 developing countries. The empirical evidence shows that there is no trade-off between inflation and economic growth in developing countries, not even in the short run (Fry, Goodhart and Almeida 1996: 13).

[7] States in OECD countries borrow 3 percent of their total financial requirements from their Central Banks compared to 45 percent for states in developing countries (Fry, Goodhart and Almeida 1996: 28).

In developing countries, in contrast, these indexes fail to take into account informal mechanisms that also constrain the degree of CBA. Alternative measures include: governor turnover and self-perceptions of bank officials regarding their own autonomy (Cukierman, Webb and Neyapti 1992; Cukierman 1992).[9] Yet, these proxies can only be used as a proxy for CBA in a very restricted sense since the notion of autonomy embodies a wider set of institutional provisions.

According to the indexes provided by Cukierman (1992) some of the countries with the highest average rate of inflation during the 1980s like Argentina, Peru and Nicaragua have ratings of legal autonomy above the median. Nonetheless, countries such as Panama, Japan and Belgium, with very low rates of inflation, are ranked in the lowest quartile of legal CBA (see Table 7.1). These observations suggest that greater legal CBA is neither necessary nor sufficient to secure low inflation.

Table 7.1

Central Bank Autonomy and Inflation in the 1980s

Country	LA(1)	GT(2)	Inf.(3)	Country	LA(1)	GT(2)	Inf.(3)
Switzerland	0.68	0.13	3	India	0.33	0.33	9
West Germany	0.66	0.10	3	Indonesia	0.32	NA	10
Austria	0.58	NA	4	Britain	0.31	0.10	7
Egypt	0.53	0.31	17	Zambia	0.31	0.38	28
Greece	0.51	0.18	19	Australia	0.31	NA	8
Chile	0.49	0.45	21	China	0.29	0.34	8
Tanzania	0.48	0.13	31	Romania	0.29	0.20	4
Ethiopia	0.47	0.20	4	Ghana	0.28	0.28	44
Denmark	0.47	0.05	7	France	0.28	0.15	7
Canada	0.46	0.10	6	Western Samoa	0.28	NA	8
Bahamas	0.45	0.19	6	Sweden	0.27	0.15	8
Malta	0.45	0.28	3	Singapore	0.27	0.37	3
Kenya	0.44	0.17	11	Finland	0.27	0.13	7
Argentina	0.44	0.93	319	New Zealand	0.27	0.15	12
United States	0.51	0.13	5	South Africa	0.30	0.10	15

[8] Legal autonomy is negatively related to growth but the coefficient is not significant (Cukierman, Kalaitzidakis, Summers and Webb 1993).

[9] That paper found that governor turnover rates are positively related to levels of inflation in developing countries, though not in industrialised countries. However in a latter paper, they found for a cross-section of countries including industrialised and developing countries that Central Bank governor turnover is positively related to inflation and negatively to growth (Cukierman, Kalaitzidakis, Summers and Webb 1993).

Cont. Table 7.1

Country	LA(1)	GT(2)	Inf.(3)	Country	LA(1)	GT(2)	Inf.(3)
Turkey	0.44	0.40	50	Thailand	0.26	0.20	6
Peru	0.43	0.33	194	Brazil	0.26	NA	230
Israel	0.42	0.14	105	Nepal	0.25	NA	11
Costa Rica	0.42	0.58	25	Bolivia	0.25	NA	230
Netherlands	0.42	0.05	3	Hungary	0.24	0.18	9
Philippines	0.42	0.13	14	Zimbabwe	0.23	0.15	13
Nicaragua	0.42	NA	258	South Korea	0.23	0.43	8
Honduras	0.41	0.13	7	Italy	0.22	0.08	11
Zaire	0.41	0.23	58	Uruguay	0.22	0.48	56
Barbados	0.40	0.11	7	Spain	0.21	0.20	10
Ireland	0.39	0.15	9	Pakistan	0.19	NA	7
Venezuela	0.37	0.30	21	Belgium	0.19	0.13	5
Uganda	0.37	0.34	105	Qatar	0.18	NA	4
Luxembourg	0.37	0.08	5	Morocco	0.16	NA	8
Botswana	0.36	0.41	11	Japan	0.16	0.20	3
Iceland	0.36	0.03	38	Panama	0.16	NA	3
Mexico	0.36	0.15	65	Norway	0.14	0.08	8
Malaysia	0.34	0.13	4	Yugoslavia	0.13	0.23	108
Nigeria	0.33	0.19	19	Poland	0.10	NA	43

Source: Cukierman (1992: 381)
(1) LA is an index constructed to measure central bank autonomy using variables on governor appointment, objectives, limitations on lending and policy formulations. The range of the index goes from zero (minimal autonomy) to one (maximum autonomy).
(2) GT is a proxy for real autonomy and measures the average number of changes per annum of central bank governor
(3) Inflation is measured as the yearly geometric average during the 1980s
NA: not available

From these same indexes it can also be seen that inflationary performance was relatively homogenous and good for developed countries, in sharp contrast, with the performance of developing countries that was very poor in general and fairly uneven (see Table 7.2). The mean of the average inflation rate for developing countries over the 1980s was substantially higher than that for developed countries. Latin American countries as a separate group have a less homogenous inflationary performance and far worse on average than developing countries as a group. As regards legal autonomy, there are no substantial differences between these three groups of countries; central banks in Latin American countries have on average the same degree of legal autonomy as central banks in developed countries. Furthermore developing countries are slightly more homogenous regarding the legal status of their central banks compared to developed

countries. However, the expected relationship between central bank legal autonomy and inflation has the right sign for the case of developed countries only.[10]

Table 7.2

Statistics for Central Bank Autonomy and Inflation

Variable	Statistics	Developed countries	Developing countries	Latin American countries
Inflation (Inf)	Mean	8.05	48.22	119.00
	Variance	12.50	5803.15	13683.36
	Std Dev	7.35	76.18	116.98
Legal Autonomy (LA)	Mean	0.36	0.33	0.35
	Variance	0.15	0.01	0.01
	Std Dev	0.16	0.11	0.10
	Cov (Inf,LA)	-0.21	0.76	1.11
Governor Turnover (GT)	Mean	0.12	0.28	0.40
	Variance	0.002	0.03	0.06
	Std Dev	0.05	0.16	0.25
	Cov(Inf,GT)	-0.12	5.37	15.76

Source: Calculated from Cukierman (1992)
LA: Legal Autonomy
GT: Governor Turnover

In order to capture the effect of informal arrangements on the degree of CBA, some studies have used governor turnover as a proxy for real autonomy (Cukierman, Webb and Neyapti 1992; Cukierman 1992). In this case, the results are more consistent with the theoretical claim of greater CBA bringing along lower inflation. Latin American countries have on average substantially higher governor turnover rates than the rest of developing countries and than developed countries revealing the relative lack of autonomy of their central banks. However high turnover may also mean that the central bank governor is not coping with the task of achieving price stability more than opposing to the state policies, especially in the context of high inflation as it was the case for Latin America during the 1980s (Cukierman 1992: 392). If this is the case then this information is not sufficient to establish a causal relationship for developing countries between CBA and lower inflation. These observations are consistent with the

[10] It is very important to note that the statistics presented in Table no. 2 are only descriptive and therefore they cannot be taken as evidence that there is not a casual relationship between inflation and CBA. However they serve to establish the contrast between a fairly heterogeneous inflationary performance among group of countries, developed and developing, and a somewhat more homogenous situation regarding legal status of Central Banks among countries.

results obtained from Cukierman's (1992: 419) regression analysis in which legal autonomy does not have significant explanatory value on inflation performance. Also real autonomy as measured by governor turnover is positively related to inflation in developing countries. And finally legal autonomy is a reasonable good proxy for actual CBA in developed but not developing countries.

As it is evident from the results presented above there is an important gap between developed and developing countries when trying to establish the relationship between CBA and inflation on empirical grounds. In the case of industrial economies this relationship is somewhat better established (Grilli, Maschiandaro and Tabellini 1991; Cukierman 1992; Alesina and Summers 1993; Havrilesky and Granato 1993).[11] However, the same relationship is still not well established for developing countries.

The Political Economy of CBA

The literature has a different type of explanation to CBA based on arguments of political economy. According to Sylvia Maxfield (1997: 4) 'politicians use central bank autonomy to try to signal their creditworthiness to potential investors. The more global financial markets become, the more politicians must concern themselves with signalling investors.' In this context, the importance CBA is not so much about bringing inflation down but about the confidence that central bank inspires to the financial community, both international and domestic. This confidence rests upon the expertise and non-partisanship of the bank staff, able to deliver high quality and impartial analysis of the country's economic situation (Volcker, Mancera and Godeaux 1991: 26). Under this approach CBA is used as a 'partial commitment device' intended to achieve greater credibility, reduce inflationary expectations and lower interest rates along with wage demands (Eijffinger and De Haan 1996: 41). Despite the fact that the relationship between CBA and lower inflation is not well established for developing countries, international capital perceives CBA as a desirable institutional feature in any country seeking to attract foreign investment. Furthermore, as financial systems have become

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[11] Grilli, Maschiandaro and Tabellini (1991) constructed a detailed and homogenous set of indexes of CBA for a group of European countries plus the United States, Canada, Japan, Australia and New Zealand. They found a significant negative relationship between some of their indices and average inflation in some periods.

more sophisticated and more globally integrated monetary policy has gradually lost its power to stir the economy even in the short run. States are less interested in preserving control of an increasingly less effective monetary policy and therefore are willing to give up such control in exchange of a favourable rating from the financial community.

International investors are seeking certainty and higher returns in emerging economies and since they have little access to local information and risks on returns are relatively high they look for signals that domestic states will stick to sound economic policy in the future. Depending on the type of investment the importance of signalling also varies. For instance direct investment is not very sensitive to signals on macroeconomic policy because it is long term, expected returns depends more on sectoral policies, investors usually have good access to local information. Besides investors try to influence decisions by lobbing more than by leaving the country since this type of investment is relatively fixed. In contrast, financial investment in state securities is highly responsive to these signals because its expected returns depends on macroeconomic policy, investors do not have great access to local information, and they try to influence policy-making by leaving the country since this investment is relatively liquid (Maxfield 1997: 39). It is evident then that the importance of signalling is closely related to the nature of foreign investment. The more it is concentrated in securities, especially from the state, the more important is to provide a good investment climate.

International investors search for emerging economies with macroeconomic stability aware that it requires sound and consistent fiscal and monetary policies. Having an autonomous central bank means that each one these two policies are controlled by different organisations. In this case is expected that they will be most probably used for the purposes they are more suitable to serve, i.e. monetary policy for price stability and fiscal policy for economic efficiency and income re-distribution (Alberti 1995: 480). However even the most autonomous central bank is still constrained by prior choices of fiscal stance and exchange rate regime (Fry, Goodhart and Almeida 1996: 27).[12] Communication and co-ordination between the bank and the state is still very important otherwise there is a risk that the monetary and the fiscal authorities will compete against

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[12] Inflation is caused ultimately by fiscal imbalances that at certain point have to be financed by monetary expansion (Sargent and Wallace 1981).

each other leading to an undesirable outcome with high budget deficit and high interest rates (Doyle and Weale 1994: 76).

Paul Volcker, former chairman of the Federal Reserve Board, described the role of central bankers as gatekeepers of growth in the following terms: 'the function of the central bank is to set limits, to set a framework—which other people may not like—that provides an environment in which growth and stability may be achieved in the interest of the economy as a whole' (Volcker, Mancera and Godeaux 1991: 14). Alternatively, as a member of the Federal Reserve Board of governors put it: 'it is the role of the central banker to take away the punch bowl, just when the party is getting going' (Volcker, Mancera and Godeaux 1991: 14; Capie, Goodhart, Fischer and Schnadt 1992: 60). In order to preserve price stability, central banks are expected to implement deflationary policies in the face of an expansionist impulse. Deflationary policies leading to higher interest rates have important distributive consequences in favour of creditors, usually richer people who are holders of financial assets and against debtors, usually poorer people more dependent on credit for its own consumption. Therefore the politics of CBA is not only about price stability but also about who benefits from such price stability. Poor, small-scale, indebted farmers are likely to be most opposed to deflationary policies, the rich retired, large holders of financial assets are likely to be the most supportive. This configuration of opponents and supporters to CBA can be translated to the spectrum of political parties, where parties on the left are expected to oppose such measure and parties on the right to support it (Capie, Goodhart, Fischer and Schnadt 1994: 60). However with increasing capital mobility and financial markets usually suspicious of left-wing states, such prospective states might even have the incentive to allocate the control of inflation to an autonomous agency in order to secure financial inflows for their economies to grow and develop.

Central banks are important in the process of development when a country strengthens its financial and economic relations with the rest of the world (Volcker, Mancera and Godeaux 1991: 84). Granting greater autonomy to them represent one of the most important signals to obtain investors confidence given the institutional features of central banks. They more than any other state agency share a common policy culture with international capital enhancing communication and collaboration. Central bank's top officials in industrialised countries are important members of international capital.

They have a very active role in shaping the world political economy by controlling monetary policy in their own countries and by participating in the decision making process of organisations like the International Monetary Fund (IMF). Top officials of central banks from smaller countries are in continuous communication with their counterparts in industrialised countries (see Volcker, Mancera and Godeaux 1991).

In this context greater real autonomy is expected to bring along greater institutionalisation of central banks which means that their operations are expected to conform their own scale of values more along with the standards of international capital than with the objectives of specific domestic interest groups. International investors believe than their ability to influence policy and keep it on a stable, consistent course is greater the more autonomous is the central bank. Securing in this fashion an environment in which expected returns from investment are more certain and can be more easily calculated.

Legal vs. Real Autonomy

Sketching the distinction between legal and real autonomy helps to frame the discussion of the reform to the legal status of BdeM. By real autonomy it is usually understood the ability of the central bank to change the key operational instrument in monetary policy without consultation or challenge from the state (Capie, Goodhart, Fischer and Schnadt 1994: 50). The state grants this capability to central banks through statutory arrangements in most of the cases. However, as already shown the actual practice deviate very often from the law, especially in the case of countries with weak institutional frameworks (Cukierman, Webb and Neyapti 1992: 355). Legal autonomy is not necessarily real autonomy at the same time that formal lack of autonomy, does not mean that the central bank is not influential and does not enjoys certain degree of real autonomy either.[13] The law, in general, is incomplete in the sense that it cannot regulate

[13] For instance, the Bank of England, formally subordinated to the Treasury, is one of the most influential Central Banks in the world thanks to its long tradition and excellent research department. The Bank of England was created in 1694 in order to finance the war against France at that time,. The history of Central Banking in general is closely associated to the history of the Bank of England. In this case the formal relationship of subordination have not prevented conflicts between the Bank of England and the government. However the degree of real autonomy have varied over time depending on economic conditions and on the personality of the governor. The case of the Bank of England illustrates how, even in industrialised countries, there is a big gap between formal and real autonomy. Also suggests that there

all the potential situations and therefore leaves some voids that have to be filled by tradition or political power.

For real autonomy is usually understood those informal arrangements through which the central bank influences the state's decisions on monetary policy. The sources of this autonomy can be divided into two different categories: (1) conditions in the financial markets, both domestic and international, existing at a given point in time; (2) personal characteristics of the central bank's top officials. Among the most important determinants comprised in the first category are: the liquidity in international capital markets, size of the domestic market for state bonds and the level of outstanding public debt (Cukierman 1992: 448). The second category includes: the prestige and personality of top officials running the bank, the quality of the banks research department, and the fact of having personnel and senior officials career oriented (Volcker, Mancera and Godeaux 1991: 65; Cukierman, Webb and Neyapti 1992: 355).

Decisions about monetary policy have important consequences for economic stability and income distribution and therefore they are expected to be accountable to the society at large. However by granting greater autonomy to an organisation managed by officials that have not been democratically elected creates a problem of accountability, namely: how to reconcile greater autonomy to an organisation isolated from the democratic process with the need of preserving it accountable to the rest of the society. Yet insulation from political pressures does not mean that central banks are completely alienated from political processes. In fact one source of influence and real autonomy is their ability to be close to the political process but not part of it. To the extent central banks are sensitive and aware of the general social, political and economic contexts within which monetary policy is conducted, they enjoy greater real autonomy. As Jean Godeaux, former governor of the National Bank of Belgium, clearly put it: 'the influence and autonomy of the central bank do not rest upon legal arrangements but on public opinion' (Volcker, Mancera and Godeaux 1991: 76). Being accountable to the greater interest of the society as a whole without giving up to influences from particular interest groups make central banks more influential and autonomous. In fact, legal

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are more important determinants, other than legal provisions, of the degree of real autonomy enjoyed by a Central Bank (Doyle and Weale 1994: 63).

autonomy can always be taken away from the central bank when the Congress perceives that the bank is not pursuing the best interest of the society as a whole.

In sum, real autonomy is the relevant variable to control inflation, whereas legal autonomy, in the specific case of developing countries, is relevant only to signal commitment to consistent macroeconomic policies in the future. Based on the distinction between real and legal autonomy, I argue that the legal reform to BdeM was intended as a signal of future macroeconomic stability to foreign investors rather than as a real institutional change to avoid future upsurges in inflation.

7.2 The Context

This section shows from a historical perspective how BdeM's real autonomy has not necessarily followed from statutory reforms, or vice-versa. In the case of BdeM, real autonomy has been historically determined by the conditions in the financial system, the organisational culture of the bank and the personal characteristics of the bank's top officials. This section also introduces the international events that led to the generalised trend towards greater CBA all over the world, namely: institutional changes in the international monetary system; financial integration; and stabilisation programmes in Latin American countries.

Historical Overview

Throughout the history of BdeM, since it was created in 1925, the bank's real autonomy has been determined by the state's responses to domestic problems mediated by the prevailing conditions in the international financial markets. Central banks, in general, have enjoyed a greater degree of independence at times when domestic economies are heavily dependent on foreign capital inflows and therefore the leverage of international creditors and their domestic allies rises relative to other policy coalitions (Maxfield 1997: 33). BdeM has enjoyed different degrees of real autonomy throughout its history depending on financial needs of the state.

The state founded BdeM in the 1920s, when it was almost bankrupt and needed very badly to re-negotiate new loans with foreign banks. Then in the 1930s and 1940s, when

the international financial markets were in chaos and therefore could not provide financing to countries like Mexico, the financial coalition was less influential and BdeM was less autonomous. This situation was reversed during the 1950s and the 1960s, when multilateral lending was the most important source of development financing; the relative strength of BdeM improved vis-à-vis other organisations within the state. However, in the 1970s, excess global liquidity made redundant the links of BdeM with international capital and, consequently, eroded the influence of the financial coalition (Maxfield 1997: 33). Finally, the debt crisis in the 1980s altered once again the balance of power between policy coalitions; early in the 1980s, Mexico did not have access to the international financial markets but towards the end of the decade it became a major recipient of capital inflows bringing back the financiers to prominence.

The need to consolidate BdeM as a central bank made the issue of autonomy to be addressed only in the Ley Orgánica del BdeM (LOBdeM/Organic Act of BdeM) but never in practice. When BdeM was created in 1925, autonomy was explicitly stated as a desirable characteristic of the new central bank along with limited regulation, and limited state intervention on the bank's internal affairs (González 1997: 9). In the LOBdeM of 1925 there were already some limits to BdeM's financing to the state. However, the Ministry of Finance kept the right to veto any resolution of the bank's board of governors whenever they were considered to affect the economic equilibrium of the country (González 1997: 12). Since then, the state has had an active role in the board's resolutions; the minister of finance is a member of this board. Then again in 1932, the stated purpose of the reform to LOBdeM was to secure greater autonomy from the state (Borja 1996: 101). However, important issues like the appointment of the governor and the right of the minister of finance to veto the board's decisions remained intact.

The reform to the LOBdeM in 1938 made the minister of finance head of the board of governors and consolidated the subordination of BdeM to the President.[14] External and internal conditions reduced the autonomy of the bank: international financial markets were closed to Mexico as a response to the 1938 nationalisation of the oil industry;

political pressures to raise state spending directed to build up popular support for the incipient post-revolutionary regime; and constraints on tax collection from a system with high costs and a reduced base of taxpayers. The major concern of the state at that time was institution building, and therefore the political cost of taxing in combination with the pressure for greater spending forced the state to look for alternative sources of funding. In addition, international financial markets were just recuperating from the great depression in the late 1920s and foreign investment was not interested in Mexico because of the nationalisation of the oil industry in 1938. The only option open was domestic credit and seigniorage.[15] Dividends from BdeM's operations, mainly from seigniorage, go to finance the state since 1942 (Borja 1996: 113).

