# El financiamento de la inversión

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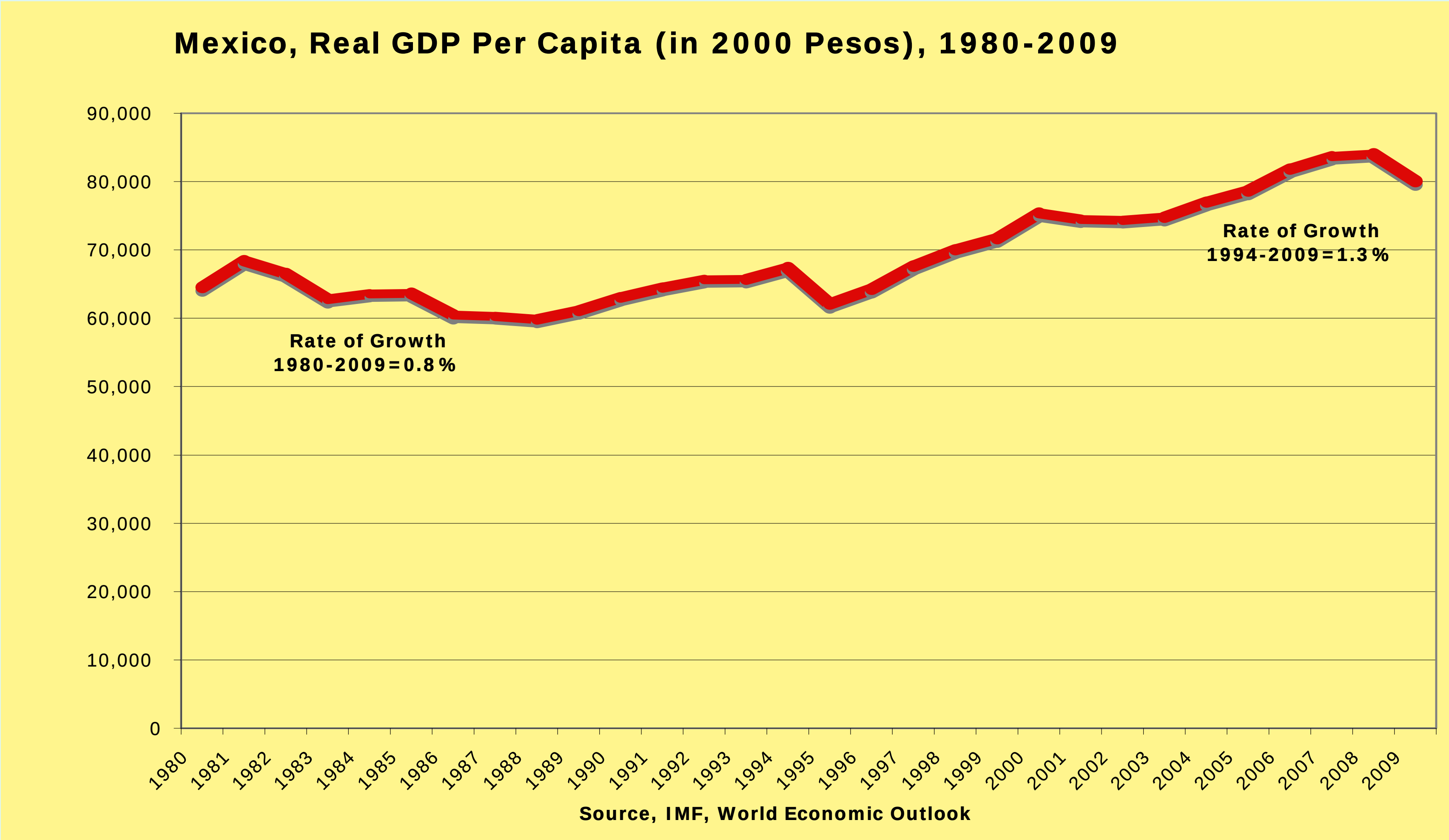
