FRBSF Weekly Letter

Number 92-40, November 13, 1992

NAFTA and U.S. Banking

On August 12, 1992, the U.S., Mexico, and Canada completed negotiation of the North American Free Trade Agreement (NAFTA). Assuming it is eventually approved by the legislative bodies of all three countries, NAFTA will progressively eliminate barriers to trade in goods and services, remove investment restrictions, and protect intellectual property rights (patents and copyrights) from the Yukon to the Yucatan.

While the implications of liberalizing trade in goods (manufacturing and agriculture), and of easing investment restrictions in Mexico have been widely discussed, somewhat less attention has been given in the media to how NAFTA will liberalize access to Mexico's financial sector and what the potential opportunities may be for U.S. banks. This *Weekly Letter* attempts to shed some light on this question by reviewing NAFTA's provisions for U.S. bank access as well as factors affecting the attractiveness of the Mexican market.

Financial reform

The adoption of NAFTA by Mexico is part of wide-ranging Mexican financial reform seeking to limit government intervention in the financial sector and stimulate market forces. As part of this process, all of the 18 banks which had been nationalized in 1982 have now been reprivatized, resulting in the creation of large financial conglomerates that offer universal or multiservice banking. Onerous regulations that had placed the Mexican banking sector at a severe competitive disadvantage also have been lifted. In 1989, controls on interest rates and the allocation of credit were abolished. Marginal reserve requirements, which exceeded 90 percent until 1986, were replaced by a 30 percent liquidity ratio, which itself was suspended in late 1991. Foreign exchange controls also were abolished at that time, so Mexican banks may now engage more freely in external transactions.

NAFTA and banking

NAFTA reverses a 50-year policy of prohibiting foreign bank ownership of Mexican banking institutions. It will allow U.S. and Canadian banks or other financial institutions to acquire or to establish wholly owned banking, insurance, and securities operations in Mexico and to compete on the same terms as Mexican financial institutions. From the standpoint of foreign investors, this is a significant improvement over the current law, which limits individual foreign ownership of Mexican banks to a minority share of no more than 10 percent of the paid-up capital of an individual banking institution. (Currently, Citicorp, which entered Mexico in 1929, is the only foreign banking organizations allowed to do business on its own in Mexico.)

Beginning in 1994, NAFTA would allow U.S. banks to acquire or establish Mexican banking subsidiaries, as long as the combined holdings of U.S. and Canadian banks do not exceed 8 percent of the Mexican banking industry's total capital. This ceiling is to be raised gradually to 15 percent by the year 2000, and then eliminated completely soon thereafter. During the transition period, from 1994 to 2000, individual foreign banks' market shares will be limited to a maximum of 1.5 percent of the industry's capital. Although the ceiling on the total market share of foreign banks will be abolished after 2000, bank acquisitions will be subject to "reasonable prudential considerations" and a 4 percent market share limit for an individual institution. If the United States adopts interstate branch banking, NAFTA may eventually allow U.S. banks to establish branches as well as separately capitalized subsidiaries south of the border.

The extent to which NAFTA will lead to significant increases in U.S. banking operations in Mexico will depend on the attractiveness of the Mexican market, which in turn is likely to depend on three factors: (i) the prospects for economic stability in Mexico; (ii) U.S. direct investment by nonfinancial corporations in Mexico; and (iii) banking opportunities in Mexico's domestic market.

Economic stability

A potentially very important factor in determining the attractiveness of a foreign market for any bank is the degree to which the government is able to achieve economic stability. For example, economic instability in Latin America in the 1980s resulted in heavy losses to U.S. banks and prompted them to shift their operations to more stable economies, such as Europe and the Asia-Pacific region, or, in many cases, to curtail their international banking operations.

Mexico has made great strides in achieving a more stable business environment as a result of policy reforms adopted since the 1980s that have reduced the government's claim on economic resources and given freer rein to market forces. As part of these reforms, monetary policy was tightened and the government budget deficit (the borrowing requirement) was cut sharply, from a recent peak of 16 percent of GDP in 1987 to 3.5 percent in 1990. Deficit reduction efforts were facilitated by the privatization of public enterprises, which generated revenues from asset sales and also ended government subsidies to unprofitable enterprises. Over 85 percent of about 1600 public enterprises existing in 1982 have been privatized. Revenues were further enhanced by improvements in economic efficiency following the elimination of burdensome regulations and of barriers to trade and foreign investment, and by more effective tax collection.

As a result of these economic reforms, inflation fell from a recent peak of 160 percent in 1987 to around 7 percent in the first half of 1992. The resulting decline in inflationary expectations appears to have contributed to falling interest rates and greater stability of the Mexican peso. The Mexican treasury bill rate fell from 103 percent in 1987 to under 15 percent in the first half of 1992, while the annual rate of depreciation of the Mexican peso slowed from around 56 percent to less than 7 percent over the same period.

Mexico's standing among external creditors and private investors also has improved. The bulk of Mexico's debt to foreign commercial banks has been restructured, significantly cutting Mexico's external debt burden. Interest payments as a proportion of exports of goods and services fell from 38 percent in 1986 to 23 percent last year. The burden of servicing the external debt has been further reduced by private capital inflows into Mexico, which increased nearly sixfold between 1989 and 1991, to $22 billion.

U.S. direct investment

Although economic stability in Mexico encourages expanded U.S. banking operations in that country, it is not by itself sufficient to spur entry. Traditional commercial banking requires the development of long-term relationships between bankers and their corporate clients. Such relationships give bankers information on borrowers and the deep knowledge of credit markets that is required to make sound and profitable credit decisions. In the absence of such close relationships with clients in Mexico, U.S. banks initially may be reluctant to incur the costs of setting up subsidiaries in Mexico, even if NAFTA allows them to do so.