During the 1950s and 1960s the circumstances faced by the country were very different to those in the preceding decades. At a domestic level, the political hegemony of the PRI was already consolidated and at an international level, there was a steep rise on development lending from the recently founded Multilateral Financial Organisations (MFOs). Furthermore difficulties in the balance of payments in 1954, early in President Adolfo Ruíz Cortines' term, brought to the attention of politicians the importance of capital inflows (Maxfield 1997: 95). The nature of the relationship between BdeM and the President changed radically in the 1950s, although no major change to its legal status was made. For instance, the governor turnover fell sharply; Rodrigo Gómez was the only governor of BdeM throughout this period.

During this period, known as stabilising development, fiscal policy was conservative and reliance on credit from BdeM was not excessive despite the fact there were no legal limits on state financing. BdeM influenced expenditure decisions on state programmes in co-ordination with the Ministry of Finance, although the bank had no legal role in shaping the budget and was not legally autonomous (Maxfield 1997: 98). The alliances of BdeM with the Ministry of Finance, on the one hand; and with the IMF, on the other, were the two pillars of the bank's autonomy. Antonio Ortiz Mena at the Ministry of

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[14] The Ministry of Finance plays a crucial role in the relationship between BdeM and the rest of the state. We use hereinafter the figure of the President to represent the state and the Ministry of Finance as the agent of the state for the specific relationship with BdeM.

[15] Seigniorage is an optimal source of government revenue if there is widespread tax evasion or in the presence of large tax collection costs (Cukierman, Edwards and Tabellini 1990: 553).

Finance and Rodrigo Gómez at BdeM had a virtual monopoly on major economic policy decisions. This alliance had the institutional support of the IMF.[16]

Further changes in domestic and external circumstances during the 1970s brought about a new swing in the relationship between BdeM and the President. During this decade the state had major access to international capital; increasing oil export revenues associated with rising oil prices, and new loans associated to excess liquidity in the international financial markets flooded the Mexican economy with capital inflows. The importance of sound macroeconomic policies usually heralded by an autonomous central bank fell sharply mainly due to the state's easy access to foreign loans. International capital did not sanction sound economic policies anymore. At the same time and on the domestic side, the political system faced a legitimisation crisis sparkled by a left-wing challenge to the PRI (Maxfield 1997: 98). Despite the relative abundance of foreign capital there were strong pressures for expansionist fiscal and monetary policies. In this context, the state took away the autonomy the bank enjoyed in the preceding decades in order to secure greater control over BdeM's credit.

During this period, the state forced BdeM to undertake various types of quasi-fiscal operations.[17] These operations were illustrative of the reduced BdeM's real autonomy since they meant state guidelines guiding banks operations. Conflicting policy standpoints between the President and the governor of BdeM were common, first between President Echeverría and governor Fernández Hurtado, and then between President López Portillo and governor Romero Kolbeck (Maxfield 1997: 101). In all these conflicts, the President subdued the governor. Once more during the 1970s, the real autonomy of BdeM decreased substantially despite the fact that there were no major statutory changes and it was completely disassociated from the legal status of the bank.

The debt crisis in the 1980s represented the end of the 1970s' lending bonanza and brought back to the attention of politicians the urgent need of international

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[16] Antonio Ortiz Mena once said: "...we go to the IMF to make us do what we know we have to do... this help us to control public opinion (Maxfield 1997: 95).

[17] Quasi-fiscal activities are state operations directly financed by the Central Bank and consequently not registered on the public accounts. It was very common for BdeM to extend subsidised credit to agriculture, exports projects, and other development banks. The mechanisms were very much alike to

creditworthiness (Maxfield 1997: 102). A new reform to the LOBdeM in 1985 eliminated the minister of finance's right to veto any important decision of BdeM; tough it was never exercised (Borja 1996: 54). In apparent contradiction, this same reform introduced explicitly the obligation of the bank to act in conformity with the monetary and credit policies dictated by the Ministry of Finance (Borja 1996: 102). This change came after a decade in which the bank was especially subservient to the President's policies and preceded a period in which BdeM gained autonomy steadily.

Towards the end of 1982 the investment climate had severely deteriorated and the country faced strong balance of payments difficulties. This context altered once more the relationship between BdeM and the Ministry of Finance. The change of presidential administration in combination with a severe economic crisis initiated a process in which BdeM gradually gained greater real autonomy. One of the first moves of incoming President Miguel de la Madrid was to re-appoint conservative banker Miguel Mancera as governor of BdeM. Also in 1982 the state ceased to receive the dividends from BdeM's operations, these went into investment funds within the bank.

Mexico became a big recipient of foreign investment once again in the late 1980s, although under very different circumstances. Now, increasing capital mobility turned investors' perception on Mexico's economic outlook a major concern for policy makers. Among the state policies intending to secure a good investment climate, the reform to the legal status of BdeM was prominent. BdeM achieved a great deal of real autonomy long before the reform of its legal status took place. In fact three years before the reform, in 1990, Paul Volcker former chairman of the Federal Reserve Board reported:

> '... [BdeM] is not independent in a formal, legal sense. But I think that I can report to you without fear of contradiction that BdeM and Mr. Mancera have a great deal of influence, not just in monetary policy but in the economic policy of Mexico, generally. They are independent in a functional sense, and everybody knows it. That is a very considerable asset in my opinion to the state of Mexico in dealing with the rest of the world, because there is a certain inherited

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those of development baking: directed lending to pre-specified sectors, explicit or implicit deposit insurance, and exchange rate subsidies.

confidence and trust in dealing with the central bank that frankly may not apply in the same degree to the rest of Mexico' (Volcker, Mancera and Godeaux 1991: 33).

It is evident from this section that formal reforms to the legal status of BdeM are usually disassociated to changes in the bank's real autonomy. The last reform in 1993 is not an exception and before it took place BdeM already enjoyed a great deal of real autonomy, being very influential not only over monetary policy but also over economic policy in general. Furthermore, as shall be discussed below, it did not prevented the strong input from the President in 1994, an elections year, when monetary policy succumbed to political pressures and was rather loose.

International Trends

I have argued throughout the thesis that the dominant policy paradigm at international level is a major factor influencing the behaviour of the state; in the particular case of this chapter, the relationship between the President and the central bank. The costs and benefits of different economic strategies depend very much on international conditions. For instance, in the 1930s, a global depression reduced the expected payoff of an economic strategy of greater integration at the same time of reducing the expected cost of a domestic-oriented economic strategy. In this period inward development strategies associated with 'structuralism' like Import Substitution Industrialisation (ISI) in Latin America flourished. Then, in the late 1980s, the reverse is the case, increasing financial globalisation has raised the payoff of economic integration and the costs of inward economic strategies. Therefore export promotion strategies and structural adjustment programmes associated with a neoliberal ideology are highly in vogue.

CBA is determined to a great extent by the international context where trends towards state control or market liberalism have alternated over time since early last century (Capie, Goodhart, Fischer and Schnadt 1994: 51). The revolution of the market is by no means negligible to understand the current trend towards CBA around the world. This revolution has its origins in the convergence of two major events: a global crisis of governance triggered to a great extent by the 1980s debt crisis, and the resurgence of neo-classical orthodoxy (see chapter two). In this international setting, the scope of

economic activities susceptible of state control has become increasingly narrower (Bowles and White 1994: 242). The generalised move towards greater CBA is consistent with the main postulates of this new orthodoxy, leaving monetary policy out of the state's sphere of control.

The 1993 reform to the legal status of BdeM took place in the midst of a worldwide trend in which states, from both developed and developing countries, were granting greater autonomy to their central banks. States in countries as diverse as Chile, France and New Zealand enhanced the statutory autonomy of their central banks in the last ten years. Since 1989 twenty five countries have upgraded the legal independence of their central banks, which is remarkable when contrasted with the few changes that occurred in the previous forty years (Lippi 1997: 1; Maxfield 1997: 3). CBA has been an issue ranking high in the economic agenda of countries all over the world in this period. This widespread interest is associated mainly to three set of events: (1) institutional changes at an international level; (2) the globalisation of financial markets; and (3) the introduction of costly stabilisation programmes in Latin America.

The most important institutional changes moving forward CBA in the agenda of domestic states were: (1) the breakdown of institutions designed to safeguard price stability, namely: Bretton Woods and the European Monetary System; (2) the clause included in the Maastricht Treaty requiring an autonomous central bank as a pre-condition for membership in the Economic and Monetary Union (EMU); (3) the search for institutional arrangements to prevent future inflationary experiences after successful stabilisation programmes; (4) the creation of many autonomous central banks in former socialist countries; and (5) recent literature suggesting that inflation and CBA are negatively related (Eijffinger and De Haan 1996: 1; Maxfield 1997: 3-10).

The abandonment of the Bretton Woods system between 1971 and 1973 was a major monetary regime change. Under this system there was a *de facto* fixed exchange rate and the monetary policy framework was directed towards stabilising exchange rates by pegging the currency value to gold. Then and for the first time in history the world adopted a peacetime fiat monetary regime. Under this new system of fiat currency there are limitless possibilities for expanding money supply and therefore the preservation of the currency's value became a major concern for monetary authorities (Lippi 1997: 7).

At the same time, the international policy community became increasingly aware of the inflationary performance over the past forty years of countries like Germany, the Netherlands and Switzerland with some of the most autonomous central banks in the world.

In 1987, the Maastricht Treaty laid the foundations for the EMU consisting of a single currency for the European Community and a European System of central banks to manage the single currency. This event heated the debate of CBA in European countries. The Treaty, for instance, imposed a prescribed standard of CBA for the countries participating in the EMU (Fischer 1994: 301). Finally the pioneering reform to the legal status of New Zealand's central bank introduced a new contractual relationship between these types of organisations and the rest of the state. In this contract the central bank was explicitly mandated to preserve the annual inflation below 2 percent otherwise the state could dismiss the governor of the bank.

Financial globalisation has increased capital mobility to levels difficult to anticipate 25 years ago. This process has tended to harmonise policy decisions regarding financial systems around the world, producing a convergence in financial standards. CBA is no exception and there is now a general trend towards greater autonomy. Financial globalisation has increased the cost of poor monetary policy, the desirability of CBA, and the competition between state securities from different countries. In other words, financial globalisation has increased the competition for investment in international capital markets; state leaders are constantly persuading international capital to invest into their securities. There is currently undergoing a shift in the balance of power between national states and international capital in favour of the latter as a consequence of the increasing globalisation of financial markets; the leverage of international capital is at an all time high (Bowles and White 1994: 243; Woodall 1995).

CBA influence the perception of international capital on countries' economic perspectives and therefore states' trying to improve their securities competitiveness are induced to include changes to the legal status of their central banks in their agendas. CBA represents an attempt to signal creditworthiness. National states seeking to attract financial inflows cannot afford to ignore this type of perceptions and therefore make their policy decisions accordingly. A state will be more inclined to do so when it needs

balance of payment support and there is a lower degree of financial regulation (Maxfield 1997: 35).

The process of financial globalisation has been accompanied by financial liberalisation over the last 15 years, especially in developing countries. Financial repression characterised by interest rate ceilings, credit rationing, and directed lending schemes was replaced by policies aimed to unleash market forces. Monetary policy is increasingly implemented through open market operations and not through central bank's credit or reserve requirements on commercial banks deposits. Capital flows to developing countries have increased substantially over the last few years because of financial liberalisation.

Finally, the historical experience of some countries that faced deep economic crises in combination with high inflation, illustrates how successful stabilisation programmes often lead to CBA like in the case of Germany after the World War II, or Israel, Chile and Mexico in the 1980s (Cukierman 1992: 454). State and society are well aware of the costs of price instability in countries coming out from a period of high inflation and costly stabilisation programmes.[18] CBA after stabilisation programmes all over Latin America intended to avoid future surges in inflation, specially given the great social costs of these programmes (Fraga 1994: 68). Most of the Latin American countries that implemented strong stabilisation programmes granted greater autonomy to their central banks. However, it is not possible to establish any relationship between their degree of autonomy and the success of the programme in bringing down inflation as the cases of Mexico and Venezuela serve to establish despite the fact that central banks were instrumental actors in the stabilisation programmes of each country (see Table 7.3).

In the case of Mexico the strength of corporatist structures was crucial to bring down inflation in the late 1980s. The Mexican stabilisation programme was based on a system of Pacts in which the state called leaders from business and labour corporatist

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[18] Inflation inhibits the investment process, making very difficult to asses costs and benefits of an investment project; saving decisions are impaired by volatile real interest rates; authorities become tempted to establish price controls; prices of goods and services provided by the public sector lag behind inflation, deteriorating the public deficit; labour contracts have to be renewed more often, though wages are always lagging behind price increases leading to redistribution effects; and at some point, inflation destroys the financial system (Volcker, Mancera, Godeaux 1991: 20).

organisations to control price and wage increases. It was the state advised by BdeM who designed and implemented this stabilisation programme. The strength of the institutionalised corporatist partnership between state, labour and entrepreneurs was crucial to achieve price stability by inducing interest groups to forsake distributive conflict more than the autonomy of BdeM itself (Schmitter 1981; Cameron 1984; Maxfield 1997: 25).[19]

Table 7.3

Stabilisation Programmes in Latin America

Country	Central Bank	Stabilisation Programme
Argentina	Currency board	Preservation of the value of the currency according to the convertibility law. It was highly successful to bring down inflation but there is no room for sterilisation of balance of payments surpluses
Brazil	Weak institutional framework	Elimination of monetary budget (quasi-fiscal operations performed by the central bank); elimination of subsidised credit. Greater legal autonomy not yet made effective. The results are still uncertain.
Chile	Autonomous since 1989	The central bank controls the exchange rate policy and it is not allowed to lend to the government. It was highly successful.
Colombia	Not autonomous until 1993	It was the only country with relative price stability during the 1980s (inflation around 20 percent). Good prospects for gradual reduction.
Mexico	Not autonomous until 1993	Banco de Mexico played a key role in the stabilisation programme since 1988, long before it was given formal autonomy.
Venezuela	Autonomous since 1992	Stabilisation programme has failed thus far despite the reform that granted greater autonomy to the central bank.

Source: Fraga (1994)

In sum, the importance of CBA depends very much on the international environment (Doyle and Weale 1994; Maxfield 1997). The statutory reform of BdeM was the result of the world-wide interest on CBA as has been argued in this section; and of the urgent

[19] Havrilesky and Granato (1994) found that CBA more than corporatist structures explained the comparative inflation performance of eighteen industrialised countries.

political need to avoid any major economic disruption in 1994, a presidential elections year, as it will be argued in the next two sections. The next one turns to the highly volatile economic situation that the state faced during the second part of President Salinas's term, and the last section deals with the relevant political institutions and processes shaping the state's policy responses.

7.3 The Reform

Political explanations to CBA are based on several arguments: politicians wanting less responsibility upon unpopular monetary policy; legislators wanting of a well-informed third party to monitor the monetary policy of the state; state leaders seeking creditworthiness in international financial markets; party leaders leaving office wanting to constrain the incoming party to change monetary policy (Maxfield 1997: 12). The approach taken in this chapter emphasises the state's need to abate economic uncertainty during 1994, a presidential elections year. The experience in the 1988 elections illustrated that major economic disruptions actually impair the electoral performance of the PRI, the state's party.

This section argues that despite the reform, BdeM was not completely insulated from political pressures and therefore its decisions conformed to the policies dictated by the President. The argument addresses the issues of reform team and timing. This section also describes the major institutional changes to BdeM and shows how they were irrelevant for the overall behaviour of the bank and to its relationship with the rest of the state. Previous sections have already shown how formal and real autonomy have been dissociated throughout the history of the bank and how BdeM was autonomous in its day-to-day operations to a great extent prior to the reform.

Reform Team

The inflationary performance of a country reflects to a great extent the economic priorities of the dominant policy coalition within the state. If price stability ranks high in their economic agenda then inflation will be low regardless of the legal status of the central bank. In like manner, policy makers that are not inflation averse always find the way to get around the legal status of the central bank and promote expansionist policies

(Fischer 1994: 298). Usually financial groups are more concerned with price stability than workers and industrialists who are more interested in economic growth and employment (Bowles and White 1994: 245); they have more to lose from inflation and have closer institutional links with the central bank. The financial coalition in Mexico has traditionally protected the anti-inflationary policy of the central bank.

According to Adam Posen (1993) the degree of CBA can be explained in terms of this opposition to inflation. This opposition is higher in the presence of universal banking, low regulatory power of the central bank over the financial sector, a federal political system and a low fractionalised party system (Posen 1993). All these conditions are present in the case of Mexico where the financial opposition to inflation increased sharply after the privatisation of the commercial banks in the late 1980s. The opposition to inflation from the financial coalition since 1982, exercised through institutional and policy networks has determined anti-inflationary policy.

MFOs have direct institutional links with central banks. BdeM has been the main link between the Mexican state and the MFOs and therefore its reputation before these organisations is essential when it comes to get financial support and policy advice from them. Stanley Fischer (1993: 264), Chief Economist at the IMF, said: 'the capacity and reputations of, for example, the central banks of Israel, Italy and Mexico have all played a key role in helping bring about stabilisation and stability in their countries.' BdeM is the organisation with the best reputation for sound macroeconomic policy-making among the international financial community. At the same time BdeM is also linked to the domestic financial groups through networks of consultation and policy co-ordination (see chapter four).

Top officials from BdeM and executives from major banks often share common backgrounds and are also part of common policy networks.[20] Expertise and credibility are usually considered among the most important sources of central bank authority (Volcker, Mancera and Godeaux 1991: 76). The central bank's expertise, credibility to

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[20] For instance Miguel Mancera, governor of BdeM, share personal links with Pablo Aveleira, Director of the Research Department of Banamex. There is continuous communication between top bank officials and the representatives of this financial community on top of other type of informal links. For twenty years they have been meeting in a monthly lunch with other executives from the commercial banks and other officials from BdeM (Alonso Ríos, Interview, Mexico City, 14/09/1995).

control monetary policy, ability to regulate financial markets becomes more valuable to the extent that the financial system becomes more sophisticated (Maxfield 1997: 24). Top officials at BdeM aware of President Salinas's concern for capital inflows used their links with international capital to promote CBA (Maxfield 1997: 33).

Timing

Most of the Political Business Cycle (PBC) literature is built upon elections, political parties, state and voters (see Willet 1988).[21] Monetary policy, as in the case of most state policies, is usually under pressure towards short-run goals determined by the electoral calendar and the politicians' desire to remain in power. In the last twenty years, the PBC in Mexico has been associated to inconsistent macroeconomic policies—monetary, fiscal and exchange rate policies. The last three presidential terms, before President Salinas, have ended up under the shadow of an economic crisis. Hence the main challenge for President Salinas's towards the end of his term was to avoid any major economic disruption and consolidate the new bases of popular support for the regime. The autonomy of BdeM in combination with the signing of the North American Free Trade Agreement (NAFTA) was the most important moves for that end. However when it looked that NAFTA might fail due to US congressional opposition, the statutory reform of BdeM acquired greater importance.

Timing is a relevant issue for the final outcomes of any reform, but also illustrates the driving forces behind the decision. The timing of the reform to BdeM was influenced by electoral considerations. The state has to legitimise the regime every six years through elections and this is becoming increasingly difficult. Before 1988 bad policy outcomes never threatened the electoral triumph of the PRI. As a result of the poor performance on the 1988 elections, President Salinas perceived that devaluation and inflation were important determinants of voters' behaviour and therefore structured its strategy for the 1994 elections around the economic outlook of the country.[22] The statutory reform of

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[21] The basic idea of the PBC literature is that because the typical lags in adjustment of inflation to changes in macroeconomic policy are larger than for unemployment, a carefully engineered economic expansion can give politicians the advantage of a booming economy just before the election, while most of the associated inflationary costs do not follow until the election is safely over (Willet 1988: 14).

[22] Inflationary performance in Mexico was very poor during the 1980s reaching its highest annual rate at 160 percent in 1987. At that point, economic reform speeded up and the state took important decisions

BdeM was not expected to be an issue in the 1994 presidential elections but President Salinas expected that a more autonomous central bank would help to reduce the economic uncertainty usually associated to the last year of any presidential administration.

The presidential initiative to reform the Constitution was sent to the Congress in June 1993 and the new LOBdeM was enacted in April 1994, just few months before the elections. These changes could not have had any significant economic impact on inflation in such a short period of time. However, the signal produced by the reform is transmitted instantaneously to international capital and therefore the effect on capital inflows is immediate. Besides, around this time there were already some signals of inconsistent macroeconomic indicators and, on top of that, it is well known that the presidential relay in Mexico usually creates a vacuum of political power that exacerbates economic uncertainty during the last year of each presidential term. Therefore it was essential to accumulate as much confidence as possible from international capital to avoid any possible run against the peso in an elections year. At this time, most of the other reforms to the financial system were already in place and therefore the autonomy of BdeM was one of the few remaining opportunities to reassure international capital of Mexico's economic soundness.