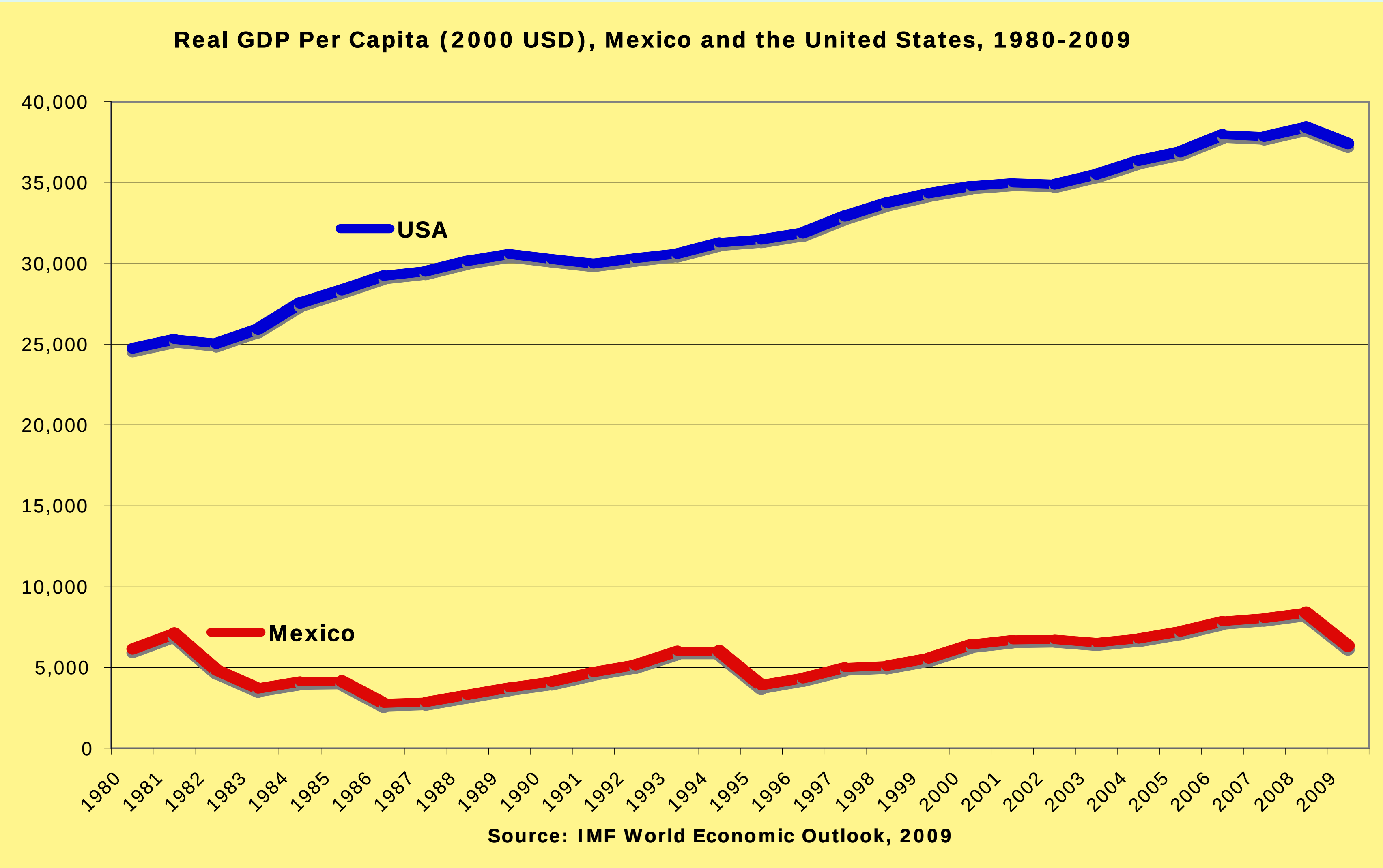
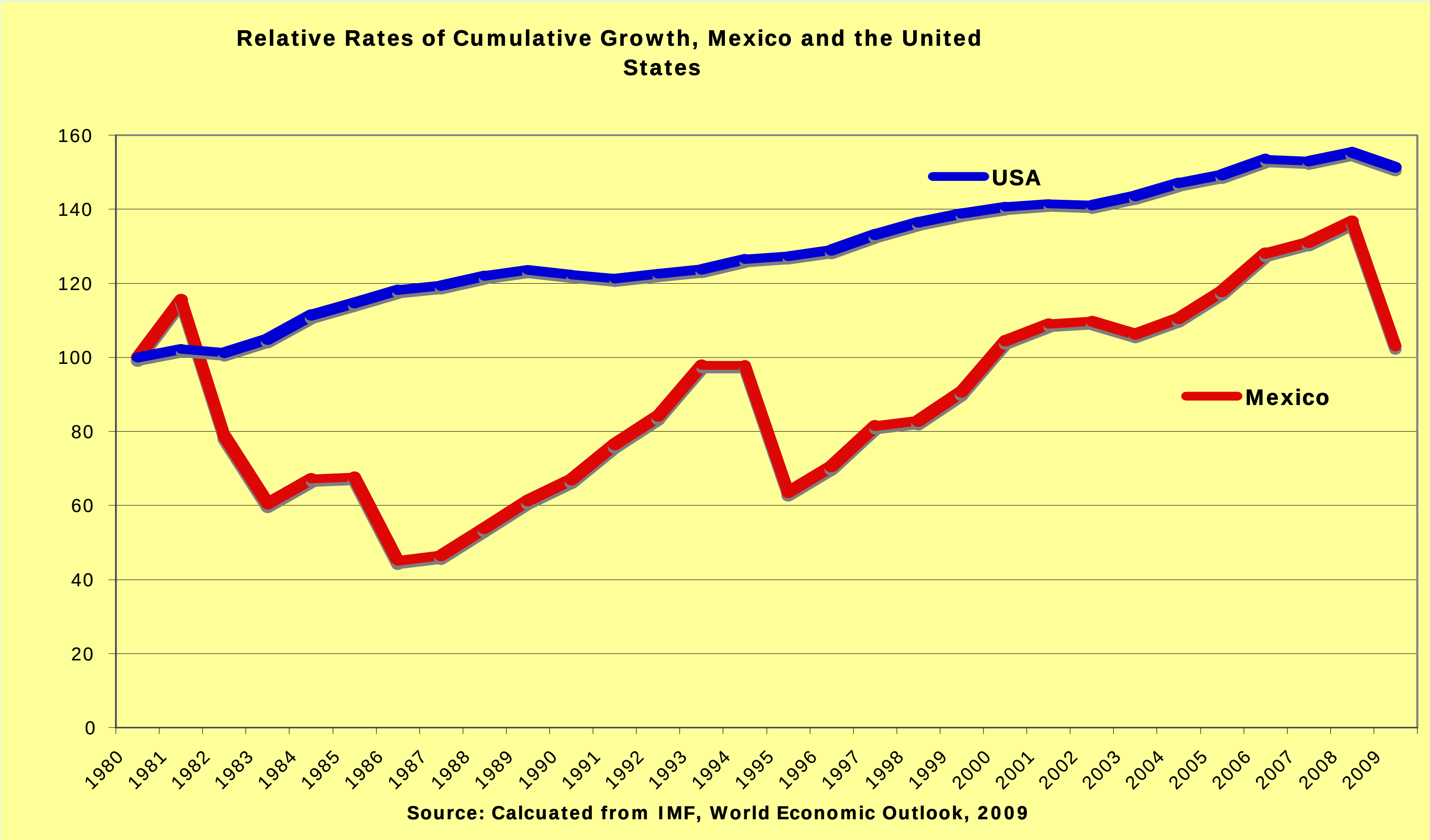
# Mexico has grown slowly over the