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Mexico's experiments with bank privatization and liberalization, 1991–2003

Stephen Haber *

Stanford University, Bldg. 200, Room 19, Stanford, CA 93906-2024, United States

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Abstract

During the 1990s Mexico conducted two experiments with its banking system. In the first experiment (1991–96) it privatized the banks. This experiment took place with weak institutions to enforce contract rights. It also took place without institutions that encourage prudent behavior by bankers. The result was reckless behavior by banks, and a collapse of the banking system. In the second experiment (1997–2003), Mexico reformed many of the institutions that promoted bank monitoring and it opened up the industry to foreign investment. It was less successful, however, in reforming the institutions that promote the enforcement of contract rights. The result was that bankers behaved prudently, but prudent behavior in the context of weak contract rights implies that banks are reluctant to extend credit to firms and households.

JEL classification: D23; F23; G21; G28; G38

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1. Introduction

Over the past decade Mexico has conducted two experiments with its banking system. The first took place in 1991 when the government privatized the commercial

* Tel.: +1 650 723 1466; fax: +1 650 723 1500.
E-mail address: haber@stanford.edu

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banks that it had expropriated in 1982. The second took place in 1997, when the government, having had to rescue the banks that it had just privatized, allowed foreign firms to purchase controlling interests in the restructured banks. It also carried out a reform of accounting rules and reorganized the country's deposit insurance system.

Neither of these experiments produced the outcome that the government and the Mexican public expected. The first experiment produced a banking system that became insolvent within four years and that had to be bailed out at a cost estimated at $65 billion. The second experiment produced a banking system that is profitable and stable, but that is risk averse. It therefore extends only modest amounts of credit to firms and households. The ratio of private sector lending to GDP in Mexico is only 11%, an extraordinarily low figure in relationship to that of other middle-income developing countries.

This paper seeks to understand why the first experiment failed and the second experiment produced disappointing results. I argue that there were two fundamental flaws in the 1991–96 privatization experiment. The first flaw was that Mexico had weak institutions to assess the creditworthiness of borrowers ex ante and enforce the contract rights of bankers ex post. The second flaw was that the Mexican government sought to maximize the prices at auction for the banks. In order to get Mexico's bankers to pay high prices, however, the government was compelled to make a series of decisions that reduced the incentives of bank directors, bank depositors, and bank regulators to enforce prudent behavior by the privatized banks. The institutions that emerged out of the privatization process included regulated entry, extremely permissive bank accounting standards, regulatory forbearance, unlimited deposit insurance, and an auction payment system that allowed bankers to purchase the banks with borrowed funds – sometimes from the same banks that they were purchasing.

The combination of these two flaws – weak property rights and weak institutions to enforce prudent behavior – produced lending strategies that, at the very least, were reckless. Even before the peso crisis of December 1994 (which is often blamed for the collapse of the banking system) many of Mexico's banks were teetering on bankruptcy.

During the liberalization experiment (1997–2003), many of the institutions that encouraged imprudent behavior were reformed. The problem of property rights, however, remained. As a result, bankers adopted a strategy that is rational for them under the circumstances but that is negative from the point of view of economic development: they tend to hold government securities or make loans to government entities rather than provide credit for private investment and consumption.

2. Privatization and collapse, 1991–96

All markets are embedded in political systems. The market for Mexico's privatized banks was not an exception to this general rule.

Two features of Mexico's political economy fundamentally shaped the process of privatization. First, the Mexican government wanted to maximize revenues from privatization because it faced a serious fiscal crisis. Second, bankers faced expropri-