Content

In general, the reform to the legal status of BdeM followed very closely the recommendations embodied in the literature of CBA, namely: (1) the central bank must have a constitutional mandate to preserve price stability; (2) the central bank cannot be forced to lend or to buy securities to any extent beyond what its governing body deems appropriate; (3) the members of the governing body cannot be removed before their term expires and that such terms does not coincide with that of elected officials; and (4) there must be a mechanism to solve disputes between the state and the central bank

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regarding privatisation of state owned enterprises, deregulation, and trade liberalisation. These structural adjustment policies were complemented with a very successful stabilisation programme that brought inflation down. By the 1991 mid-term congressional elections the economic strategy was already paying off political dividends: the PRI's electoral performance improved significantly compared to that of the 1988 presidential elections.

regarding economic policy (Volcker, Mancera and Godeaux 1991: 72; Cukierman, Webb and Neyapti 1992: 356; Maxfield 1997: 20). An additional recommended change related to CBA is their own financing from seigniorage.[23]

CBA usually refers to instrumental or operational autonomy to achieve a predetermined objective but not the political autonomy to pursue its own mandate (González 1997: 4). BdeM can refuse financing to the state and the Mexican President cannot dismiss its governor but the bank does not have the faculty to pursue its own mandate. BdeM has an unambiguous mandate, at a constitutional level, to ensure the stability of the purchasing power of the national currency (Mancera 1994: 316). The bank is free to choose the best means to achieve the goal of price stability but is not free to change that aim. However, as it is evident from the history of BdeM's autonomy there is not any guarantee that this formal reform is not going to be reversed in the future.

The new LOBdeM changed the legal status of the bank from a public and decentralised agency to an agency subject to public law but autonomous. In the statement of purpose, it is said that it is supposed to be a counterbalancing force to the executive, which means that it becomes a new type of entity, non-contemplated in the traditional division of power. BdeM is supposed to be an autonomous power from the executive, but it is not part of the legislative or the judiciary, which are by definition the counterbalancing powers to the executive in a presidential republic. The new legal status of BdeM cannot be categorised according to the prevailing division of power established in the Mexican Constitution (Díaz 1994: 105). The legal status has become not only an irrelevant feature to the bank's operations but also a contradictory one.

It is commonly recommended that central bank's top officials must be appointed for terms long enough to avoid possible influences from the actor, in this case the President, that appoints them. Also certain provisions are needed to avoid the dismissal of these officials without a justified cause. In the case of BdeM the President appoints, with the approval of the Senate, the members of the board of governors and the governor himself. Four sub-governors lasting for eight years in their position changing in a two-

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[23] Most of the banks are already financed through seigniorage and therefore this change was not included in the recent wave of reforms to Central Banks.

year scaled form integrate the board. Then to replace the governor, whose tenure lasts for six years not coinciding with the presidential period, the President chooses the new governor from the other members of the board, also with the approval of the Senate (Díaz 1994: 88; González 1997: 22). The fact that it is the Senate and not the Congress who ratifies the appointment of governor and deputy-governors poses a new question to the real autonomy of the bank. The President retained major control on the governor's appointment, by excluding the Congress from the process despite the fact that the Congress is the main responsible to assess the bank's performance. At the moment of the reform the President had stronger control over the Senate than over the Congress.

Provisions for BdeM's internal policies regarding personnel and staff remained unchanged. These policies are nevertheless directly related to its real autonomy by impinging upon the prestige and reputation of the bank, a major source of autonomy. Among the most important recruitment and career policies are the following: recruitment of the best young professionals; offer of training opportunities; offer prospects of promotion enhanced by the tradition of not hiring people without a career in the bank; encourage open discussion of the problems to be tackled by the central bank; and market salaries according to qualifications (Volcker, Mancera and Godeaux 1991: 74).

It is important to note that one of the arguments for CBA is to avoid pressure from the state demanding financing from the central bank. BdeM may extend loans to the state but is under no obligation to do so. The loans are deposited in an account held at BdeM itself; cheques to third persons cannot be extended from this account in order to avoid possible overdrafts; and the balance of this account is limited to an equivalent of 1.5 percent of total public expenditures approved in the federal budget. In case the balances exceed this limit, the bank will issue enough state securities to cover the deficit (Díaz 1994: 81; Borja 1996: 122). Another part of the reform intended to avoid quasi-fiscal operations which sometimes mean subsidised credit to specific sectors: BdeM stopped managing the state trust funds aiming at promoting economic development, they went to the relevant development banks (Díaz 1994: 97).

The reform intended to turn BdeM into the only body responsible for monetary policy and consequently to keep it accountable. BdeM is therefore required to: send a plan of

the monetary policy to be followed throughout the year to the executive and the congress; send a report on the monetary policy for the first semester and another for the second semester; elaborate a yearly report in the performance of the economy and the bank. The congress may call the governor to present and discuss the policies and activities of the bank and the Ministry of Finance may call officials from BdeM for bookkeeping verifications (Díaz 1994: 91; Borja 1996: 140). However, exclusively the board of governors takes decisions over monetary policy and financing to the state.

Yet policy co-ordination is still important since monetary policy is often constrained by the state's standpoints on other economically significant policies —fiscal and exchange rate mainly. The Exchange Commission integrated by three members from the Ministry of Finance and three from BdeM determines the Exchange rate policy. However, the President keeps control of the Exchange Commission since the minister of finance has the quality vote in case of a draw and each resolution needs the vote of at least one of the members from the Ministry of Finance (Díaz 1994: 84; Borja 1996: 130). The main mechanisms to co-ordinate economic policy between BdeM and the state are: (1) the participation of BdeM along with the Ministry of Finance in different economic boards and commissions like the Expenditure-Financing Commission and the Economic Cabinet chaired by the President; (2) the right of the minister and the deputy-minister of finance to be present at the meetings of the board of governors of BdeM; (3) the exclusive participation of BdeM and the Ministry of Finance in the Exchange Commission; (4) the right of BdeM to be heard by the Ministry of Finance before they issue any financial regulation; and (5) the participation of BdeM and the Ministry of Finance in the board of governors of the Commissions regulating and supervising the financial system (Borja 1996: 138). There are also important informal co-operation mechanisms between the state and BdeM, the most important being the private meetings between the minister of finance and the governor of BdeM (Borja 1996: 54).

7.4 The Outcomes

The outcomes from reform to the legal status of BdeM were not immediate, or at least not evidently. However, the observed trends on some key economic indicators are consistent with the thesis claim on the main causes of the reform. Future inflation, for instance, was not a major consideration: monetary and credit policies during 1994 were

rather loose; signal economic soundness became more important as the size of the current account skyrocketed: capital inflows in 1993 reached an all-time high and in 1994 remained very high despite the political turmoil. These indicators also show how the political rationale for the reform contributed to the conditions leading to the crisis in December 1994: loose monetary and credit policies, emphasis on capital inflows, delay on corrective action on the exchange rate.

Monetary Policy and Inflation

President Salinas stated in his initiative for reform to BdeM that price stability was not an end in itself but a necessary, albeit not sufficient condition, to attain social equity and economic development. However by the time the state decided to reform the legal status of BdeM in June 1993, the annualised monthly inflation was 6.7 percent, the lowest in the last twenty years (see Table 7.4). In this view it was not inflation control what really motivated the reform to BdeM. Besides, CBA is not as important to control inflation in a context of low inflation across countries. This was the case in the early 1990s when inflation rates in Latin America and some other developing countries were already substantially lower than during the 1980s (Doyle and Weale 1994: 64). Yet President Salinas deployed a great deal of his political capital in the stabilisation programme implemented during his presidential administration. Controlling inflation was an instrumental goal to gain investors' confidence and secure capital inflows throughout his term. Fiscal, exchange rate and monetary policies were all consistent with this goal. Granting greater autonomy to BdeM was an institutional change in line with improving the investment climate but it was only secondary to the goal of controlling inflation.

A striking feature of monetary policy during the stabilisation programme during the first half of President Salinas's term is that it was not restrictive. M2, the monetary aggregate used as target to control inflation, increased significantly between 1989 and 1991; surprisingly, inflation was falling at the same time (see Table 7.4).[24] It is important to note that at this point the source of the expansionist monetary policy was not increases in BdeM's credit, which became negative in this period but the accumulation of

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[24] The traditional definition of M2, includes coins and bills in circulation, cheques accounts, and short-term deposit accounts.

international reserves, which were not fully sterilised.[25] In this case the monetary policy was mainly determined by the exchange rate policy under the decision domain of the state. The state keeps exchange rate policy under its control because its link with foreign investment policy also under state control is regarded as more important than its link with monetary policy under BdeM' control (Borja 1996: 37). Besides, exchange rate policy has an important political dimension given the costs of devaluation. To the extent that this remains the case the freedom of BdeM to conduct monetary policy is severely restricted regardless of its legal status.

Table 7.4

Macroeconomic Policy, 1982-1994

Year	Inflation	Public Deficit (1)	Monetary Base(2)	BdeM's Credit(1)	M2(2)(3)	Change in M2(4)
1982	98.8	16.9				
1983	80.0	8.6				
1984	59.2	8.5				
1985	63.7	9.6	51.8	1.4	247.7	
1986	105.7	16.0	49.3	-0.8	232.0	-6.3
1987	159.2	16.0	38.7	-9.2	215.8	-7.0
1988	51.6	12.5	40.5	0.8	202.4	-6.1
1989	19.7	5.6	43.0	0.9	241.8	19.5
1990	29.9	3.9	44.8	0.0	272.0	12.5
1991	18.8	1.5	48.3	-1.8	337.2	24.0
1992	11.9	-0.5	49.2	-1.4	362.9	7.6
1993	8.0	-0.7	48.9	-2.6	384.3	5.9
1994	7.1	0.3	55.1	1.9	440.3	14.6

Source: Presidencia de la República 1995; Aspe 1993
(1) As % of GDP
(2) Billions of 1994 pesos
(3) Coins and Bills, Cheque accounts and short-term banking accounts
(4) Annual real change (%), December/December

As mentioned above exchange rate policy is still under state control. The crisis of December 1994, greatly magnified by inadequate handling of the devaluation decision and mainly caused by the exchange rate policy, was indirectly fuelled by a monetary policy which was not restrictive enough. President Salinas succumbed to political pressures to expand economic activity prior to the August 1994 presidential elections and BdeM did not have enough power to oppose the President's standpoint on this issue

[25] Sterilisation refers to the operations performed by the Central Bank in which the bank reduces its credit as a response of strong capital inflows in order to keep the monetary base constant.

despite the fact that the bank was very influential at this time as it has been argued before (Maxfield 1997: 104). BdeM's monetary policy in 1994, the year prior to the crisis, was considered as neutral. It consisted mainly in meeting the demand for money without inducing any expansionist or restrictive effect on output (Carstens 1994: 77). However, some indicators like real exchange rate overvaluation and increasing domestic credit, specially off-the-books lending through development banks such as NAFIN, were pointing towards the need for BdeM to tighten monetary policy.

As can be seen from Table 7.5 it is evident that BdeM relaxed its control on monetary expansion, violating its constitutional mandate, i.e. preserve the value of the currency. Monetary aggregates rose sharply. For instance, M2 the one usually used as target to control inflation increased 14.6 percent in real terms during 1994, one of the largest increases in the last 10 years; BdeM's credit expanded considerably, it went from -2.6 percent of GDP in 1993 to 1.9 in 1994. At the end BdeM did not tighten monetary policy despite the increasing real autonomy that it enjoyed and the reform to its legal status, signalling once more the continuous weakness of the Mexican central bank when it comes to political crucial junctures as it is the presidential relay.

State Financing and Capital Inflows

As the degree of competition for investment has increased in the international financial markets the relative importance of signalling creditworthiness has also risen (Maxfield 1997: 36). In the 1970s excess liquidity in international financial markets—supply of financial funds vastly exceeds demand—reduced the degree of competition and therefore the importance of signalling. The state back then had greater freedom to choose their own economic policies according to domestic priorities. However as capital mobility increased and new emerging economies in Eastern Europe, South East Asia and Latin America became big recipients of foreign investment, competition for investment scaled up towards the end of the 1980s. There appears to be a closer temporal relationship between the rise of portfolio finance—and the need to compete for capital associated with it—and CBA than there is between inflation and CBA. Inflation was very severe in developing countries during the 1970s and 1980s, yet CBA decreased in the 1970s and changed little in the 1980s. However the rise in portfolio finance was especially steep towards the end of the 1980s and the beginning of the

1990s, precisely when many countries increased the statutory autonomy of their central banks.

State finances are a major constraint to the real autonomy of any central bank, especially in developing countries. In order to have a monetary policy free from state's influence, state finances have to be balanced or at least with enough access to alternative sources of financing, others than central bank's credit. An important issue leading to BdeM's autonomy was the liberalisation of Mexican financial markets, which meant the development of the state securities market. At the moment of the reform in 1993 the state had a positive balance in its finances and was not reliant on banking loans or external credit to the same extent it was at the beginning of President Salinas term in 1988 (see Table 7.5). Central bank credits to the state and reserve requirements were increasingly replaced by international financial inflows buying Mexican state securities as the main source of state's financing. The cost of funding, closely linked to the degree of credibility on state's commitment to lower inflation, became a major concern for the state. And therefore by granting greater autonomy to the central bank, the state sought to secure credibility to its policies and reduce its cost of funding. The delegation of authority to the central bank is used as a device to reduce interest charges on new state debt (Cukierman 1993b: 56). CBA contributed to direct increasing amounts of international capital into state's securities at lower interest rates.

Table 7.5

Public Finances, 1987-1993

Indicator	1987	1993
Inflation (1)	159.2	8.0
Fiscal deficit (2)	16.1	-1.0
External public debt (2)	93.0	21.5
Internal debt (2)	27.5	11.1
Bank lending to the public sector (3)	74.0	13.0
Financial savings (2)	28.9	51.5

Source: Carstens (1994)
(1) Percent annual increase in the National Consumer Price Index (January-January)
(2) Percentage of the GDP
(3) Percentage of the total

As it was mentioned above the liberalisation of the financial markets with the ensuing development of a market for state securities and the improved public finances reduced the state's reliance on BdeM's credit and therefore made politically and economically

feasible to reform. In this context granting greater autonomy to BdeM did not represent a major loss of power to the state because the reform was not accompanied with an effective withdrawal of the President from economic management and BdeM's credit was secondary in the new scheme of state financing.

Balance of Payments and Exchange Rate

As it was argued above among the most important factors influencing the relationship between the state and BdeM is the exchange rate regime. Exchange rate policy is still under state control but BdeM is responsible for operating and regulating the exchange market.[26] The degree of freedom to conduct monetary policy is therefore constrained by a predetermined exchange rate regime determined in turn by other decisions regarding trade policy, external public debt and most importantly capital inflows. In this context the reform to BdeM is very limited in terms of real freedom to conduct monetary policy with the aim of preserving price stability. In 1993 and 1994 when there were increasing pressure for devaluation, the state decided to stick to its fixed exchange policy and BdeM had to direct monetary policy accordingly.

The decision to reform the legal status of BdeM was strongly influenced by the outlook of the Mexican economy towards the end of President Salinas's term. At the beginning of 1993 the President and his economic team were already aware of the precarious situation created by increasing deficits in the balance of payments. An enormous current account deficit required increasing capital inflows, which took the form of short run portfolio investment. This situation in the context of imminent presidential elections that usually bring along a great deal of economic uncertainty was especially explosive.

In November 1991 all capital controls were completely removed; the investment into state securities markets soared towards the end of the presidential term (see Figure 7.1). However, by the end of 1993, around the time of the reform of BdeM, investment in state securities represented almost 80 percent of total capital inflows. It was not only the

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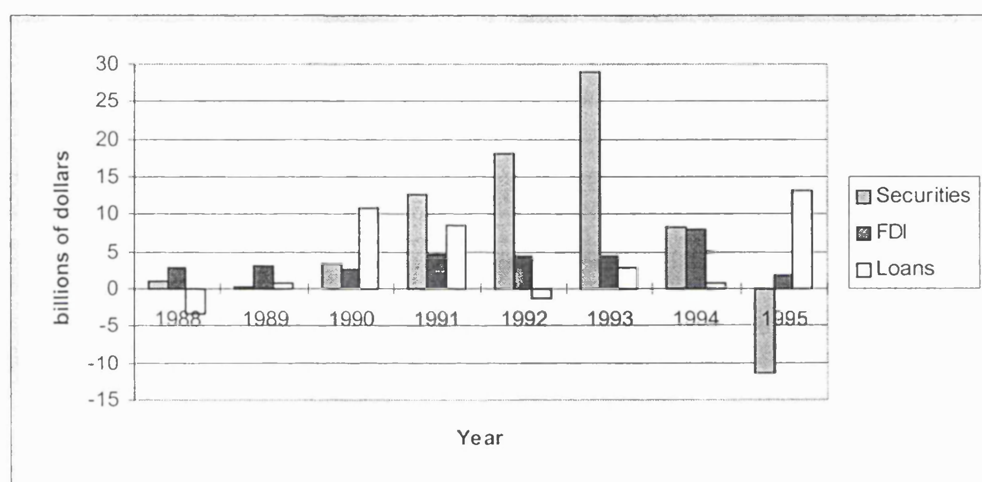
[26] Between September 1987 and January 1989 the exchange rate policy was a fixed parity of the peso to the dollar. Then a crawling peg regime was introduced (pre-announced daily depreciation), devaluing 16.8 percent the peso during that year and gradually reducing it up to 5 percent in 1991. By November 1991 a band was introduced within which the unified exchange rate may float. BdeM preserved nevertheless the prerogative to intervene inside the band to reduce excess volatility (Carstens 1994: 74).

composition of capital inflows but also their size what made Mexican economy extremely vulnerable to international capital perceptions. This made necessary additional measures to avoid any potential source of instability among which the reform of BdeM's legal status was prominent. Agustín Carstens (1994: 77), Chief Economist at BdeM, wrote: 'The inauguration of BdeM as an autonomous central bank on April 1st, 1994 should represent a guarantee that financial stability will be pursued in the years to come, adding credibility to the Mexican macroeconomic programme.'

Figure 7.1

Capital Inflows



Source: Presidencia de la República 1995

The balance of payments in combination with the country's export capacity and foreign exchange reserves are the main determinants of a country' need for international financial resources in the short run. However, there is a strong element of confidence and perception, which may accentuate or ameliorate the financial needs of foreign currency regardless of the above variables. At the time of the reform the export capacity was very low because of real exchange rate appreciation, the trade balance had a deficit of more than 13 billion dollars in 1993 (see Table 7.6). The current account deficit was above 23 billion for the same year. These two indicators revealed the strong need of capital inflows for the last two years of President Salinas's term.

Summary

The conventional argument for CBA stating that it brings along lower inflation does not fully apply for the case of Mexico. The relationship between CBA and lower inflation is not fully established on empirical grounds for developing countries. In fact Miguel Mancera, governor of BdeM once stated that 'central bank autonomy is not a necessary nor sufficient condition to have price stability' (Volcker, Mancera and Godeaux 1991: 71). However, there are institutional features of central banks that bring them closer to international capital than any other state organisation. Therefore granting them with greater autonomy is perceived as a move towards greater communication and co-ordination in economic policy between domestic states and international capital; central banks with greater autonomy signal greater soundness in economic policy-making to international capital.

Table 7.6

External Indicators (1), 1985-1995

Year	Current account	Trade balance	Capital account	Foreign reserves
1985	800	8,398	-315	-2,328
1986	-1,372	5,020	2,715	985
1987	4,240	8,788	-1,188	6,924
1988	-2,375	2,610	-1,164	-7,127
1989	-5,822	405	3,177	272
1990	-7,451	-882	8,163	3,414
1991	-14,647	-7,278	24,951	7,822
1992	-24,439	-15,933	26,573	1,161
1993	-23,399	-13,481	32,582	6,083
1994	-28,786	-18,464	11,549	-18,884
1995	-619	3,089	3,089	3,817

Source: Presidencia de la República 1995
Millions of dollars

From a historical perspective in the specific case of Mexico legal autonomy has not determined the real autonomy of BdeM. On the contrary, legal changes usually follows from increases in BdeM's authority with a considerable lag. A stronger BdeM in the 1950s and in the 1980s led to statutory changes in 1962 and 1993 respectively. However the reform in 1962 did not prevented the decline of BdeM's authority in the 1970s and the reform in 1993 did not insulated the bank from political pressures in 1994. BdeM was autonomous to a great extent in practice even prior to the reform to its legal status

and then after the reform is was not completely autonomous either. Furthermore the conditions for attaining price stability in the long run, which was the stated purpose of the reform, were already in place before the decision was taken. The reform was motivated by the necessity to attract and secure financial inflows from abroad more than by the long-term objective of price stability. This is not to say that the state officials do not regard this goal as a desirable one, nonetheless the autonomy of BdeM was not primarily directed towards that end.