past three decades



# It has also grown slowly in relative terms



# The pattern is even clearer when expressed as relative rates of cumulative growth



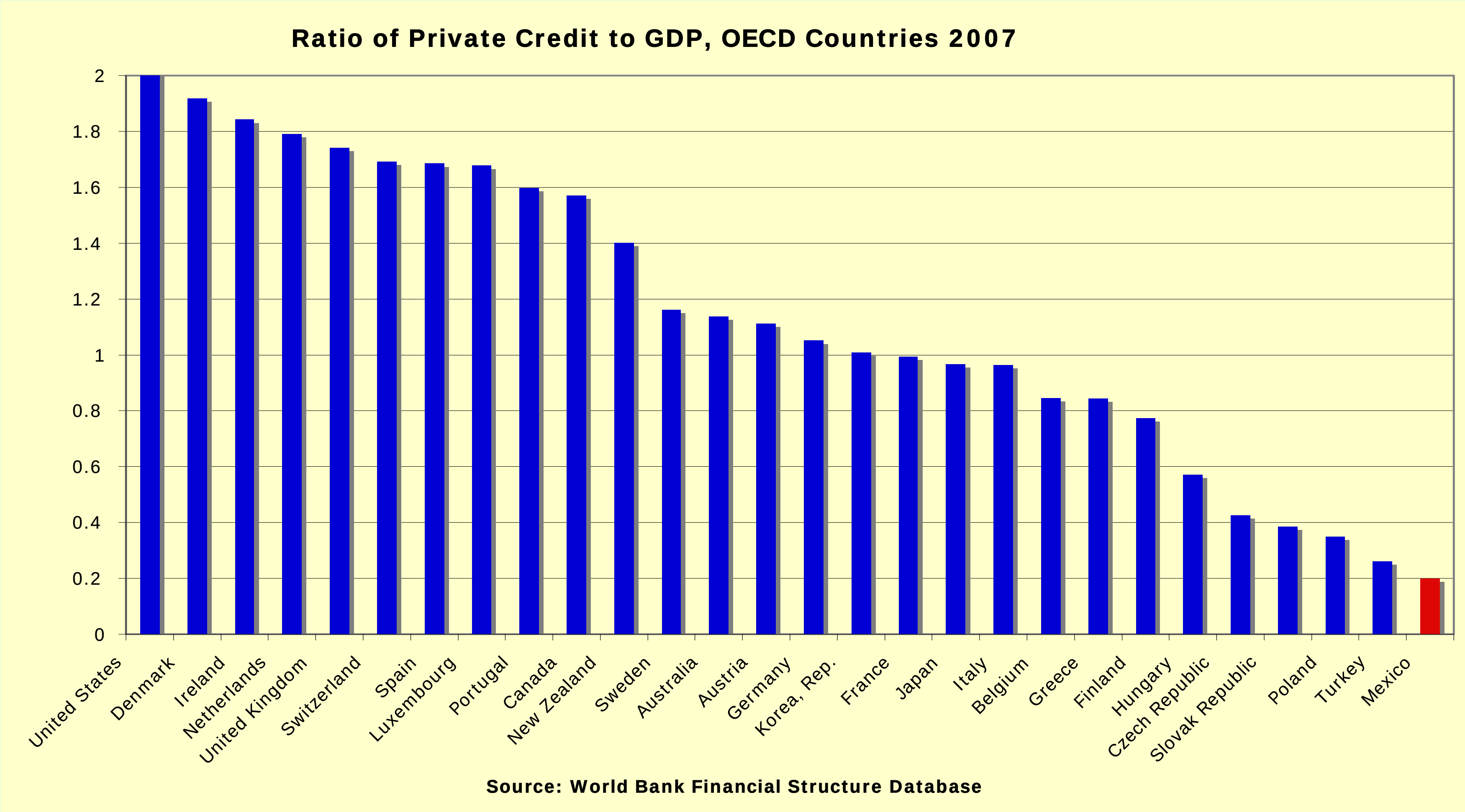
# A variety of causes of Mexico's laggard growth