One factor that may help banks to overcome this hurdle is the rapid growth in direct investment by U.S. nonfinancial firms in Mexico, which may encourage U.S. banks to follow in order to serve the financing needs of their U.S. corporate customers. In response to efforts by the Mexican government to attract foreign investors, U.S. direct investment in Mexico increased at a 24 percent annual rate between 1987 and 1992, to nearly $12 billion last year. NAFTA is expected to encourage continued rapid growth in U.S. investment for two reasons. First, U.S. producers are expected to invest in Mexico in order to exploit the opportunities for increased exports to the U.S. and Canadian markets offered by NAFTA. Second, with some exceptions (such as the petroleum sector, which is reserved for the Mexican state), NAFTA would remove discriminatory restrictions on foreign investors that had discouraged U.S. investment in Mexico in the past.

Mexican demand for banking

U.S. banks may find it profitable to serve not only their U.S. clients in Mexico, but also the domestic market, as rapid increases are expected in the demand for banking services. Mexico has a relatively large population, totaling 86 million in 1990, compared to 250 million in the U.S. and 27 million in Canada. And, though total Mexican output in 1990 was only about 4 percent the size of U.S. output and 40 percent the size of Canadian output, due to lower output per worker, it is likely that the Mexican economy will grow rapidly in coming years. Mexico's real output grew at a respectable 4 percent average annual rate in 1990 and 1991, compared to 1 percent annually in 1985–1989, and the approval of NAFTA is likely to accelerate growth further.

Rising incomes and greater economic stability are expected to increase the demand for banking services by Mexicans, most of whom live outside the major cities and currently have no banking relationship at all. Institutional changes that will provide many Mexicans access to bank services will further stimulate demand. For example, under a new government pension fund system, many companies will for the fist time pay a percentage of each employee's salary into a bank account. Workers will receive pension account statements at home, and can choose how they want their money invested.

As rising incomes are expected to give the main impetus to bank growth, Mexican bankers see the largest growth potential in retail banking and consumer credit. Bank lending grew by over 15 percent last year and is likely to grow by as much or more in 1992, with most of the growth comprised of consumer loans for durable goods, including automobiles, and for mortgages and credit cards.

Rapid growth in demand for bank services is expected to continue for some time. Mexico's central bank estimates that the flow of funds into the Mexican banking system will double over the next eight years, and the number of bank accounts is expected to double by the year 2014.

Competitiveness of Mexican banks

Aside from its growth potential, the Mexican banking market may prove attractive to U.S. banks because it has so far been relatively sheltered from competition. This has contributed to inefficiency as well as unusually large profits. Under these conditions, U.S. banks may profit by producing bank services in Mexico at a lower cost, while also charging lower prices.

One reason for the relatively weak competitive environment is the years of government ownership and constraints on pricing and credit allocation, which appear to have reduced Mexican banks' incentive to compete. Another reason is that the domestic banking sector is characterized by an apparently very high degree of concentration. As of mid-1992, the top three banks in Mexico held 58.7 percent of total Mexican bank assets, while the top three in the U.S. held only 12.4 percent of total U.S. bank assets. This relatively high concentration was encouraged by the sharp decline in the number of banks over the years, as a result of abandoning specialized banks in favor of "full service" banks in the 1970s and a deliberate government policy to promote mergers in the 1980s. Currently, there are 20 banks in Mexico (including Citicorp), compared to 109 in 1974 and 59 in 1982.

The lack of effective competition in Mexican banking is reflected in two ways. First, Mexican banks appear to be relatively inefficient and have not kept pace with innovations in the U.S. and Canadian financial sectors. In 1990, the ratio of noninterest operating costs to assets in Mexican banks was 6.3 percent, compared to 3.4 percent for U.S. banks. Including interest expenses, the 1990 ratio rises to 22.9 percent for Mexican banks, but increases to only 9.5 percent for U.S. banks. In particular, Mexican banks appear to lag in the efficiency of their technology and in the efficient provision of corporate banking services, including services that take advantage of relatively new financial technology, such as interest rate swaps.

Second, Mexico's banking sector appears to be highly profitable. As of June 30, 1992, the average return on equity for all U.S. banks was 12.7 percent, while the return on assets averaged 0.9 percent. In comparison, the average return on equity of the 12 largest banks in Mexico as of the same date was a relatively high 27.2 percent, while the average return on assets for these banks was also relatively high, at 1.7 percent. (Average figures for all Mexican banks were unavailable. However, because of Mexico's highly concentrated banking market, average statistics for the 12 largest banks can be considered representative of the Mexican banking market as a whole.) Consistent with this, Mexican banks appear to enjoy relatively large interest rate margins. For example, while the average cost of funds for the banking sector was about 24 percent in the first half of 1991, the average rate for bank loans to private sector borrowers was around 40 percent. Such a large spread does not appear to reflect unusually high risk, as the nonperforming loan ratios of Mexican banks are reportedly relatively low, and the financial condition of Mexican firms is currently fairly strong.

Conclusion

For decades, the door to Mexico's financial sector has been closed. However, Mexico has undergone a change in attitude over the past decade towards free markets and foreign entry, of which NAFTA is the most recent expression. As U.S. firms take advantage of the improved investment opportunities resulting from this change, U.S. banks likely will follow them to Mexico and eventually find profitable opportunities in serving Mexicans themselves.

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Printed on recycled paper with soybean inks.

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