When the ruling party faces a greater probability that it will be removed from office it has a stronger interest in developing an apolitical institution that will restrict the range of action of the opposition if and when the latter comes to office (Cukierman 1992: 446). An alternative argument says that states, when challenged by opposition, will reduce CBA in order to have more policy instruments to resist the challenge (Eijffinger and De Haan 1996: 44).[27] The case of Mexico is more consistent with the second argument. At the time of the reform in mid 1993, President Salinas was at the peak of his popularity, making a victory for the opposition in the 1994 presidential elections very unlikely. Without a serious challenge from the opposition the state relinquished its control upon monetary policy. Furthermore, legal autonomy is by no means the same as real autonomy and therefore even if the central bank was granted with formal autonomy, the state could always find a way to influence the bank's decisions.

As mentioned before price stability is a major issue in financial markets and, therefore, international capital welcomed any safeguard against possible future upsurges in inflation. This led to a strong international trend towards CBA, which in combination with a development strategy heavily reliant upon capital inflows made the reform to the legal status of BdeM a necessary decision to increase and secure the financial inflows from abroad. In general, the case for CBA is based on keeping inflation under control. However, from a wider perspective, the decision to grant greater autonomy to the central bank follows from the need to signal discipline and credibility on the state economic

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[27] In the presence of uncertainty about electoral outcomes, the monetary policies of different parties have different effects on economic activity even if voters are rational as the experience of the Unites States between 1948 and 1984 serves to establish (Alesina and Sachs 1988). Right wing governments are generally thought to give a high priority to lower inflation, left wing governments are often supposed to be more concerned about inflation (Eijffinger and De Haan 1996: 12).

policy (Bowled and White 1994: 237; Maxfield 1997). President Salinas promoted the decision to grant greater autonomy to BdeM chiefly concerned with the electoral performance of its own party, the PRI. The decision was clearly not a social demand and the debate over the decision never captured the public attention. In this case the only relevant level of political organisation was the state.

Chapter 8

The Political Economy of Mexico's 1994 Financial Crisis

The preceding chapters showed how the reforms to the financial system were examples of successful state engineered changes that conformed to the dominant orthodoxy in economic thinking.[1] However, in hindsight they were clearly insufficient to prevent the 1994 crisis and in some cases they even contributed to its generation. The crisis brings back the question raised at the beginning of the thesis, namely why did the financial reform failed to prevent the end-of-sexenio crisis despite the participation of well-trained policy makers?

This chapter explores the events leading to the peso devaluation and to the subsequent crises in the state finances and the banking sector. I argue that although the financial reform created some of the conditions for the crisis, political change and policy miscalculations were crucial for the final outcome as well. The analysis of Mexico's 1994 financial crisis brings together all the elements discussed throughout the thesis: external dependency (chapter two), political change (chapter three), financial liberalisation (chapter four) and institutional changes to the financial system (chapters five, six and seven). Financial liberalisation, for instance, weakened the grip of the government on the management of the financial system. The banks' privatisation turned their management 'too entrepreneurial' and resulted in too much lending. Political change pushed the government to delay corrective action in the exchange rate. Dependency on international capital forced the government to swap peso-denominated CETES for short-term dollar-denominated TESOBONOS.

This chapter is divided into four sections. The first section presents the links between the financial reform and the 1994 crisis. The discussion addresses the issues of portfolio investment and banks' lending boom. These events were direct consequences of the

[1] By successful state engineered change I mean that the government effectively implemented the desired reforms regardless of their outcomes.

financial reform and contributed to the 1994 crisis. The second section introduces the political conditions leading to the crisis. In this part, the main issues are increasing electoral competition, the political business cycle and the political turmoil during 1994. The third section discusses two crucial policy mistakes, namely the government delayed corrective action in the exchange rate and changed the term-structure and exchange rate exposure of the public debt. Finally, the fourth section describes the main outcomes of Mexico's 1994 financial crisis: foreign investment in the banking sector and the banks' bailout.

8.1 Financial Reform

The 1982 debt crisis created the conditions to introduce a sweeping programme of economic transformation in Mexico—the financial reform was an important part of this programme. However, only twelve years later, another crisis made evident the shortcomings of Mexico's financial reform. This time, the crisis included the collapse of the exchange rate on December 20th, the subsequent inability of the government to meet its financial liabilities and the decline of banks' capitalisation below 'financially sound' levels.[2] The peso devaluation started the crisis; the state's over-dependence on short-term and dollar-denominated securities deepened its consequences; and the banks' bailout transmitted the cost of the crisis to the rest of the economy over the following years.

Mexico's financial reform produced two important outcomes that contributed to the generation of the 1994 crisis: a surge in capital inflows, much of it into portfolio investments; and a lending boom —Mexican commercial banks to the private sector grew at an average annual rate of 32 percent from 1988 to 1993.[3] Capital inflows secured financing for the state and the economy during most of this period, though in a very unstable form. The lending boom provided large financial groups with profitable

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[2] Although most of the events related to this financial crisis took place after 1994, the first event, namely the devaluation of the peso, happened in 1994 and therefore I refer to the whole set of events as the 1994 crisis.

[3] The rate of expansion on bank lending in Mexico over this period was very large by any standard. For instance, bank assets in developing countries grew at an annual rate of only 8.6 percent between 1949 and 1963 (Goldsmith 1969: 262).

businesses and increased the consumption possibilities of the population at the same time. Large capital inflows and abundant credit created a 'feel-good' factor in favour of the government and the PRI in the context of increasing electoral competition.

Table 8.1

Total Savings, 1970-1994 (1)

		Domestic			External
Year	Total	Total	Public	Private	
1970	20.1	17.1	3.2	13.9	3.0
1971	18.3	16.1	2.7	13.4	2.1
1972	19.0	17.0	2.2	14.8	2.0
1973	19.1	16.6	4.0	12.5	2.5
1974	20.0	16.0	3.6	12.4	4.0
1975	21.2	16.7	1.4	15.2	4.5
1976	20.8	17.1	3.2	13.9	3.7
1977	19.7	18.0	4.3	13.7	1.8
1978	20.8	18.5	5.0	13.5	2.4
1979	23.1	19.8	5.2	14.6	3.2
1980	25.6	20.5	5.9	14.6	5.0
1981	25.7	19.6	1.2	18.4	6.1
1982	21.5	18.8	3.7	15.1	2.7
1983	19.7	23.4	6.1	17.3	-3.7
1984	18.8	21.1	5.5	15.6	-2.2
1985	20.1	20.5	5.4	15.1	-0.4
1986	17.4	16.4	4.5	11.9	1.0
1987	18.5	21.3	6.5	14.8	-2.8
1988	22.6	21.3	0.6	20.7	1.3
1989	22.9	20.3	3.3	17.0	2.6
1990	23.1	20.3	6.8	13.5	2.8
1991	23.3	18.7	6.5	12.2	4.7
1992	23.3	16.6	6.6	10.0	6.7
1993	21.0	15.1	5.1	10.0	5.9
1994	21.7	15.0	4.0	11.0	6.7

Source: SHCP 1997.

Capital Inflows and Portfolio Investment

The financial reform failed to address the most important structural deficiency of the Mexican economy, namely the low rate of domestic savings (see Table 8.1). In fact, the financial reform was counterproductive in this sense. Domestic savings decreased steadily throughout Salinas's *sexenio*. Despite the fact that officials in the Ministry of

Finance and BdeM were aware of the importance of raising domestic savings they took no decisive action.[4] The introduction of the System of Savings for Retirement (SAR) was the only government policy oriented to meet this end. However, the SAR was only a partial reform to the pension system and consequently had a very limited reach.[5] In fact, most policy decisions stifled internal savings and promoted an excessive inflow of external savings in the form of portfolio investment.

According to Martin Feldstein (1995) the structural cause of Mexico's 1994 crisis was a low rate of domestic savings; the economy was investing far more than it was saving. Investment increased substantially from 1988 to 1994 (see Table 8.2). Besides, consumption rose during the same period and consequently the already low level of domestic savings further decreased. The lending policies of the banks induced greater consumption and fewer saving. According to BdeM in 1992, when the banks' privatisation was concluded, personal deposits in the banks were greater than personal credits in an amount equivalent to 1.7 percent of the GDP. However, in 1994, only two years later, the opposite was true: personal credits exceeded personal deposits for an amount equivalent to 2.6 percent of the GDP (quoted by *La Jornada*, February 9th 1999).

Capital inflows financed the widening gap between investment and savings. In last three years of Salinas's *sexenio*, the economy recorded net inflows of capital equivalent to more than four percent of the GDP. The size of the current account deficit increased dramatically from 2.4 billion dollars in 1988 to 28.8 billion in 1994. Besides the obvious problem related to the size of the deficit and to the fact that an important part of the deficit reflected a slump in savings and thus higher consumption; the deficit had the additional weakness of being mostly financed by short-term portfolio investment. Almost 75 percent of the capital inflows went into easily liquidated portfolio investments and a significant part of that figure came from flight-capital repatriated by Mexicans.

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[4] Pedro Aspe stated in his address to the VIII Bankers Convention: '...We face the challenge of increasing the level of internal private savings in order to satisfy our needs of capital. We know that healthy financing for development is based on the strengthening of internal savings, and only in complementary fashion on contracting debt from abroad' (*El Mercado de Valores*, October 1992).

[5] The full-scale reform to the Mexico's pension system took place under President Zedillo.

Table 8.2

National Accounts, 1988-1994 (1)

	1988	1994
Consumption	74	78
Investment	18	22
Net Capital Inflows	-2.2	5.1
Current Account Deficit (2)	2.4	28.8

Source: Presidencia de la República 1995: 20, 68
Notes: (1) As percentage of the GDP
(2) Billion of dollars

Given the low rate of savings, the state stressed the importance of luring capital back into the economy as the only option to boost the economy in the short run and to expand the country's productive capacity in the long run. Therefore the immediate and most important point on the economic agenda of the state became the improvement of the investment climate. The government stressed its commitment to price stabilisation and structural adjustment in order to gain the confidence of the large business groups and international capital. Foreign investors, usually concerned with stability and economic prospects, expected that a privatised economy would create an efficient and decentralised process of decision-making as opposed to a bureaucratised economy where management was centralised and highly inefficient (Esfahani 1994). Capital inflows were the result of perceived improved economic prospects associated to a great extent to Salinas's reforms.

The financial reform under President Salinas changed the traditional instruments of state financing. Under the old framework, public indebtedness was determined by policy parameters like reserve requirements, monetary expansion and international loans. Under the new framework government financing depended on parameters given by the market. The state could not determine interest rates and levels of indebtedness simultaneously anymore. Investment climate became paramount to secure better terms for public debt under this framework. The implicit policy demands of international capital and domestic business groups increasingly circumscribed government policies. For instance, the banks' privatisation served as a clear signal of the state's commitment to efficient and decentralised economic management (Schneider 1990).

As soon as President Salinas took office, his economic team started to work on the public finances. The government made important moves on three different fronts. First, on external debt, a thorough re-negotiation with commercial banks on the terms and conditions of the debt took place.[6] Second, on tax income, the Ministry of Finance implemented a far-reaching tax reform that expanded the tax base and reduced tax evasion.[7] Finally, on internal debt, the state invested the proceeds from the privatisation programme into a special fund to buy back internal debt, and in this fashion these once-and-for-all revenues made permanent contributions to the state accounts through reductions on debt-servicing expenses. By the end of 1991, the financial deficit, which includes interest payments, amounted to the equivalent of only 1.5 percent of the GDP down from 16 percent in 1987 (Presidencia de la República 1995: 51). The stabilisation of the economy and its structural transformation was expected to attract foreign investment and bring back flight capital invested abroad during the 1980s.[8]

The massive inflows of capital into Mexico in the early 1990s was partly the response to Salinas's economic reforms and partly the result of portfolio diversification by rich-country investors at time of low American interest rates. Much of the capital inflows between 1991 and 1993 (estimated around $75 billion dollars) was a one-time portfolio reallocation of foreign investors and also a one-time repatriation of flight capital. It was a mistake to assume that it was an steady flow rather than a one-time jump in the stock of foreign investment. Early in the 1990s there was a new enthusiasm in the international financial system. The new methods of finance were thought to be grounded on firmer foundations: private borrowing is better than public borrowing; portfolio finance spreads risk more safely than bank debt; and foreign direct investment brings technology, new ideas and access to rich-country marketing networks (*The Economist*, August 25th 1993).

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[6] The agreement reached in July 1989 meant a reduction of US $53 billion on Mexican external debt (Solís 1996: 159). Moreover it also improved the market conditions for the internal debt. Between July 1989 and July 1990 internal interest rates on government bonds (CETES) decreased by more than 20 percentage points, representing savings of more than US $10 billions annually (Hanley et.al. 1991: 14).

[7] Fiscal revenues almost doubled from US $31 billions in 1988 to US $58 billions in 1991 (INEGI 1994: 763)

[8] The size of potential flight capital returning to Mexico was difficult to estimate. However a rough figure for all Latin America of flight capital invested abroad tells us that in the late 1980s it was near US $300 billion (*The Economist*, December 9th 1995)

The surge of foreign portfolio investment was possible because of the development of the BMV in the 1980s and the increasing issues of government securities between 1988 and 1994. In 1988, internal public debt was contracted 40 percent with BdeM, 40 percent through government securities and the remaining 20 percent from other sources. By 1994, public debt was completely contracted through government securities (Presidencia de la República 1995: 55). Foreigners became increasingly active in the Mexican securities market once the new institutional framework for the financial system was in place. Foreign investors, mostly American, according to *the Economist* (February 13th 1993), had $27.7 billion dollars invested in the BMV at the end of November 1992, a 21 percent stake. In March 1993 foreign investors already had larger holdings of government securities ($18.4 billion dollars) than their domestic counterparts ($17.2 billion dollars, half their holdings at the end of 1991), who were already reducing their investments in government securities. Higher yields of Mexican CETES (around 8.5 percent after being adjusted for inflation and exchange rate depreciation) and American T-BILLS (between 3 and 4 percent) explain to some extent the enthusiasm of foreign investors for Mexican government securities (*The Economist,* October 7th 1995).

The crisis, however, showed the imperfections of liberalised financial markets and their inability to secure stability. International capital rewarded Mexico's economic reform by pouring investment into the stock exchange but failed to take corrective action when the current account deficit was running above sustainable levels. Andrew Crockett, general director of the Bank for International Settlements, conceded that the financial markets 'failed to spot the point when the carrot needed to be replaced by a stick' (*The Economist,* October 7th 1995).

Lending Boom

Another major outcome from the financial reform that had distressing consequences after the peso devaluation was the lending boom of the recently-privatised commercial banks. State officials were aware of possible malpractice and abuses from bankers.[9]

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[9] Pedro Aspe stated in his address to the VIII Bankers Convention: '...The challenge is double. On the one hand, it is necessary to avoid excesses and abuses, by promoting good systems of self-regulation and codes of high practices within the institutions. On the other hand, it is necessary to avoid that

However, when lending was rising very rapidly and interest rates spreads were widening the authorities did not step in to stop these trends. Valencia (1997) traced the banking collapse in Mexico back to their privatisation, when they were sold to the risk-prone stockbrokers and the high prices paid for them demanded risk taking and aggressive lending. Business practices in the SBHs, characterised by higher risk taking, replaced the traditionally conservative management at the banks (Danby 1996: 72). Furthermore, the highly leveraged nature of the banks and the mechanisms of deposit insurance made them especially vulnerable to the problem of 'moral hazard'.[10] The fact that no bank was ever allowed to fail in Mexico since the 1920s exacerbated the problem of 'moral hazard' that encouraged the banks to engage in high risk lending.

Between 1988 and 1993 the stock of bank loans to the non-financial private sector more than tripled, with consumer lending being the fastest-growing component (Danby 1996: 90). Banking credit to the private sector went from less than 10 percent of GDP in 1988 to almost 40 percent in 1994 (Rojas-Suárez and Hausman 1996: 49). After their privatisation, banks had to expand and keep up with other banks and generate increased earnings needed to repay owners and finance the banks' own capital investment. By aggressively seeking to expand consumer lending, banks worked counter to the stated goal of financial liberalisation advocates, namely, to raise individual savings.

The larger banks undertook the most rapid expansion, had the larger interest rates spreads. The relation between expansion of consumer lending and profits is also evident in data obtained from the CNBV (1994). Between March 1992 and March 1993, revenue from mortgage loans roughly doubled from 0.6 to 1.2 billion of Mexican pesos, rising from 14 to 17 percent of total bank income. Revenues from other consumer loans increased from almost nil to 1.2 billion pesos for the same period, reaching 10 percent of bank's total income. Banks profits increased from 0.7 billion dollars in 1988 to 2.8 billion in 1993.[11] More illustrative, in 1992, three Mexican banks were among the top ten banks in the world in terms of profits on capital: BANAMEX, second with 107

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discrepancies in regulation between Mexico and its competitors, shift the banks' operations to other markets' (*El Mercado de Valores*, October 1992).

[10] The problem of 'moral hazard' refers to the situation when the individual has the incentive to take higher risks than optimal because the costs of his actions are spread among many other agents.

[11] Calculated from CNBV (1994: 7) for profits and Zedillo (1995: 77) for the exchange rate.

percent; BANCOMER, sixth with 82 percent; and Banco Mercantil del Norte, ninth with 71 percent (*The Banker*, July 1993: 75).

The boom in consumer lending consolidated the profitability of the commercial banks. According to Colin Danby (1996: 69), the elimination of the liquidity coefficient in September 1991 reduced the domestic demand for CETES, which had their prices high, and allowed the banks to shed their holdings of these securities in exchange for loans, assets which paid higher interest rates. Between October 1991 and August 1992 banks liquidated most of the state securities they held, selling them to foreigners and freeing up funds for lending. The prospectuses of GF BANACCI (1992) and GF SERFIN (1993) argued that the greatest source of profitability was in their consumer lending. Expansion in this segment also represented the best way to establish a strong hold on the consumer market and therefore deter the other firms entry. Bankers were fond of pointing out that while the stock of consumer debt in the US and Canada was equivalent to over 60 percent of GDP in 1991, in Mexico the equivalent figure was barely 6 percent (Natella and Mason 1992).

The fact that Mexico was, and still is, under-banked fuelled the surge in lending, especially consumer lending like—mortgages and credit cards. Jose Costello, banking analyst at Baring Securities in Mexico City, reckoned that lending over the next ten years could increase at three times the rate of economic growth (quoted by Wood 1993). Expected profits from an under-banked system lured stockbrokers to pay high prices for the banks (3.5 times their book value on average). However, rapid expansion also increases the risk of losses and too often ends in disaster for financial institutions and the economy.

The banks lacked the required risk-management experience to deal with the surge in consumer lending. In December 1993, the ABM attempted to introduce a credit bureau with the aid of Trans Union, a big American credit-rating company (*The Economist*, December 12th 1994). The purpose of this bureau was to pool information on borrowers in order to improve the banks' risk management systems. This initiative, however, did not prosper because the three largest banks —BANAMEX, BANCOMER and SERFIN— who controlled 90 percent of the market for consumer credit were reluctant to disclose information on their best clients.

As early as 1992, investors had already identified those banks that eventually experienced the largest capital deficiencies. In 1992, BANAMEX and BANCOMER raised funds at 11.8 percent, whereas the riskier banks had to pay 14.5 percent (Rojas-Suárez and Weisbrod 1995: 14). High-risk premiums lured investors to supply short-term funds to risky banks. These inflows, however, took place under conditions of extreme volatility. Investors were ready to pull away their funds as soon as any sign of financial distress appeared. In February 1993, Ramírez de la O, an analyst of the Mexican financial system, warned of a full-scale banking crisis within the following eighteen months (Wood 1993). Then, in July 1994 the American rating agency Moody's issued a report noting that Mexican banks lending was growing several times faster than the GDP (*The Economist*, July 30th 1994). According to *The Times* (July 24th 1998), between 1991 and 1994, loans grew 10 times faster than the economy.

Despite these warning voices, bankers, investors and most analysts believed that the non-performing loans problem was chiefly caused by the economic slowdown in 1993 and 1994. As soon as the economy slowed in the third quarter of 1993 (output shrank by 1.2 percent), non-performing loans emerged as a serious threat to the stability of the recently privatised banking sector. The ratio of non-performing loans to total loans climbed from 4.1 percent in December 1991 to 7.1 percent in September 1993 (*The Economist*, January 29th 1994).