1. Contagion from US financial crisis of 2008
2. Lack of competition.
3. Inadequate investment in human capital.
4. Inefficient allocation of public finance.
5. Crime and corruption.
6. Lack of credit/differential access to finance.

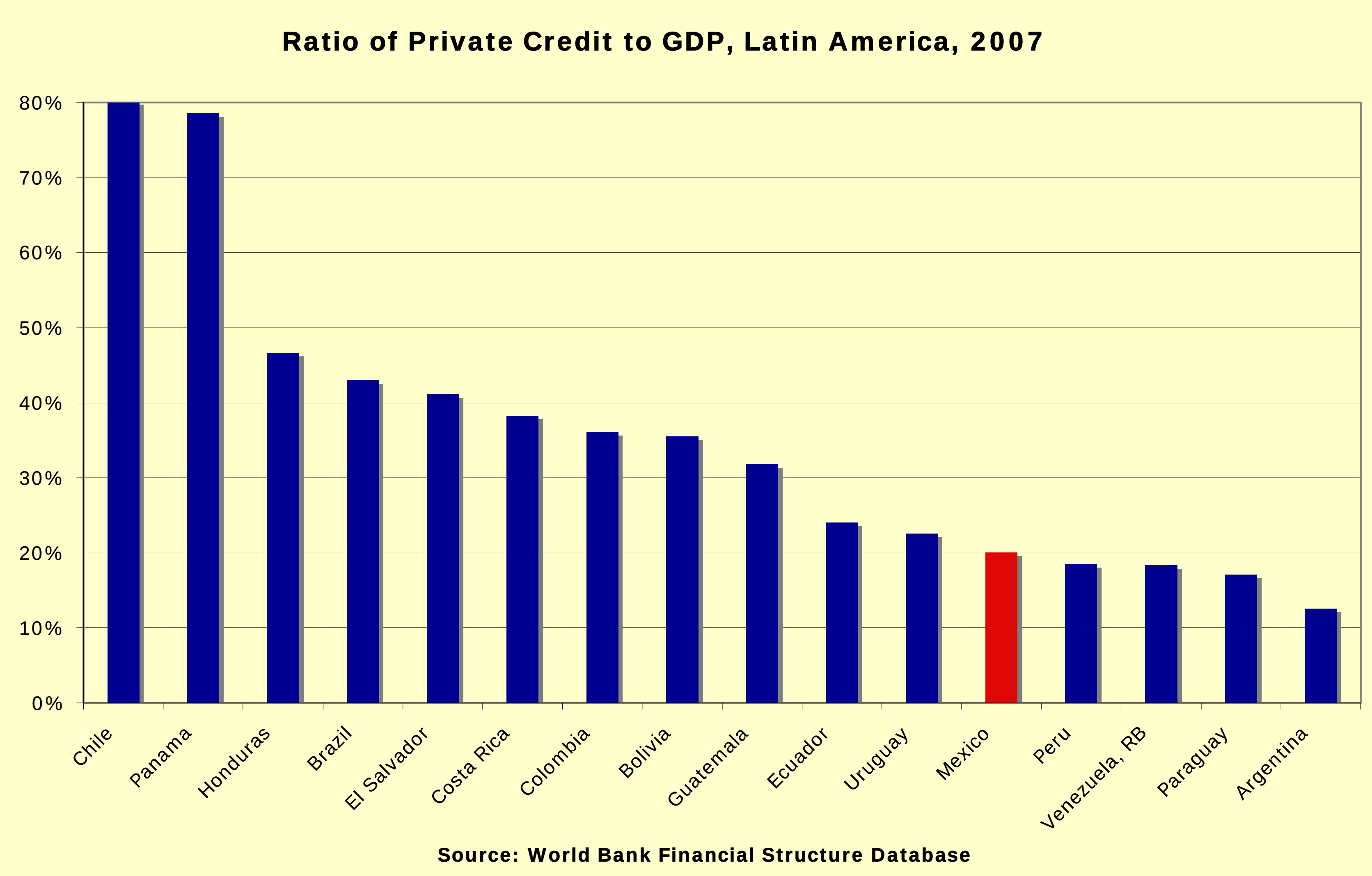
# Focus of this presentation