By the mid-1990s, the 'Tequila' and Asian crises brought hard times to the banking sectors all over the emerging economies.[12] In Mexico, the banks' already fragile financial conditions were severely damaged after the peso devaluation in December 1994 and the subsequent economic slump in 1995. Non-performing loans rose from less than $7 million dollars at the end of 1992 to almost $28 million dollars just before the peso devaluation in December 1994 (*Proceso*, May 6th 1996). Non-performing loans represented more than ten percent of the total, a higher figure than those recorded in previous banking crises in other countries (see Table 8.3). To make things worse, the

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[12] According to Valencia (1997), in India and Indonesia, up to 20 percent of the state bank's loans, and 15 percent of the private bank's loans were non-performing. The figures for Taiwan are similar, where banks had little reserves to cope with losses. Lending policies in Thailand and South Korea also had detrimental effects for the quality of their bank's portfolios. In South-America, the countries most badly hit were Venezuela, whose banking system was already in crisis before the peso devaluation, Argentina and Mexico.

banks lost, after the devaluation, around 10 percent of their equity because of their foreign exchange exposure, weakening further their financial health (*The Economist*, October 28th 1995).

Table 8.3

Ratio of Non-performing Loans to Total Loans

Year	Country	Ratio
1980	Argentina	9.1
1982	Chile	4.1
1989	United States	4.8
1992	Finland	9.3
1993	Venezuela	9.3
1994	Mexico	10.6

Source: Rojas-Suárez and Weisbrod 1996: 12

As a result of the adjustment plan devised after the peso devaluation by the Ministry of Finance, headed by Guillermo Ortiz, interest rates hit 110 percent, inflation reached 52 percent, unemployment doubled and GDP decreased by 7 percent (*The Times*, July 24th 1998). The plan effectively stabilised the economy but at the expense of causing further damage to the banking system. As a result of the liquidity crisis, real interest rates remained above 30 percent during most of 1995 causing further defaults on banks' loans. Public spending, private consumption and investment decreased abruptly. The draconian adjustment brought about by the Ministry of Finance made the economy to shrink by 7 percent, sharply contrasting with the estimated growth of 1.5 percent considered in the agreement between Mexico and the IMF at the beginning of that year. At this point, the non-performing loans problems reached alarming levels and threatened to cause the collapse the whole financial system.

8.2 End-of-Sexenio Politics

Political factors were as important in the genesis of the financial crisis as the economic trends. Much of the political upheaval during 1994 was a reaction to the strong and exclusive exercise of presidential power by Carlos Salinas throughout most of the *sexenio*. The presidential power usually weakens during the last year of the term. Political groups, from the PRI and opposition parties alike, increasingly challenged the President's authority in this juncture. Electoral competition under President Salinas and

end-of-*sexenio* business cycle reduced the capacity of the government to steer the economy the year prior the crisis. Approaching presidential elections pushed the government to take decisions potentially harmful for the economy but necessary from electoral and power perspectives.

Electoral Competition

Relatively transparent electoral processes was a new feature of Mexican politics under President Salinas (see chapter three). Wining the popular vote in clean elections became the only legitimate way of remain in power, especially after the 1988 'collapse' of the system. This 'Schumpeterian' democracy forced the government to implement policies aimed to secure popular support for the PRI. President Salinas wrote in his PhD thesis: 'the state hopes to capitalise in the ballot boxes its economic effort because the competition for the vote will be much harder in the following years' (quoted by Borge 1993). This element introduced a new constraint on state policies. In fact, the financial policy in 1994 was subordinated to the political needs of the PRI for the presidential election that year.

When President Salinas took office in 1988, the most urgent issues in the national agenda were economic, i.e. bring down inflation, re-establish economic growth and increase personal income. The political costs of stabilisation and economic stagnation under President de la Madrid became evident from the results of the presidential elections in 1988. President Salinas had little political legitimisation as a result of the bungled elections and therefore sought to overcome this shortcoming by delivering good economic results. Since the onset of his term, Salinas stressed the importance of capital inflows to finance the structural transformation of the Mexican economy and to carry out the stabilisation programme without the natural economic slowdown associated to this kind of programmes. The results in the 1991 mid-term elections favouring the PRI, signalled the clear and strong support of the population to the government policies. But most important, confirmed the fact that electoral outcomes were linked to government performance.

Greater electoral competition pushed for policies with popular outcomes like lower inflation, higher economic growth and higher real income. An over-valued exchange

rate served the prime objective of anchoring domestic prices and consequently bring down inflation. However, as a by-product of this policy, exchange rate overvaluation boosted the purchasing power of the peso and produced a 'feel-good' factor that translated into support from the urban middle class to the government. According to Jorge Castañeda, President Salinas's liberal trade policies were improvisations to maintain an over-valued exchange rate and thus placate Mexico's fractious urban middle classes with cheap imports of consumer goods (quoted by *The Economist*, March 16th 1996). The Mexican state arguably needed the consumption boom that an overvalued exchange rate brought about in order to foster popular support in an increasingly competitive political system. Cheaper imports made easier for the population to bear the faltering growth observed during the second part of the *sexenio*.

Political Business Cycle

The political cycle associated to the presidential *sexenio* has been a permanent feature of Mexican politics since the 1940s and the relay of presidential power has been at the heart of these cycles. Most of the political activity in Mexico is organised by this temporal framework. However, the political cycle did not have strong pernicious effects on the economy until 1976, when for the first time economic imbalances became critical at the end of the *sexenio*. Economic cycles of boom and bust have repeated systematically at the end of each presidential term since then; devaluation and elections seemed to go hand-in-hand between 1976 and 1994.

Each President pursues their own government programme with determination and single-mindedness because of the fact that they have only six years to achieve their goals. According to José López Portillo (*Proceso*, May 12th 1997), each new President arrives with novel and exalted intentions, among which is to remove any remaining prestige from his predecessor's 'well-intended' government. The political system relied on breaks between incoming and outgoing Presidents to make the transition between one government to another. President López Portillo (1976-1982) made the point very clearly in the following account:

> '...some days before I handed over presidential power, the closest aide of my successor, in a dinner to which he invited my eldest son, confessed to him: 'at a

> personal level, friendship; but at a political level, we'll have to abuse your father in order to stabilise the country'. I accepted the fatality of the cycles I had to go through... The closest aide of Miguel [de la Madrid], is now, in turn, going through his own tribulation' (quoted by *Proceso*, May 12th 1997).

The system is always at its weakest in the last year of each sexenio, as the incumbent President prepares to deliver the power to his handpicked successor. As the time for the nomination of the PRI's presidential candidate approaches, the outgoing President gradually loses authority creating a vacuum of power in the political system. Excessive concentration of power in the executive makes very difficult to prevent the political uncertainty at the end of each *sexenio* from destabilising the economy (Philip 1998). President Salinas's decision to accommodate electoral competition while preserving PRI's hegemony instead of making a swift move to democracy preserved the essential conditions for the end-of-*sexenio* political crisis.

However no President faced the series of events at the margin of the legal and institutional framework as Carlos Salinas did. The President became increasingly isolated as 1994 went by, partly as a result of its own success. According to Jorge Castañeda, Salinas and his economic team of technocrats swept away the social checks and balances of Mexico's corporatist system without replacing it with more democratic institutions (quoted by *The Economist*, March 16th 1996). In Mexico, according to Torres (1997), a deliberate sharp fragmentation of authority articulated by a strong presidency was replaced with an unintended fragmentation of political power subjected to market forces. Holding regular cabinet meetings weakened the decision-making and arbitration powers of the President, while enhanced the role of the ministers in shaping policy by increasing its bargaining function. President Salinas's efforts at reasserting presidentialism along traditional lines in an liberalised economy failed as proved by the turbulent end of his term. The danger is that when the presidential grip weakens, there are no other institutions capable of playing an effective role (Philip 1996). As soon as the political instability surfaced associated to the natural weakening of the outgoing President and to the perceived weakness of incoming President, the economic safeguards put in place with the economic reform, including NAFTA, were clearly insufficient to prevent the run against the peso.

Most of the external observers were concerned with the result of the presidential elections in 1994 and paid little attention to the more subtle features of the Mexican political system, namely, the power vacuum created by a weakening outgoing President and a weak incoming President. Domestic investors were fairly more aware of this important political phenomenon with its potential consequences for economic stability. Foreign investors, in contrast, were relatively calm because their perception of political risk was confined to the electoral process, which was reasonably clear and transparent. Furthermore, foreign investors saw President Zedillo as a good substitute for Salinas in terms of his commitment to sound economic management.

Political Turmoil

By the end of 1991, Mexico's public finances were substantially sounder, the economy was growing, inflation was declining, and capital inflows were soaring. On the political arena, the PRI won the mid-term elections without resorting to major political reforms. In the President's view, PRONASOL was bringing social infrastructure to millions of impoverished Mexicans. This encouraging context allowed Salinas to prepare the ground for his own succession well in advance and without major constraints. The demise of the SPP in April 1992 and the creation of the ministry of Social Development (SEDESOL) were unmistakable steps in that direction (Torres 1997: 161). The President strengthened considerably the position of Pedro Aspe, minister of finance and Donaldo Colosio, minister of social development.

Nomination politics in Mexico under Salinas still took place inside the bureaucracy and not in the party or in the elections (see Torres 1997). Most of the political activity was structured around the nomination of the next President. Contending ministers brought together groups of support for their nomination and created important divisions within the executive. This divisions were especially damaging for the economic policy towards the end of the *sexenio*. The most notorious division took place when Manuel Camacho, then mayor of Mexico City, presented his resignation as a statement against the nomination of Luis Donaldo Colosio as presidential candidate for the PRI. This dispute was further exacerbated when Camacho was designated as the government's special peace envoy in the *Zapatistas* conflict in the southern state of Chiapas. At the end, this

personal conflict between Colosio and Camacho became one of the major elements damaging the political climate in 1994.

Stronger political competition and the experience in the 1988 presidential elections raised the issue of electoral appeal for the candidate. Despite the fact that Salinas used the state machinery to strengthen the position of the PRI for the elections, the lack of public appeal of Luis Donaldo Colosio at the beginning of his campaign posed some doubts on the eventual triumph of the PRI.[13] Colosio's campaign failed to produce social mobilisation partly because of Camacho's appointment as peace envoy in the *Zapatistas* conflict. This appointment not only revived Camacho's presidential ambitions and placed him in a position where he could fulfil them. However, it also triggered an explosive and fierce reaction from those who opposed him. This bureaucratic infighting hindered the ability of the PRI's candidate to consolidate his leadership and articulate enough support within the political elite.

The *Zapatistas* uprising in the southern state of Chiapas on January 1st 1994 gained great notoriety in the foreign press and wide support all over the world. Despite the fact that the conflict remained geographically limited, the movement raised a national issue. The *Zapatistas* were not a serious threat to the government's hold of power but they represented the best platform to denounce the failure of Salinas's policies to address national problems. In an election year, the movement alienated an important part of the PRI's popular constituencies. To make things far worse, Luis Donaldo Colosio was assassinated in late March 1994. The crime severely damaged the image of the President and the government. The nomination of Ernesto Zedillo as the replacement candidate, though welcomed by international investors, did very little to improve the political climate in Mexico. Zedillo was perceived as a weak candidate that could not consolidate the political and economic groups upon which the grip of the outgoing President was getting looser. The mere possibility that the PRI could lose in 1994 debilitated the system more than strengthened it. The political forces behind the PRI were not as committed and disciplined as before in the face of a possible defeat in the elections.

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[13] The nomination of Luis Donaldo Colosio, made public on December 8th 1993, was immediately overshadowed by Manuel Camacho decision to resign as Mexico City Major.

A week before Ernesto Zedillo took office, while he was in Washington greeting Bill Clinton, Mario Ruíz Massieu, special prosecutor to investigate the recent murder of his brother and PRI's secretary general, Francisco Ruíz Massieu, resigned alleging that Ignacio Pichardo, PRI's President, and other top officials were obstructing his investigations (*The Economist*, December 3rd 1994). All these events raised the question on the President's capacity to discipline the political elites. Beside these major events, there were other trends that also revealed the government's declining political control: the north of the country suffered an outbreak of drug-related violence; Alfredo Harp, chief executive officer of BANAMEX, was kidnapped; and economic growth proved more elusive than originally expected.

The problems were not circumscribed to the *Zapatistas* and the political elites but also included groups of support for the party at the grass-roots level. The results of President Salinas's efforts to restore popular support for the regime were mixed. The PRI won with a relatively comfortable margin over the other two major opposition parties in the 1994 presidential elections despite all the political turmoil of that year. Nevertheless, increasing protest mobilisations took place during that same year. For instance, in 1994 more than 1200 demonstrations and 550 marches —a daily average of five acts of protest were organised in Mexico City. On one day in March 1995, there were over 100 acts of protest. This and subsequent acts of street protests in the form of marches and demonstrations that culminated in a May Day rally of over 150,000 were followed in subsequent moths by a huge coalition of ten diverse social movements and organisations of farmers, peasants, independent business operators, workers and Non-Governmental Organisations (NGOs) to reject the state's economic model (Veltmeyer et.al. 1997: 51).

8.3 Policy Mistakes

In hindsight, most actors (public officials, investors and economic analysts) agree on the major policy mistakes leading to Mexico's financial crisis in 1994—the government delayed corrective action on the exchange rate and replaced CETES by short-term-dollar-denominated TESOBONOS. However, at that time, policy calculation became less precise because of financial liberalisation. In the preceding months to the devaluation, financial authorities were unable to anticipate the size of potential capital flight and the political turmoil. Furthermore, effective electoral competition pushed the

government to use their optimistic scenarios of capital flight and hold off devaluation. According to Summers (1995) there is natural tendency magnified by the political process in every country, to regard good news as permanent and bad news as transitory. However, capital inflows are often the result of transitory changes in the international context, while outflows are usually the sign of structural problems.

Expansionist Economic Policy

The first major policy mistake of the government was to indulge in expansionist economic policies just before the presidential elections. Governments under democratic regimes often make the same mistake producing a political business cycle (see Alesina and Sachs 1988). President Salinas had to many commitments difficult to reconcile at the end of his sexenio: continue economic reform, keep inflation down, clean elections and PRI's electoral triumph. Policy decisions during 1994 clearly subordinated the economic issues to the political priorities of the government. Despite the risk of a new surge in inflation or the collapse in the exchange rate, economic policy was strongly expansionist throughout that year.

Apparently the government did not increase public spending in any substantial way during 1994, the final balance in the public finances was a modest deficit equivalent to 0.3 percent of GDP (Presidencia de la República 1995: 51). However, the government relied on quasi-fiscal operations to expand domestic credit and public spending.[14] The operations of development banking were removed from the balance sheet of the federal government in 1993. This accounting trick misled many observers and investors regarding the real source of Mexico's economic strength. Interest rates remained relatively stable throughout 1994 with a downward trend in the second part of the year. The rate paid on CETES went from 16.32 percent in May to 13.74 percent in November and the rate for TESOBONOS stayed around seven percent all the time (Presidencia de la República 1995: 59). Decreasing interest rates were the result of a strong expansion of domestic credit rather than economic strength. The money supply (bills and short-term banking deposits) jumped from 32.9 percent of the GDP in 1993 to 36.3 in 1994.

Banking deposits was the component with the largest growth, more than 27 percent in real terms (Presidencia de la República 1995: 56).

The government used development banking and BdeM to expand domestic credit. Credit allocated from the domestic banking sector (BdeM, development and commercial banks) increased from 57.8 percent of the GDP in 1993 to 81.3 percent in 1994. Development banks lending, a form of off-balance public spending, increased from 14.2 percent of the GDP in 1993 to 21.7 percent in 1994; BdeM's lending expanded from 1.6 percent of the GDP to 5.8 percent (Presidencia de la República 1995: 62). Government banks (BdeM and development banks) observed a remarkable increase in their credit portfolio during 1994: more than 60 percent increase in real terms. This abrupt increase in domestic credit deteriorated the financial health of development banks: the ratio of capital to credit fell from 7.8 percent in December 1993 to 4.9 percent in December 1994 (Presidencia de la República 1995: 61). The equivalent figures for commercial banks were 9 and 7.6 percent respectively (CNBV 1995: 21, 24).

'Dolarisation' of the Public Debt

Mexican authorities believed that the decreasing appeal of Mexico's capital markets to foreign investors was the result of temporary shocks (i.e. political turmoil and raising interest rates abroad) (Ortiz 1996: 217). The government responded by raising interest rates and issuing short-term, dollar-denominated TESOBONOS in vast quantities. TESOBONOS were issued during 1994 in order to signal the government commitment not to devalue the peso. The 'dolarisation' of the public debt was a government decision that caused great economic distress after the devaluation. At first, this decision was intended to prevent devaluation; but as dollar-denominated debt piled up, devaluation became ever more costly and corrective action became ever more unlikely.

During 1994 Mexico faced increasing difficulties to preserve the size of capital inflows amounting to $21 billion dollars per annum on average since 1990 (or $2 billion dollars per month) (Presidencia de la República 1995: 68). Given the need for these inflows for

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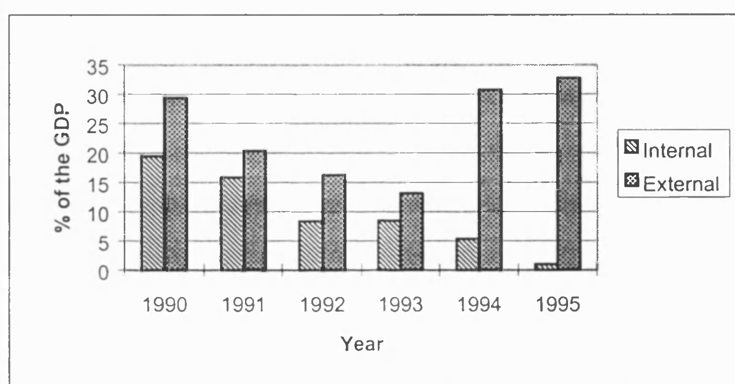
[14] Quasi-fiscal operations are those undertaken by government organisations not included in the public accounts. For instance, BdeM's lending to development banks or other public agencies is not included in the public deficit.

the stabilisation and opening up programmes combined with the political events, domestic investors changed the composition of their investment portfolios, and the firms changed the structure of their liabilities. Domestic investors (firms and banks) reduced their holdings of government securities by more than 40 percent between March and November. Foreign investors followed their domestic counterparts and reduced their holdings of CETES by more than 50 percent. However, they increased abruptly their holdings of TESOBONOS to more than $18 billion dollars.

Figure 8.1

Public Indebtedness



Source: Presidencia de la República 1995: 53

The government increased its exposure to currency-risk by issuing dollar-denominated TESOBONOS. As a result of the devaluation, external indebtedness (denominated in pesos) jumped from $149 billion pesos in 1993 to $385 billion in 1994, an increase of more than 150 percent (see Figure 8.1). The liquidity crisis arose from a temporary inability to repay the TESOBONOS since international reserves were nearly depleted trying to support the peso and avoid devaluation throughout 1994. After the devaluation, foreign investors refused to rollover their holdings of TESOBONOS[15] leaving the government with the difficult task to raise $22 billion dollars to repay the dollar-denominated debt due in 1995. In the second half of January alone, the government needed $2.2 billion dollars (*The Economist*, January 14th 1995). According to the *Financial Times* (February 15th 1995) if all $28 billion dollars of TESOBONOS due to mature in 1995 were staggered so as to repay $5 billion dollars a year from 1996 on,

[15] In the auction of January 10th, the government managed to place only 20 percent of the $400 million dollars offered (*The Economist* January 14th 1995).

there would be no crisis. Those extended principal payments could be met, along with punctual payments of interest. January 1995 went down, as the month when the enthusiasm for emerging bond and equity markets was suddenly moderated (*Financial Times* April 22nd 1995).

Exchange Rate Overvaluation

The main differences between countries that suffered the consequences of the Tequila crisis like Mexico and Argentina and those that escaped it like Chile and Colombia were the exchange rate policy and controls on capital inflows. Mexico and Argentina used the exchange rate for stabilisation purposes and removed all controls on capital inflows. The devaluation of the Mexican peso in December 1987 produced an exchange rate estimated undervalued by 32 percent as part of the PSE (Solís 1996: 87). Since then, the government used the exchange rate as a nominal anchor for domestic prices and started a process of continuous real appreciation. Sometime in 1991, the exchange rate reached the equilibrium level and thereafter, it became increasingly overvalued. Solís (1996: 87) estimated that the exchange rate was overvalued by 48 percent at the time of the devaluation in December 1994. The government did not attempt to bring back the exchange rate to its equilibrium level. Instead the government emphasised capital inflows to finance the current account deficit resulting from a clearly overvalued exchange rate.

The current account balance deteriorated substantially between 1988 and 1991. The current account deficit recorded a dramatic increase: from 3 percent of the GDP in 1989 and 1990 to 5 percent in 1991 and then to almost 7 percent in 1992 and 1993 (Presidencia de la República 1995: 68).[16] The Ministry of Finance insisted that the deficit was not a problem because it was financed voluntarily from private investors and the capital inflow was paying for private investment rather than government deficits.

As early as 1992, the financial markets sent the first signals of their potential volatility: in June the main index of the BMV, fell by 14 percent after it soared by 111 percent in

[16] The current account balance went from a small surplus in 1987 to a deficit of $7.11 billions in 1990 (INEGI 1994: 900).

1991 and 25 percent more in January and February; Mexico lost up to $2 billion dollars in foreign exchange reserves in June, before the interest rates were raised to stem the flow (*The Economist* July 17th 1992) Early in 1993, Rudiger Dornbusch, a professor at MIT and mentor of Pedro Aspe, told Wall Street investors that a devaluation of the peso was unavoidable (*The Economist*, May 29th 1993). Throughout 1994 several analysts insisted on the dangers of an overvalued exchange rate. On July 18th, Marcel Ospel, head of Swiss Bank Corporation's International Division, called for a devaluation of the peso if Mexico was to keep foreign investment flowing into the country (*The Economist*, July 23rd 1994). According to Lawrence Summers (1996: 211), deputy-secretary of the American Treasure, the particular combination of Mexican monetary and exchange rate policies was not sound, and these policies were certain to collide, sooner of later.

According to *The Economist* (July 23rd 1994), in the first three weeks of July domestic investors sold over $100 million dollars-worth of pesos a week in the exchange market. Between January and December 1994 international reserves fell from $24 billion dollars to slightly more than $6 billion dollars. Despite waning investors confidence early in 1994, President Salinas and his economic team stuck unwaveringly to its commitment to keep the peso within a fixed band against the dollar. Salinas's economic team did much to preserve economic stability and the value of the currency throughout 1994 despite the continuous political turmoil. BdeM, supposedly autonomous, fully supported the President's position and hurled money into the currency and money markets. The American and Canadian governments also backed the position of the Mexican government not to devalue the peso. In April 26th, the monetary authorities from Canada and the US announced an agreement on a permanent $8.8 billion dollars swap facility to defend the peso (*The Economist*, April 30th 1994).

Blundered Devaluation and Capital Flight

Investment confidence deteriorated as a result of unreliable information regarding the levels of government indebtedness. According to Solís (1996: 87), economic analysts in foreign investment banks received different figures from the BMV, BdeM and the Ministry of Finance. BdeM also kept undisclosed the figure of international reserves for a long time. The severity of the crisis was heightened as a result of the lack of precise

and timely information. This situation prevented corrective action and produced an over-reaction on the side of the investors to the devaluation of peso. The mishandling of the affair exacerbated the consequences of the peso devaluation. The blundered devaluation was translated into a vicious circle. Jaime Serra Puche, minister of finance at the time, did not anticipate a run against the peso as large as the one that actually took place and therefore did not make any provision to secure the payments on the short-term public debt. Investors refused to rollover their holdings and the few that accepted demanded sharply higher yields to do so. The cost and the amount of funds required to refinance the state skyrocketed.

According to a recent report of the IMF (Kramer and Smith 1995) better-informed Mexican investors rather than foreign investors triggered the devaluation on December 19th and the subsequent liquidity crisis. The report asserted that foreign investors sold only $326 million dollars-worth of government bonds, and actually made net purchases of equity during the three weeks before the devaluation. However international reserves fell by a significant $2.8 billion dollars. Mexican investors also mainly carried out the run against the peso after the initial devaluation. The figures for December are far more dramatic: foreign investors sold only $370 million dollars-worth of bonds and equity, while international reserves tumbled by $6.7 billion. The current account deficit represented only $1.7 billion dollars, capital flight of Mexican investors accounting for the rest. Foreign investors, according to Kramer and Smith (1995) only started to sell their holdings of government securities on a grand scale in February 1995.

Domestic investors clearly had a better idea about the precarious financial conditions of the state and therefore about the prospects of a devaluation than foreign investors. Although the Ministry of Finance and BdeM kept crucial information regarding the level of international reserves undisclosed for very long, domestic investors managed to determine the government's inability to defend the peso against an speculative attack. Domestic investors beat the government as to the extent of how sustainable the exchange rate was. The ability of the Mexican state to deal with the private sector is seriously weakened by the ever-present threat of capital flight; no developed country currently faces this difficulty to any similar degree (Philip 1998b).

8.4 Outcomes

The 1994 crisis further changed the configuration of Mexico's financial system. Banks' weakening financial health forced the government to step in and avoid a major collapse of the system. The government took two main decisions to face the crisis in the banking sector: open up the sector to foreign investment and bailout the whole system. A new round of mergers and acquisitions took place after the crisis, where many foreign banks took over troubled banks and other medium-sized banks merged among them. But most important, the legacy of the 1994 crisis for the following years was a huge burden in the public finances as a result of the banks' bailout.

Foreign Investment

President Salinas opened up the financial system to foreign investment only partially. At the beginning foreign firms were not allowed to own a majority stake in any domestic bank and their market shares were circumscribed to a pre-set limit. In 1994, Guillermo Ortiz, deputy minister of finance at that time, said that 18 foreign banks and 16 brokerage houses were ready to start operations in Mexico (*Associated Press*, October 22nd 1994). It was estimated that they could provide more than $5 billion dollars, in lending in their first year.[17] Then, during the IX Bankers Convention, Pedro Aspe, announced the formal authorisation to 52 foreign financial firms—banks, brokerage houses and insurance companies (see Table 8.4) It was an explosive opening up, at least, on paper. If all the foreign and domestic financial firms that received an authorisation would had started operations in Mexico, the system would have increased from 18 commercial banks to 117 financial firms (*Business Mexico*, January 1995). At the end, these financial firms did not start operations because of the uncertainty produced by the 1994 crisis.

According to the original schedule for opening up the financial system, signed under NAFTA, complete liberalisation was due for the year 2000. This schedule was modified

[17] From experiences in other countries, foreign banks were unlikely to go into the retail banking business; instead they usually concentrate on corporate banking. They were expected to compete with the large domestic banks to serve the high-income segment of the market: treasuries from blue-chip companies, high-income customers, and transnational corporations.

in February 1995, after the collapse of the peso, as part of a programme to capitalise the banks. The government allowed foreign firms to fully own domestic banks (*Proceso*, May 6th 1996). The government changed the legal provisions on foreign ownership a couple of times, gradually making the financial system more open. Then, in June 1995, the Ministry of Finance tried to entice foreign banks to lend by offering them the option to swap their debt for equity in Mexican banks (*The Economist*, July 1st 1995). Foreign banks, which were barred from taking part in the bank privatisation in 1992, were urged to invest in the banking system only five years later.

Table 8.4

Foreign Financial Firms Entering Mexico

Financial Groups	Banks	Brokerage Houses	Insurance Companies
Associates Caterpillar Chemical Chrysler Citicorp Ford Credit GE Capital ING Group JP Morgan Santander	AMN-AMRO American Bank AMEX Bank Santander Bank of Boston Bank of Tokyo Societe Generale Chase Manhattan Chemical Bank Citibank Dresdner Bank First Chicago Fuji Bank ING Capital JP Morgan Nations Bank Republic New York Bank Banke Nationale de Paris	Citibank Bankers Trust Baring Securities Bear Stearns Chemical Bank Deutsche Bank Goldman Sachs Indosuez ING Securities James Copel JP Morgan Lehman Brothers Merryl Lynch Morgan Stanley Santander Swiss Bank	Allianz of America American Bankers Insurance Combined Insurance Co. ING Insurance Pioneer Life Insurance Co. Reliance National Insurance Co. Tokyo Marine Transocean Holding Corp. Windsor Insurance Zurich (Damage) Zurich (Life)

Source: *Business Mexico*, January 1995

Even prior to the crisis there were some cases of foreign investment into domestic banks. By the end of 1993, three foreign banks had stakes in Mexican banks: Bank of Nova Scotia from Canada controlled 5 percent of GF INVERLAT; Banco Bilbao Vizcaya from Spain controlled 20 percent of GF PROBURSA; and Banco central Hispano also from Spain controlled 20 percent of GF Internacional (*Financial Times*,

November 10th 1993). Domestic banks also tended to consolidate and by the end of 1993, three financial groups have already merged: Banco UNION and Banca CREMI, two multi-regional banks; BANCRECER and BANORO, a multi-regional and a regional bank; and Grupo AFIN and BANORTE, a brokerage house and a bank (*Financial Times*, November 10th 1993). Foreign investment surged after the changes to the law in 1995. Spanish and Canadian banks were the most active investors in this second round of acquisitions (see Table 8.5)

Table 8.5

Mergers and Acquisitions

Bank	Buyer	Country	Date	Operation
CREMI	UNION	Mexican	n.a.	n.a.
PROBURSA	BBV	Spain	May 1995	$175 m. dollars for 70 percent
BITAL	Banco Central Hispano	Spain	August 1995	plans to acquire
INVERLAT	Bank de Nova Scotia	Canada	July 1996	$225 m. dollars for 55 percent
SERFIN	Hong Kong Shanghai Bank	Hong Kong	May 1996	buy between 16 to 20 percent
BANCOMER	Bank of Montreal	Canada	February 1996	$600 m. dollars for 20 percent
INVERMEXICO	Santander	Spain	1996	$372 m. dollars for 100 percent
ORIENTE	BBV	Spain	June 1996	plans to acquire
BANORTE	Investment Fund	American		24 percent
UNION	PROMEX	Mexican	n.a.	n.a.
BANPAIS	BANORTE	Mexican	n.a.	n.a.
CONFIA	Citibank	American	1998	controlling stake

Source: *Proceso*, May 6th 1996; *The Economist*, April 23rd 1996; *The Economist*, January 24th 1998; Mergers and Acquisitions Database, *FT Profile*.
n.a.=not available

At present it is possible to have complete ownership of any bank whose assets represent less than 6 percent of the entire system. So far, foreign investors have paid roughly $2 billion dollars for five Mexican banks. According to Valencia (1997) foreign ownership rose from 2 percent of total banking assets in 1995 to around 10 percent one year after. Ana Bofin, head of Mexican operations of SANTANDER bank, claimed that foreign investment was already changing the configuration of the Mexican banking system (quoted by *The Economist*, April 23rd 1996).

Banking Bailout

The government usually has four main ways to deal with troubled banks. First, liquidation: the authority pays off insured deposits and sells any residual assets. Second, closure by merger: the government promotes the merger between a sick bank and a healthy one—regulators offer the rescuer an incentive, usually withholding a portion of the non-performing loans. Third, government loans or transfers: the government cleans up the banks balance sheets by acquiring their worst assets, usually through an agency which holds the bad assets until they mature or can be sold.[18] Fourth, outright nationalisation: the government takes over the ownership and administritation of the banks.

The immediate response of the Ministry of Finance to the banking crisis had three components: a dollar window in BdeM to enable banks to straighten out their mismatched dollar-denominated assets and liabilities; a re-capitalisation programme for specific banks; an interest rate reduction for small and mid-sized debtors. As the financial situation of the banks deteriorated and the government had to implement a comprehensive bailout. Mexico's banking bailout was a combination of the second and third options. The government did not liquidate any bank but promoted several mergers. In the cases of corruption, the financial authorities took over the banks' management but only long enough to restructure it and find a buyer.[19] The state through FOBAPROA (Banking Fund for Savings Protection)[20] took over the portfolio of non-performing loans from collapsing banks burdened also with scandals of corruption and money laundering. FOBAPROA exchanged non-performing loans for 10-years government bonds paying market rates, took over collapsed banks, restructured them and later on sold them.

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[18] Examples of these agencies can be found in Sweden (Securum), the US (Resolution Trust Company), and Japan (Co-operative Credit Purchasing Company).

[19] Venezuela faced a similar banking crisis in 1994. The government bailout, estimated at $10 billion dollars or 13 percent of the GDP, went into banks whose problems were mainly caused by inefficient and/or corrupt management. At the end, the government was forced to take over 17 out of 41 banks in the system.

[20] FOBAPROA (Fondo Bancario de Protección al Ahorro/Banking Fund for Savings Protection), funded in 1990, is Mexico's equivalent of the US Resolution Trust Company, funded 10 years earlier to deal with the Savings and Loans crisis. FOBAPROA is allowed to buy and sell banking loans, capitalise banks, take over and sell assets.

The immediate antecedent of FOBAPROA was FONAPRE (Banking Fund for Preventive Aid), created in 1984 as a result of the reform to the LGIC. It was a fund managed by BdeM and financed by the then state-owned commercial banks. A technical committee headed by the Ministry of Finance directed credits to ailing banks. By being ready to bailout any bank and prevent its failure, FONAPRE indirectly guaranteed all of the banks' deposits and liabilities. Well known examples are the fund's assistance to BACRECER, BCH (now UNION) and BANPAIS (*Business Mexico*, April 1991). The last one made a successful recovery that allowed it to be one of the first three banks offered for sale.

FONAPRE was replaced by FOBAPROA because the government wanted to reduce its exposure to a possible banking collapse once the banks were privatised. At first, the reform to the fund was intended to make sure the government did not get stuck with the bill in the case of a massive bank failure, as happened in the US. Although the technical committee was made up of nine members from the Ministry of Finance, BdeM and the CNBV, the government did not finance the fund. Banks contributed 3 pesos per 1000 pesos of insured deposits each month. Because of the reform, the fund covered only certain deposits (i.e. checking accounts, savings accounts, and all bank promissory notes). The reforms tightened the requirements to ailing banks for receiving credits: guarantees for borrowing and prompt repayment. Furthermore, the reform considered the possibility to increase the banks' contributions from 3 to 7 pesos per 1000 pesos of insured deposits in case several banks overwhelmed the fund (*Business Mexico*, April 1991). However, all these condition and safeguards were completely irrelevant once the banking sector threatened to collapse massively. The government stepped in, regardless of the enormous size of the bailout and did not call for extraordinary contributions.

On July 15th 1994, FOBAPROA concluded the first major deal to reschedule the banks' non-performing agricultural loans, estimated to represent a fifth of the total overdue loans at that time (*The Economist*, July 30th 1994). As part of the deal, FOBAPROA agreed to guarantee some of the principal of the rescheduled loans. Then, in 1995, FOBAPROA agreed to take some $700 million dollars in non-performing loans off the books of PROBURSA; in return, BBV agreed to inject about half that much in new money into the bank and to take control of it. Banca SERFIN, the third largest bank, looked for a similar deal at that time (*The Economist*, July 1st 1995). Eventually, most of

the banks, including BANAMEX and BANCOMER, sold part of their non-performing loans to FOBAPROA.

Early in 1996 officials from BdeM and the Ministry of Finance estimated the cost of the bailout around 5 percent of the GDP. However, Moody's, according to *The Economist* (March 23rd 1996), anticipated that the cost could be three times that figure because of slower growth in 1995. At this time, FOBAPROA already owned 13 percent of the banks non-performing loans. By mid-1998 the size of the banks bailout reached $61 billion dollars, equivalent to 14 percent of the Mexican GDP (*The Times*, July 24th 1998).[21] According to *The Times* (July 24th 1998) the state pays to the banks for interest on its bonds $11 billion dollars a year, equal to 2.7 percent of the GDP. The Mexican bailout ranks among the most expensive in the world's banking history (see Table 8.6). The Scandinavian countries faced a similar banking crisis in the late 1980s. The size of their bailout reached $16 billion dollars between 1989 and 1992. Around the same time, the US savings and loans system collapsed and the government spent, though difficult to know exactly, around $150 billion dollars (*The Economist*, March 25th 1995).

Table 8.6

The Cost of Banking Bailouts

		Cost as a Percentage of	
Year	**Country**	**GDP**	**Total Loans**
1982	Argentina	13.0	42.5
1985	Chile	19.6	22.5
1985	Colombia	6.0	40.0
1988-1992	Norway	4.5	5.5
1989	US Commercial Banks	1.5	3.9
1991	US Savings and Loans	5.1	7.8
1991-1993	Sweden	4.5	5.5
1991-1993	Finland	8.2	9.7
1994	Venezuela	13.0	57.2
1998	Mexico	14.0	n.a.

Source: Rojas-Suárez and Weisbrod 1996: 11; *The Times*, July 24th 1998

The Congress approved the conversion of FOBAPROA's liabilities into public debt in the 1998 budget but only after long and exhausting negotiations between the Ministry of

Finance, the PRI and the opposition. In the meantime, uncertainty raised the costs for the economy, for the banks and for the bailout itself: interest rates remained high, which caused further defaults on loans, banks stopped lending completely, and jeopardised the banks' capitalisation programmes. Once more, the banks bailout showed how much the government is committed towards the financial sector, regardless of institutional arrangements. A government official, quoted by *Business Mexico* (April 1991), accepted that 'even the smallest Mexican bank, Banco de Oriente, is not expected to fail'.

Finally, FOBAPROA was not free from corruption and actually was accused of corrupt and illegal transactions in several occasions. In 1994 the fund poured loans into Carlos Cabal's UNION and CREMI banks, which collapsed anyway some time later in the middle of a corruption scandal. Those were the first rescue operations of the fund (*La Jornada*, November 11th 1998). Then in 1996, the fund lent $80 million dollars for seven years at 3 percent interest rates to Grupo Lomel, whose owners were on the FOBAPROA committee that handled the loan (*The Times*, July 24th 1998). It is noteworthy that FOBAPROA's charter bars the fund from lending.

Conclusions

At a structural level, the financial reform failed to raise the level of domestic savings, which is often attributed as the ultimate cause of the 1994 crisis. At an operational level, financial liberalisation re-directed capital inflows from commercial loans into volatile portfolio investments. Regarding the banking sector, the combination of privatisation and liberalisation produced a lending and consumption boom mostly financed by external savings. Between 1989 and 1993, aggregate demand grew by 5 percent per annum on average in real terms, whereas production grew by less than 3 percent only. The gap was filled with an increasing current account deficit, which rose to 8 percent of the GDP in 1994, higher even than it had been on the eve of the 1980s debt crisis (Presidencia de la República 1995: 21,68; INEGI 1994: 892). Finally, the government used the exchange rate as an anchor for price stabilisation. Between 1988 and 1990 the pre-determined annual rate of devaluation fell from 16 to 3 percent, well below the

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[21] Some estimates put the figure above $75 billion dollars (Patricio Nelson, US economist, quoted by *The Times*, July 24th 1998).

differential between internal and external inflation. In the policy trade-off between realistic devaluation (and risking feeding inflationary expectations) and devaluation below inflation (despite the harm to the exporting sector) it was systematically chosen the last option.

Some of the events that triggered the devaluation in December 1994 —political turbulence, a widening current-account deficit, a pre-election public-spending spree and a lax monetary policy— cannot be attributed to the financial reform. Nevertheless, the size of the run against the peso was possible because capital was free of controls in the new financial framework; 'the markets simply lost their heads' (*The Economist,* October 7th 1995). Fernando Solís accepted that 'we have never seen a run against Mexican securities nearly as large as the one experienced in the aftermath of the peso devaluation' (Interview: Mexico City, September 1st 1995).

The causes of the financial collapse were a mixture of policy misjudgements and adverse circumstances, but the depth of the crisis was mostly the result of the financial reform. The political economy that emerged from the financial reform promoted by the Salinas's government and the increasing electoral competition reduced the space for policy management. The combination of political change and financial reform prevented policy makers to take corrective action earlier in 1994 to avoid the collapse of the peso. End-of-*sexenio* institutional weakening and the most contested presidential elections in post-revolutionary Mexico produced policy paralysis in the months before the devaluation. The poor health of the banking system associated to the financial reform (banking deregulation and privatisation mainly), also ruled out the possibility to devaluate the peso.

Deregulation of banking operations and the banks' privatisation produced new business practices in the financial system. Institutional changes in the financial system unleashed market forces leading to an excess of 'animal spirits'. Government and bankers alike, in an under-banked economy, tried to align the lending levels in Mexico to those in the OECD countries, but without having the risk management systems available in those countries. There were serious gaps in the banks' supervision: reporting procedures and provisions for non-performing loans were inadequate. Excessive lending to high-risk borrowers boosted the level of non-performing loans. Then, the devaluation reduced the

banks' capitalisation and high interest rates increased the level of non-performing loans. Many banks came to the brink of collapse.

In hindsight, the two major policy mistakes in 1994 were the delay of corrective action in the exchange rate and the replacement of CETES by the dollar-denominated TESOBONOS. Other minor mistakes, were the lack of reliable and timely information on international reserves and public debt. Exchange rate over-valuation produced a non-sustainable current account deficit. The substitution of CETES by TESOBONOS magnified the consequences of the devaluation and transformed what was supposed to be a simple misalignment into a full-scale financial crisis in the state finances. Some of the policy mistakes leading to the 1994 crisis were clearly associated to the lack of accountability of the presidency. For instance, the President used development banking credit, a kind of quasi-fiscal spending, to expand aggregate demand without the Congress approval in the months preceding the elections. As one member of Zedillo's economic team clearly put it: 'If there had been any real checks on the executive in 1994, we simply would not have been able to issue nearly $30 billion dollars of dollar-denominated debt behind Congress back' (quoted by *The Economist*, March 14th 1998).

Economic reform was needed to lure foreign investors but political reform is needed to discipline domestic investors. Foreign investors who remained confident in the economic prospects even after the devaluation did not trigger the crisis, but domestic investors who knew the strong link between the economy and the political calendar. The state have had usually little control over capital in the last year of each *sexenio*, but in the case of Salinas's *sexenio* this control was virtually non-existent. The main causes were being the financial reform and a simultaneous process of political transition. A fixed exchange rate policy combined with expansionist fiscal and monetary policies were at the heart of the runs in 1976 and 1982. In 1994, a semi-fixed exchange rate policy with a completely open economy produced the current account deficit behind the run. However the trigger has always been capital flight during the last year of the *sexenio*. The structural causes of the economic disruptions at the end of each *sexenio* may have changed but the trigger remained the same. The margin for economic miscalculations has become increasingly narrow in Mexico as the economy and the financial system has become increasingly integrated to the world economy. The threat of capital flight is greater than ever.

Conclusions

At the outset of this research project, when I was trying to identify the main elements of Mexico's financial reform under President Carlos Salinas, four main themes came forth consistently, namely: financial globalisation, political democratisation, institutional change and financial collapse. Throughout the thesis I also found that the financial reform was relevant for the discussion of an important theoretical issue: the autonomy of the state. The conclusions are organised into five sections—one for each main theme.

The financial reform was part of a wider and global programme of economic restructuring triggered by the 1982 'debt crisis'. At a global level, the crisis persuaded Multilateral Financial Organisations (MFOs)—mainly the World Bank and the International Monetary Fund (IMF)—and domestic governments that a state strongly involved in the economy becomes very vulnerable to economic swings. At a domestic level, the crisis jeopardised the economic and political leadership of the Mexican state. The reform responded to both external influence and domestic politics. Increasing dependence on the world economy forced the state to align its policies with the dominant economic orthodoxy. Increasing electoral competition pushed the state to re-engineer economic institutions in order to re-establish its political leadership.

Financial reform in Mexico took place despite the fact that the electorate was not particularly pro-market: Salinas was effectively challenged by a left-wing coalition in the 1988 presidential elections. The reform was not the result of an electoral mandate; it was rather the result of a technocratic initiative. A state elite committed to the imposition of a policy paradigm directed from above, the reform (Centeno 1994: 4). The specific content of the reform was shaped by the convergence of two trends: first, a 'revolution of the market', consisting in global economic integration and domestic economies increasingly driven by market forces; and second, a 'technocratic revolution', in which the most important positions in the Mexican state were captured by a group with very well defined policy preferences favouring liberalisation. The stated objective for the reform was mainly to create a flexible and stable financial system where decisions on savings and investment could be made efficiently and in a growth-oriented way (Aspe 1993; Ortiz 1994).

State Autonomy

The state is the political unit at the intersection of the external and internal dimensions of policy reform. The survival of domestic states is conditioned to a great extent by external factors, especially financing and political recognition, on the one hand; and states are the most influential organisations in domestic political systems, on the other. According to Theda Skocpol (1985: 9), 'the linkage of states into transnational structures and into international flows of communication may encourage state officials to pursue transformative strategies even in the face of indifference or resistance from politically weighty social forces.' Following the tradition of Schumpeter (1934), Hirschman (1958), Gerschenkron (1962) and, more recently, Evans (1992), I place the emphasis on the policy networks that connect domestic organisations with international capital within a 'developmental' state. Internal autonomy breaks up the existing alliances favouring the *status quo*, whereas external connectedness provides the initial drive for reform (Veltmeyer et.al. 1997: 95).

The autonomy of the Mexican state is rooted at the first level, in the PRI, an electoral machine that secures electoral legitimacy rather than articulating the interests of the electorate. At the second level, the autonomy is based on a tacit alliance with large business that has developed effective mechanisms of communication and policy co-ordination with the state. Finally, at the third level, an extremely powerful President and a coherent executive bureaucracy allowed the state to pursue its own priorities and shape its policy agenda according to their preferences. The President has the ability to re-engineer the political institutions every six years. The state is sensitive to business groups demands and popular needs since the regime is built upon the tacit alliance with business groups and now includes increasing electoral competition.

Mexico's financial reform under President Salinas shows how policy decisions are determined by the convergence between two different, though interrelated, sets of variables: international trends in policy-making and domestic political institutions. The first determines the range of feasible policy options available to the state; it highlights the context that set the parameters of political action, whereas the second shapes the interaction between the different actors within the system, giving a more precise insight into the institutional and circumstantial variability of political processes.

Each one of the reforms to the financial system supports the original claim: external dependency and internal autonomy brought about policy reform under President Salinas. However, this finding seemingly turned the autonomy of the Mexican state into a puzzle (see Bazdresch and Levy 1991). According to the evidence found, the state is highly receptive to the policy preferences of capital and, at the same time, the state has institutional resources to align coalitions of support for its policies. To answer this puzzle I approached the question of state autonomy from a different angle. I accept that external dependency, meaning the need for external financing, confines the set of feasible state policies to those agreeable to international capital. However, I recognise that institutional arrangements in the Mexican political system create a policy space where the state operates to secure its own reproduction and survival. This is very close to the notion of embedded autonomy developed by Peter Evans (1995). In the case of Mexico, however, this combination does not always deliver a developmental state where internal coherence and connectedness blend into growth-conducive policies.

Finally, state autonomy does not represent an absolute and fixed condition but the capacity of the state to exercise its own initiative within a given policy space. Consequently, this capacity changes depending on the political leadership and the specific historical and institutional context.

Financial Globalisation

As a result of changing conditions in the world political economy, economic reform became an imperative for governments in developing countries. The thesis identified two major changes, namely: financial globalisation and the emergence of a new economic consensus in rich countries and MFOs. The combination of these two trends fostered a phenomenon of 'policy bandwagoning' (Ikenberry 1990). Developing economies urgently needed to accommodate themselves within the new dominant economic paradigm of 'free market'. Financial globalisation increased the competition for investment—governments expected to attract and retain as much international capital as possible (Maxfield 1997: 35). The competition for capital pushed governments in these economies to implement similar policies to those in vogue in the rich countries.

Financial globalisation increased the 'policy leverage' of international capital. Despite the fact that Mexico was running healthier finances in 1988, the government was still highly indebted and, therefore, needed access to international capital to rollover its outstanding balances. In addition, structural features of development meat that developing countries tended to run deficits on their current accounts (Villareal 1988). The current account deficit in the second part of Salinas's *sexenio* further increased the dependence on capital inflows.

By the time President Salinas took office, securities issues had already replaced bank loans as the main instrument for state financing. Capital inflows under the new framework were guided by signals of economic prospects and 'sound' economic policies. This scheme implied a whole set of coherent decisions aimed at improving the investment climate according to international standards. The content of the reform to the financial system—financial liberalisation, development banking reform, banks' privatisation and central bank autonomy—conformed to the policy ideas promoted by a powerful coalition of transnational interests.

Intellectual developments and re-alignments between support coalitions fostered a new consensus regarding economic policy. In what could be called a 'global revolution of the market', neoliberal ideas and liberalisation policies spread all over the world; neoliberalism became the new unrivalled orthodoxy (Centeno 1994: 22). MFOs played an important role in the 'universalisation' of orthodox economic ideas. Contrary to common belief, these organisations were more effective at fostering reform through the construction of a common base of consensual knowledge than through direct conditionality. I found that shared, and often imposed, ideas were the communication mechanism between domestic policy makers and MFOs. President Salinas's economic team featured great ideological homogeneity. Not only were policy preferences shared by the members of this team, but also a way of perceiving and analysing social problems that distinguished them from alternative coalitions.

The new orthodoxy favoured policy coalitions advocating policies like privatisation, deregulation and trade liberalisation. Mexico observed a shift in the balance of power favouring the financial coalition. The efforts of both Presidents de la Madrid and Salinas to regain credibility with international investors and creditors strengthened the position

of the financial coalition within the bureaucracy (Haggard and Maxfield 1993). International capital, including MFOs, became the most valuable source of support for domestic policy coalitions in the new world political economy.

Mexico's financial reform was an example of how financial globalisation and policy consensus conditioned the state's response to the 1980s economic decline and to the set-back in the 1988 presidential elections. Stronger political competition forced the state to provide a viable development strategy in a more integrated world economy. However, the natural short-term planning horizon of the politicians made them very keen on responses that produce immediate results. In this context President Salinas saw capital inflows as the answer to bringing back the economy to the path of long term growth, and consequently, to restoring popular support for his government. However, most capital inflows went into portfolio investment, making the economy very vulnerable to capital flight. From a historical perspective, capital flight has triggered the cyclical crises in Mexico since 1976.

Political Democratisation

Regarding domestic politics I identified two relevant issues for Mexico's financial reform: the *technocrats*' rise to power and the process of political democratisation. Economic decline favoured the rise of the *technocrats* to key government positions in 1982. At that time, universal suffrage was seen as a luxury that Mexico could not afford if the government wanted to administer a hefty dose of the correct economic medicine. The technocrats' skills and ideas were expected to provide a viable strategy for overcoming Mexico's economic difficulties. However, disappointing results during de la Madrid's *sexenio* weakened the bases of popular support for the government. The results in the 1988 elections persuaded incoming President Salinas that some degree of democratisation was necessary to restore the legitimacy to his government.

Despite increasing electoral competition, the institutional arrangements in the political system remained quasi-authoritarian. Most of the reform and policy initiatives came from the state and only rarely from society. The Mexican state under President Salinas remained to a great extent autonomous basically for two reasons: first, the state apparatus remained highly centralised under the leadership of the President; and second,

the dominant coalition was a cohesive technocratic team with a coherent set of policy preferences. A powerful coalition of interests—major domestic businessmen and international investors—was aligned behind President Salinas and his economic team.

Mexican financial reform under President Salinas reflected not only the severity of financial constraints but also his political strategy to restore legitimacy (Haggard and Maxfield 1993: 317). The capital inflows following his economic reforms allowed the state to introduce a programme of heavy social spending and run increasing current account deficits. Rural poor and urban middle classes alike benefited from these policies. This strategy produced extraordinary political dividends in the 1991 and 1994 federal elections when the PRI recuperated its electoral hegemony. Several scholars argued that President Salinas never stopped campaigning because of his poor electoral performance, and that his programme of economic reform emerged essentially as a policy response to the 1988 electoral setback.

President Salinas was a leader praised by the international economic community (press, investors and policy-makers). For them, Salinas was the visionary leader who turned around a country that had gone bust so publicly only six years before he took office, by embarking on a dramatic and successful economic reform. The weekly magazine *The Economist* (February 13th 1993) stated that Salinas, despite of his controversial beginnings, had a claim to be hailed as one of the great men of the 20th century.

President Salinas's attitude towards democracy, however, remained always ambiguous: he proclaimed his goal as 'democracy with stability' and not democratic reforms that promote 'anarchy or instability' (Wood 1993). More accurately, Salinas was not interested in reforms that could endanger his ability to steer the state and jeopardise his programme of economic reform. His implicit goal was to preserve the existing political system, and thus the PRI's dominance, by reforming it. Under the shadow of Gorvachev's failure to bring about political and economic change in Russia, President Salinas believed that the right sequence for the reform—first economic and then political—was fundamental for the final success of his government. President Salinas was tacitly a strong believer in Huntington's (1968) 'modernisation' theory: democracy is best rooted in prosperous societies. Economic reform was expected to raise Mexican living standards. However, the political turmoil revealed the shortcomings of this

approach. Running policies which are good for the people, even if they do not appreciate them, may appeal to the technocratic mind. But it is not the way political systems are supposed to be run at the end of the 20th century. Salinas's government might have been the last one to be run according to a technocratic blueprint. The PRI cannot afford to maintain its reforming ways without securing real legitimacy through real democratic practices regardless of the costs in terms of reduced state capacity.

Institutional Changes

Mexico's financial reform represented a genuine institutional change. The financial system was heavily controlled by the state prior to the reform under President Salinas. The state management of the financial system was based upon five main pillars: (1) statutory control over the determination of interest rates; (2) control over the allocation of credit through development banking and selective credit programmes; (3) control over commercial banks through outright ownership; (4) statutory control over BdeM and therefore over monetary and exchange rate policies; and (5) control over regulation and supervision through the National Commissions for the financial system. The financial reform, however, represented the elimination of most of these mechanisms through which the state conducted the financial policy. The state kept regulation and supervision only to control the financial system. However, as the 1994 crisis served to establish, the new framework failed to achieve either of the two major goals of the financial reform, namely: improving the efficiency of the financial system and promoting economic growth.

The main reforms to the financial system—financial liberalisation, development banking reform, commercial banks' privatisation and autonomy of BdeM—represent cases of effective institutional change. All the reforms conformed to the dominant consensus on economic policy. Furthermore, a bureaucratic elite made up of highly trained policy-makers successfully implemented all of them. In fact, the Mexican state under President Salinas displayed great capacity to engineer institutional change. This thesis evaluated the outcomes of the institutional changes in terms of their contribution to specific political interests—e.g. state financing, capital inflows and business opportunities—and to broad economic issues—e.g. efficiency, stability and growth. Table C.1 summarises the findings from the case studies. It is evident from the results

that the financial reform advanced the political issues better than the economic issues. This evidence refutes the neoclassical hypothesis of a benevolent planner implementing reform to improve economic efficiency.

Table C.1

Outcomes from the Financial Reform

	Political Interests	**Economic Issues**
Financial Liberalisation	• State mainly financed through the stock exchange • Accumulation of large fortunes in the stock exchange • Alliance between the state and large financial groups	• Interest rate spreads did not drop and even increased • Consumer credit rose at the expense of productive investment • Capital inflows mainly in the form of portfolio investment
Development Banking	• Expansion of development credit during 1994 • Corruption scandals regarding NAFIN operations • Ultimately reversed	• Large amounts of development funds were not allocated • The two-tier development banking system was preserved
Banks' Privatisation	• Large revenues from the sale • Corruption scandals in the newly-privatised banks • Bankers' contributions for the PRI's 1994 electoral campaigns	• Consolidation of SBHs and banks into financial groups • Excessive expansion of high-risk lending • Non-performing assets problem
BdeM Autonomy	• Exchange rate policy under President's control • The policy agenda of the *financial coalition* was furthered	• Loose monetary policy during 1994 • BdeM did not oppose the reckless lending of commercial banks

Financial Liberalisation

Financial liberalisation was the first round of changes and the most consequential; they triggered the subsequent reforms to the financial system. Once the foundations for a new framework for the financial system were laid down, the rest of the reforms followed naturally as a matter of coherence. Financial liberalisation, or more precisely the deregulation of the banks' operations, were possible thanks to the development of the securities markets under President de la Madrid. I conclude from the observed outcomes of financial liberalisation that the immediate interests of the state and financial groups were better served than the more general goals of financial efficiency and economic growth (see Table C.1). The development of the securities market and the deregulation of banking operations, policies consistent with international trends, allowed the

financial elite to accumulate great wealth and strengthened their support for the government.

Financial liberalisation improved the instruments for state financing and the profitability of the brokerage houses and the commercial banks. Government securities replaced banking loans as the main source of finance for the state, while commercial banks concentrated on the profitable segment of consumer lending. The reform, however, did very little to improve financial and economic efficiency. The business practices under the new framework favoured state financing and consumer credit at the expense of credit for physical investment and technological innovation. The interest rate spread (difference between what the banks charge for their loans and what they pay for their deposits) did not drop and in some cases even expanded.

Development Banking Reform

The reform to development banking changed the *modus operandi* of these organisations. The state eliminated the banks' direct allocation of credit to specific economic sectors or activities at interest rates below market levels. Under the new framework, development banks' main activity is to supply additional funds to the credit markets for specific sectors, reducing market interest rates and increasing the amount of credit available for those sectors. The state introduced three major changes: first, development banks were turned into second-floor banks exclusively; second, the budgetary allocations to development banks were decreased; and private firms replaced public enterprises as the main recipients of development credit. However, the outcomes from the reform were not as expected, and development banking is still a two-tier sector in which both the state and the market participate very actively.

The reform to development banking was more limited in terms of both its original aims and its observed outcomes (see Table C.1). The changes utterly failed to achieve the explicit goal of improving the efficiency of the allocation of development credit. Outcomes from the reform include: recent fraud allegations against NAFIN's operations; large amounts of funds were left unallocated; and huge expansion on development credit during 1994, an election year. With regard to the political interests of the state and major businessmen, the reform also had disappointing results. The

reform failed to advance the reform agenda since at the end it has to be reversed. The intended business opportunity for bankers never took place. Commercial banks were more concerned with the allocation of their own funds to profitable sectors like consumer credit and credit cards than to participate in the development banks financing schemes.

Commercial Banks Privatisation

The privatisation of the commercial banks was a key part of the financial reform and of the more general economic strategy of President Salinas. The banks' privatisation made a substantial contribution to furthering the wider economic agenda of the financial coalition. In addition to improving the investment climate in Mexico, large capital inflows from the banks' privatisation contributed to the financing of the increasing current account deficit. The banks' privatisation changed the configuration of the Mexican financial system by restoring commercial banks at the core of the newly created financial groups. Nevertheless, it is not possible to show on theoretical or empirical grounds that the transfer of banks' ownership improved the internal efficiency of the banks or the stability of the financial system as a whole.

The privatisation of the commercial banks was the reform that received the most attention and was most scrutinised given the consequences for the subsequent banking crisis. In this case, as in the case of the financial liberalisation, the reform did not further the economic goals of efficiency, stability and growth (see Table C.1). The business strategies of the privatised banks exacerbated the current crisis. The original revenues from their privatisation were far outweighed by the costs of the required bailout. The outcomes regarding the state political interests were rather mixed. The proceeds from the sale of the banks improved the public finances and secured financing for the PRI's electoral campaigns in 1994. Nevertheless, corruption scandals in the newly privatised banks evidenced the tacit alliance between President Salinas and some of the new bankers.

Autonomy of Banco de Mexico

Finally, the autonomy of BdeM included a new constitutional mandate for the central bank to secure price stability and a new LOBdeM in which BdeM received greater statutory autonomy for the conduction of monetary policy and for its internal affairs. One of the main political and economic achievements of President Salinas was to bring down inflation. The autonomy of BdeM intended to signal a strong commitment to avoid future upsurges in inflation. Central banks, given their institutional features, are supposed to be more adverse to inflation than governments. However, in 1993, when President Salinas decided to grant greater autonomy to Banco de Mexico the main concern of the state was not preserving low inflation in the long run but to avoid capital flight during 1994, an election year. The decision to grant greater autonomy to Banco de Mexico responded not to the theoretical claim that it would keep inflation under control in the long run, but to the need of reducing the uncertainty usually present in an election year.

The reform was cosmetic to a great extent, as can be seen from these outcomes: BdeM implicitly acquiesced to the President's decision not to devalue earlier in 1994; BdeM conducted a loose monetary policy during the election year, and BdeM implicitly approved commercial banks' reckless lending. In sum, BdeM yielded to pressure from the President, who was seeking to win the elections for the PRI, and did not take an active stance to stop commercial banks' rapid expansion. The only effective change from this reform was the advancement of the policy agenda of the financial coalition. Regarding the economic issues, the reform failed to secure stability and the effect on economic growth cannot be properly assessed. Prior to the reform, BdeM enjoyed a great degree of statutory autonomy, but its lack of control over exchange rate policy (which remained in the hands of the Ministry of Finance) severely limited its real powers.

Financial Collapse

The institutional changes discussed above were clear cases of successfully implemented policies that conformed to the dominant orthodoxy on economic thinking. Furthermore, the economic team responsible for the reform was among the best qualified in the world

(*The Economist*, February 13th 1993). Nevertheless, the financial collapse of the Mexican economy represented one of the most severe crises since the revolution and the first important setback to the neoliberal paradigm. The 1994 crisis radically changed the image of President Salinas's government in the international press. *The Economist*, the same weekly magazine that had praised Salinas's reforms, wrote on March 14th 1998: 'Mexico is still trying to come to terms with the main reason it got into trouble: the shady politics and murky economics born of seven decades of rule by the PRI'.

Mexico's financial crisis in 1994 resulted from the combination of three sets of interrelated factors. First, the financial reform that stifled domestic saving and re-directed most of the capital inflows towards portfolio investment. Second, the end-of-*sexenio* political cycle that produced a great deal of political turmoil and economic uncertainty. Third, the policy mistakes that exacerbated the size and depth of the crisis.

Financial Reform

The financial reform replaced the old framework, present for a very long time and based on controls, by a new one based mainly on the stock exchange and, therefore, essentially volatile. Securities traded in the stock exchange replaced commercial banks' loans as the main instrument for state funding. Without controls, the state depended completely on the securities market for financing, and consequently, the investment climate and a sound financial policy became paramount. The financial reform increased the political leverage of capital. In terms of sequencing, the liberalisation of banking operations kicked off the cascade of further economic reforms, not only in the financial system, but in the whole economy. The signals of healthy policies served their purpose for a while, and capital inflows skyrocketed between 1991 and 1993.

However, the failure of the reform to address the issue of domestic savings created an over-dependence on capital inflows. This problem was further aggravated by the exchange rate policy that produced a huge current account deficit. Increasing capital inflows going into government securities created a bonanza in the state finances: interest rates decreased dramatically. Capital flows responded to investors' perceptions, very often unrelated to economic fundamentals. However, in 1994, prior to the crisis, the threat of capital flight circumscribed most of decisions regarding financial policy and

macroeconomic management. Mexican officials have always been committed to free exchange convertibility but the threat of capital flight is a recent phenomenon. The first major run against the peso took place in 1976 and since then, each successive run has increased its size exponentially. The reform of the financial system under President Salinas further increased the exposure of the Mexican economy to capital flight.

In a recent report, the IMF argued that it was not international capital that initiated the run on the peso in December 1994, but domestic investors (Folkerts-Landau and Ito 1995). The figures show that Mexicans, perhaps better informed, started to sell their securities much sooner than foreign investors. Even in late 1994, international capital was still investing very heavily in state securities; partly because long delays in the publication of data on BdeM international reserves had left them without information for several months. It was not until February 1995 that foreign investors liquidated their holdings on state securities on a massive scale (*The Economist,* October 7th 1995).

End-of-sexenio political cycle

Mexican politics have introduced a great deal of uncertainty to the economic system since 1976. In the last four *sexenios*, the President and political institutions have weakened towards the end of the term. Each President, since Luis Echeverría, lost their capacity either to steer the economy or to discipline the political elites during the last year of their administration. In fact, each one of the last five presidential terms has ended with either an economic or a political crisis. The transition could not have been longer or more painful.

In the case of President Salinas the end-of-*sexenio* political cycle was overly pronounced. The financial reform increased the exposure of the economy to capital flight. But more importantly, the political turmoil throughout 1994 further impaired the government's ability to steer the economy. Investors perceived the deterioration of the political climate in Mexico and knew the economic consequences. There were clear signals of a weakening government: the resolution of conflicts between political fractions took place at the margin of the institutions and the President. The *Zapatistas*' uprising in Chiapas, the assassination of presidential candidate Luis Donaldo Colosio

and PRI general secretary Francisco Ruíz Massieu represent underlying political struggles.

Policy mistakes

Political democratisation also played a part in the genesis of the 1994 crisis. Increasing electoral competition pushed the state to take decisions with potential pernicious consequences for the economy. The financial reform was insufficient to protect the economy from misjudged presidential decisions. In hindsight, it is very easy to identify the three most important policy mistakes: first, the government delayed corrective action in the exchange rate; second, the government indulged itself with expansionist fiscal and monetary policies; and third, the state changed the term-structure and exchange rate exposure of the public debt.

The political costs of devaluation in the context of effective electoral competition prevented the government from devaluing the peso. The exchange rate was under great pressure throughout 1994 because of the end-of-*sexenio* political turmoil and the mounting current account deficit. However, the government stuck to its commitment to defend the exchange rate against any possible run. In order to persuade international capital and domestic investors that there was no risk of devaluation, the state replaced the traditional CETES for the dollar-denominated TESOBONOS as the preferred security. TESOBONOS were virtually negligible as a share of state internal borrowing in 1993, but at the moment of the devaluation in 1994, they represented 55.7 percent (Presidencia de la República 1995: 55). This decision had disastrous consequences in the aftermath of the devaluation and placed the state on the border of insolvency. In fact the exchange rate losses associated to the devaluation amounted to more then $8 billion dollars (Presidencia de la República 1995: 55, 77).

Final Remarks

Michael Camdessus, director of the IMF, labelled Mexico's 1994 financial crisis as the 'first crisis of the twenty-first century'. The crisis represented the first important set-back to the dominant economic orthodoxy. Subsequent crises in Asia, Russia and Brazil have led to a reassessment of liberalisation policies. These crises have broken the

'Washington Consensus' promoted by the IMF and prevalent in most of the industrialised countries. The institutional framework for the world's financial system still has a long way to go in order to achieve safer and more stable means of transferring resources from one country to another. At present, the framework effectively benefits a small group of people in rich economies at the expense of millions of people in developing countries that suffer the consequences of these crises.

President Carlos Salinas, despite being one of the leaders in the developing world at promoting globalisation and liberalisation, has now joined the group of those urging for a reassessment of neoliberal policies (*Excelsior*, January 13th 1999). The new alternative, according to Salinas, must keep the historical move towards market economies, but at the same time avoid the subordination of domestic states to the whims of international capital. In order to minimise the detrimental consequences of the free movement of goods and capital it is also required that labour should be able to move freely between countries. The new framework must include effective regulation of domestic financial markets and selective controls on short-term capital flows, on the one hand, and international agreements between governments on immigration, on the other.

Despite the notorious financial collapse in 1994, Mexico's economic reform under President Salinas brought about a genuine institutionalisation of economic policy-making. At present, institutions are vastly more autonomous than they were in 1982. Financial markets determine the limits of public indebtedness. An increasingly autonomous BdeM conducts monetary policy. Telecommunications and banking are under private management. The provisions of NAFTA largely circumscribe trade policy. Fiscal policy is limited by the ability of the state to get financing. Moreover, the government has now proposed to transfer the exchange rate policy and the regulation of the banking system to BdeM.

According to Miguel Mancera (1994), former governor of BdeM (1982-1997), the autonomy of BdeM is a strong safeguard of institutional change, insofar as, unlike many other countries, the reform is now included in the constitution. However, constitutional changes in Mexico are weak safeguards, considering the still quasi-authoritarian nature of the political system, where the President can introduce reforms without major obstacles. Investors, though warmly welcoming all these institutional changes, did not

perceive them as sure safeguards against potential economic mismanagement associated to politics.

> 'To the extent that there has been a strengthening of genuinely bureaucratic and market institutions in Mexico, this has occurred disproportionally in the field of economic management... Outside the field of pure economic management, Mexican state institutions may prove too weak—too under-financed, too clientelistically organised, too incompetent at social reform, too unpopular, too weak institutionally—to meet the legitimate expectations of democracy on the part of the majority of the Mexicans' (Philip 1998b).

The Mexican political system is currently changing from a stable and partially authoritarian regime to a more open and western-style democracy in which strong opposition, contested electoral processes, higher accountability of the executive to the congress, and a strong rule of law all play a role. This process, although initiated in the early 1970s, is far from complete and therefore at this moment Mexican political institutions are neither the authoritarian but stable institutions of the past nor the strong institutions of western-type democracies. In the past, the strong discipline imposed by these informal institutions on the members of the political elite assured continuity and stability. At present, the political system remains authoritarian in terms of accountability, while globalisation and greater political participation have reduced the institutions' effectiveness (Philip 1998: 24).

It is possible to reform state institutions, but it takes time. Moreover, institution building in politics is difficult to carry out without effective executive authority because of the ability of those who benefit from weak state institutions to block the reforms to those same institutions. Strong presidentialism may therefore be desirable at a time of crisis or rapid transformation (Philip 1998b). President Jose López Portillo anticipated that 'the logic of politics in Mexico leads to the conclusion that the changes and modernisation currently taking place in the country are also due to presidentialism. The President is the only one able to circumscribe presidentialism' (quoted by *Proceso*, May 12th 1997). The challenge is to find the right relationship between representative institutions and executive leadership. Mexico is gradually moving from an essentially authoritarian

political system to a more open and democratic one. The prospects are encouraging, despite the enormous political and economic costs to the current generation.

Appendix: Methodology and Sources of Information

Methodology

The original aim of introducing a methodology to the social sciences was to develop a 'method of inquiry which would be both necessary and sufficient to guide the scientist inevitably to truth' (Watkins 1957: 104). Today, methodology has the more modest task of establishing certain rules and requirements that are necessary for intellectual discussion. In order to frame my research within academic parameters I considered some questions, like what level of inquiry was appropriate to the study of the problem I was interested in; how it should be described; whether the explanation should be set in terms of individuals or institutions; and how adequate was a 'reductionist' approach to study Mexico's political economy. At the end, I favoured Weber's (1950) 'holistic' approach as the method of analysis for this thesis.[1] Explanations under this approach start with a broad characterisation of a historical situation, and then descend to an ever closer inspection of the detailed components until the relevant behaviour and relationships of the individuals involved are established. This method links social facts to individuals, but rejects that every social fact do somehow have to be reduced to claims about individuals.

This thesis partakes of both theory and history, but is neither a work of theory nor a work of history. It falls somewhere in between; it is primarily explanatory.[2] The explanation in this thesis presents an account of the linkages among several events as a process leading to Mexico' financial reform and the subsequent crisis. In other words, this thesis is a comprehensive account of the reforms, their outcomes and the links between them. It was a two-stage analytical exercise. The first stage of the analysis concentrated on the identification of the relevant elements amid the complexity of

[1] For a deeper and broader discussion on these two approaches to knowledge in the social sciences see Martin and McIntyre (1994).

[2] According to Samuel Huntington (1991: xiii), 'a good theory is precise, austere, elegant, and highlights the relations among a few conceptual variables. Inevitably, no theory can explain fully a single event or group of events. An explanation, in contrast, is complex, dense, messy, and intellectually unsatisfying. It succeeds not by being austere but by being comprehensive.'

Mexico's political economy where the reform took place. The second stage, once the elements were clearly outlined, centred on mapping the cause-effect relationships between those elements. The thesis pieces together fact after fact, each piece adding up to a causal explanation.

I favoured the approach of case studies to organise the inference process in this thesis, as opposed to experiments or surveys. The fact that the events under study were beyond my control ruled out experimentation, while the complexity of the events excluded the feasibility of a survey study. According to Robert Yin (1984: 22-23), case studies serve very well the purpose of explaining a decision or set of decisions: why they were taken, how they were implemented, and with what result. This approach allowed to retain the 'holistic' and meaningful characterisation of the social events under consideration and provided a framework to study some aspects of the problem in depth. I selected three case studies: commercial banks' privatisation, development banking reform and Banco de Mexico's autonomy. The choice of the case studies was based on the general public interest, namely the underlying issues in each case were regarded as nationally important. Each case represented a policy change that had profound consequences on the political economy of Mexico's financial system and all of them were part of the more general programme of economic transformation known as 'structural adjustment.' The case studies were 'complete' in the sense that all the available sources of relevant evidence were exhausted. The evidence was presented neutrally, with both supporting and challenging data.

Sources of Information

The information used in this thesis is divided into two different categories according to the source: primary and secondary. According to Judith Bell (1993: 68), primary sources are those which came into existence in the period under research, while secondary sources are interpretations of events of that period based on primary sources.

Primary Sources

When I started to plan this thesis, in the summer of 1994 immediately after the presidential elections, the consequences of the financial crisis and the crisis itself were

difficult to anticipate. During the first stage of this project, which comprised the literature review and the research design, the banking crisis burst. Over the next few years it reached an unexpected scale and depth. Throughout the period while this thesis was in progress, one of the most politically sensitive issues in Mexico was the consequence of the 1994 financial crisis and the banks' bailout.[3] As a result, the financial reform under President Salinas came under strong public charge. Most of the public officials that participated in the reform were consequently very reluctant to talk about it. As it is argued in the thesis, the small circle of inner advisors of the President and the President itself decides upon the financial policy. Because of the political and criminal implications of these decisions it was virtually impossible to interview these public officials. Yet, the main interest of the thesis was to find the reasons behind government's decisions.

I managed to get some interviews with high public officials in the financial branch of government, whom were useful to hint the future avenues of research. However, they were also very reluctant to speak openly about undisclosed information. The interviews carried out in the fist stage of the research were unstructured and aimed to get broad ideas rather specific pieces of information. At this stage I was trying to find out which areas or themes were important and therefore I mainly asked those interviewees to talk about what was of central importance for them. They provided the original evidence upon which the rest of the thesis was mapped out. In other words, they provided the original hints as to what to look for and where to concentrate my research efforts. In this case, these interviews were carried out with the Presidents of the National Commission for Insurance and Bonding (CNSF) and the National Commission for the Retirement Savings System (CONSAR) and with specialists in the field. The interviews in the second round were more structured and aimed to get specific pieces of information that I could not get from anywhere else. The interviewees either participated directly in the process of decision making or had a position where they observed what happened.

Because of the unexpected difficulties trying to get interviews and their obvious bias given the sensitivity of the topics (due to their political and even criminal dimensions), I

[3] At present, the issue of the banks' bailout is an issue of political conflict since the Congress has not reached an agreement yet on how much the government is going to contribute to it.

shifted the emphasis from direct interviews to comprehensive evidence collection from indirect sources. Instead of interviewing government officials, who clearly were not going to have much to say, I tried to deduce the real motives behind the decision from all the evidence I could gather. I researched systematically all possible sources of information looking for the relevant information: press reports, journal articles, official documents, statistical bulletins, other studies (official, academic and private), public addresses of government officials, on-line data bases, non-published thesis and legislation. The analysis relied largely on causal and descriptive inference and aimed to identify the real objectives of the reform from circumstantial evidence.

Public addresses of government officials, official documents and studies provided information on the arguments, justifications and explanations for the decisions and the expected outcomes. The CD ROM version of *El Mercado de Valores* provided most of the public addresses of government officials regarding economic issues and other official documents regarding agreements and letters of intent signed with international financial organisations. These pieces of information were contrasted with the evidence found in other studies (academic and private) and in the press in order to get a more balanced picture on the possible reasons why the decisions were taken. This analytical exercise also shed light on the role of exogenous or unexpected elements into the final outcomes.

Statistics were an essential ingredient for the elaboration of the arguments presented in this thesis. I collected the statistical information from the reports and bulletins published by the Ministry of Finance, Banco de Mexico, the National Banking Commission, Presidencia de la República, OECD, IMF and commercial banks themselves. Most of the economic data came from the statistical annex to President Zedillo's First Address to the Nation (Presidencia de la República 1995). The information covered in this annex included the most important economic indicators for the period 1985-1995. I obtained the information on banks' financial balances and accounts from the statistical bulletins published by the National Banking Commission (CNBV 1994). The two volumes of Mexico's historical statistics published by INEGI (1994) provided valuable information on general economic variables for most of this century up to the reform. The web pages of INEGI, Banco de Mexico and the Ministry of Finance provided more recent

information on economic variables. Finally, the on-line database DATASTREAM provided useful series on economic variables at a more detailed level.

I used extensively and intensively press reports and journal articles in the analysis presented in the thesis. In Mexico as in any other country, politics are conducted to a great extent based on the information contained in the media. By using this source, I aimed to reconstruct the picture as the actors saw it at the moment when the decisions were taken. In some cases, the information is used to contrast stated objectives against final outcomes. This type of information presented the dynamics of the events rather than simply static statements of intent as in official documents. CD ROMs and on-line services were very useful to facilitate the access and systematic analysis of the press and data-bases. On-line services like LEXIS and FT-Profile provided me with access to important and specialised publications like: *Associated Press, American Banker Newsletters, Business Mexico, El Economista, El Nacional, El País, El Universal, Este País, Euromoney, Excelsior, Expansion, Financial Regulation Report, Financial Times, La Jornada, Latin American Markets, LatinFinance, Proceso, The Banker, The Times and World Corporate Insurance Report.* I also used the CD ROMs, when available, of other publications. In this case the most important were: *Proceso, The Economist and El Mercado de Valores: La Política Económica de Mexico, 1946-1994.* The electronic access to information facilitated the search of information. I ran searches for general entries in most of these publications like: Mexico and Politics, Mexico and Finance, Mexico and Banking; and for more specific entries like: President Salinas, tequila crisis, structural adjustment, Banco de Mexico, banks' privatisation, development banking, financial liberalisation, etc. I also ran searches for most of the banks and the main investors, especially the larger ones or the ones involved in corruption scandals.

Secondary Sources

The most important secondary sources of information that I used in this thesis were other studies and unpublished thesis. Other studies were used for two purposes: first, as an additional source of information; and second, as a source of alternative arguments and ideas. Most of the thesis was aimed to develop my explanation to the problem under study using the notion of state autonomy and political leadership. The review of the literature was intended to be as complete as possible. I reviewed all the studies that I

found on the themes included in the analysis, namely: financial globalisation, political democratisation, institutional change and financial collapse. I ran searches for each theme on several CD ROMs with data bases like the *Social Science Citation Index* and the *Journal of Economic Literature.* EASI (Electronic Access to Systems of Information) provided access to all these CD ROMs.

I used intensively the services available at the British Library of Political and Economic Studies. The great collection of the library provided me with access to most of the previous studies on the subject, especially the academic studies and those from international organisations. I also visited the libraries of the major universities in Mexico City: Instituto Tecnológico Autónomo de Mexico (ITAM), Colegio de Mexico and Universidad Nacional Autónoma de Mexico (UNAM). In those libraries, I found valuable information from unpublished BSc thesis. They are usually very rich in original material and analysis. I also visited specialised libraries in Banco de Mexico, the National Banking Commission and Nacional Financiera (NAFIN). In these libraries, I found specialised studies not available elsewhere. They were usually studies either subcontracted with consulting firms or developed by their own research departments. They were also both rich in information and robust in their analysis.

Most of the historical references prior to the reform were extracted from other studies. Brothers and Solís (1966), Goldsmith (1966), Glade and Anderson (1968) Márquez (1987), Katz (1990), Maxfield (1990 and 1997) and White (1992) provided most of the historical information used in chapter four and in the introduction of each case study. Chapter six on the commercial banks' privatisation benefited from the information contained in a special report prepared by International Reports (1990). Chapter seven on the Banco de Mexico's autonomy relied on the quantitative analysis of Cukierman's (1992 and 1993) work. Other important studies were the published accounts of the reform from high public officials. The most important came from the two major reformers: Pedro Aspe (1993) and Guillermo Ortiz (1994).

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Interviewee: Fernando Solís Soberón
Place and Date: Mexico City, September 1st 1995
Present Position: President of CONSAR (1994-)
Relevant Experience: President of CONSAR (1994-); Deputy President CNSF (1992-1994); Head of the Research and Development Division at the CNSF (1990-1994)

Interviewee: Juan Ignacio Gil Anton
Place and Date: Mexico City, September 1st 1995
Present Position: President CNSF (1994-)
Relevant Experience: President CNSF (1994-); Deputy President CNSF (1990-1994); Head of the Mexican Insurance Company for Agriculture (1989-1990)

Interviewee: Isaac Katz Burstin
Place and Date: Mexico City, September 13th 1995
Present Position: Head of the Economics and Political Division at the Instituto Tecnológico Autónomo de México (1992-1997)
Relevant Experience: Expert on Mexico's financial system

Interviewee: Alonso Ríos
Place and Date: Mexico City, September 14th 1995
Present Position: Chief Economist at BANAMEX
Relevant Experience: Expert on Mexico's financial system

Interviewee: Dionisio Meade
Place and Date: Mexico City, January 22nd 1998
Present Position: Federal Deputy (1997-) and Chairman of the Congress Treasury Commission (1999-)
Relevant Experience: Technical Secretary of the Congress Treasury Commission (1994-1997); Managing Director at Banco Mexicano (1988-1991)

Interviewee: Guillermo Barnes
Place and Date: Mexico City, February 8th 1999
Present Position: Federal Deputy (1997-)
Relevant Experience: Federal Deputy (1997-); Treasurer of the PRI (1995-1997); Head of the Unit for Development Planning at the Ministry of Finance (1992-1994); Chief of Staff of the Deputy Minister of Finance (1989-1992); Chief Economist at BCH Bank (1983-1988)

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