1. Explain why finance matters for growth.
2. Explore the institutional constraints on financial development in Mexico
3. Discuss policy options

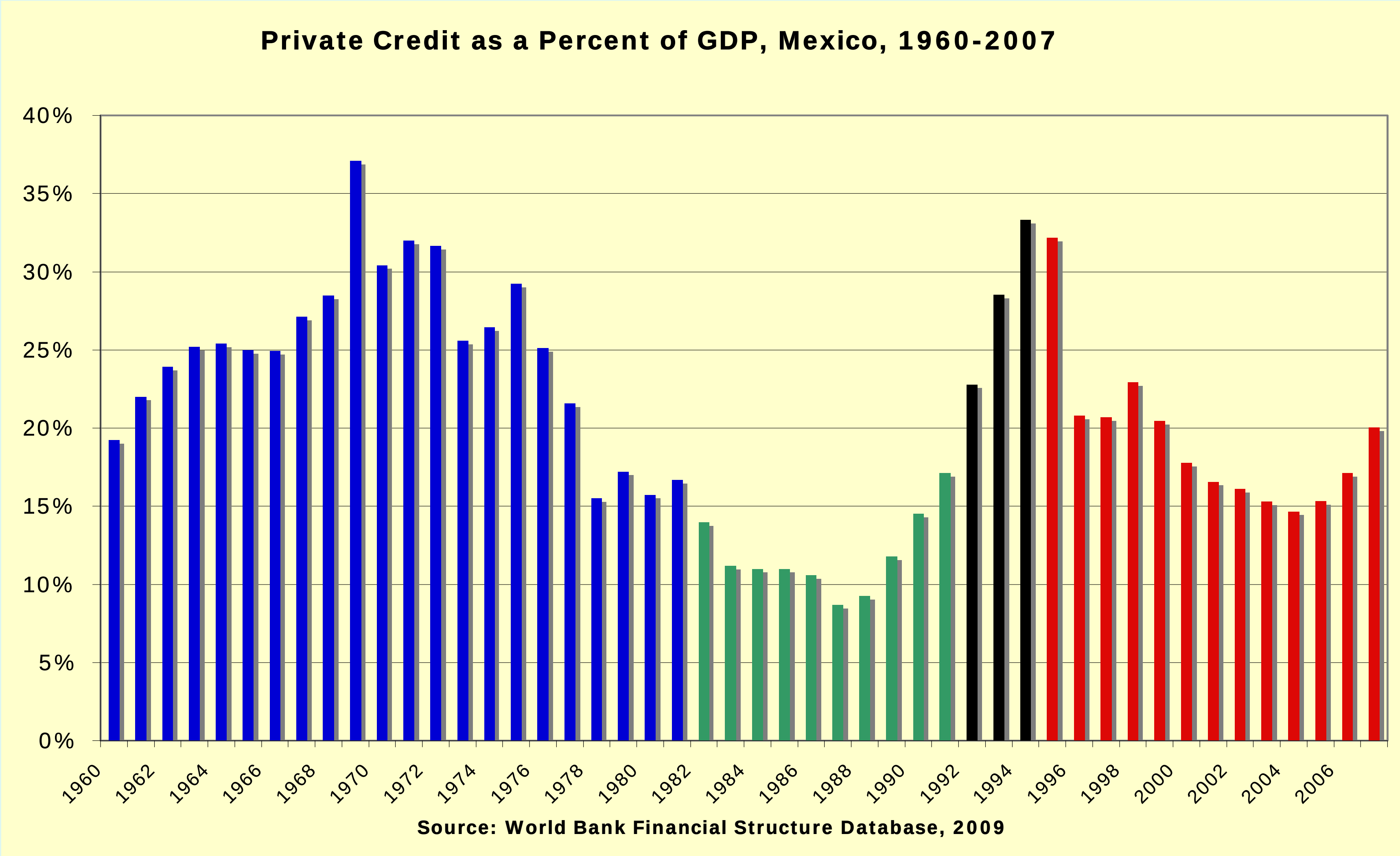
# Mexico has a very small banking system compared to other OECD countries



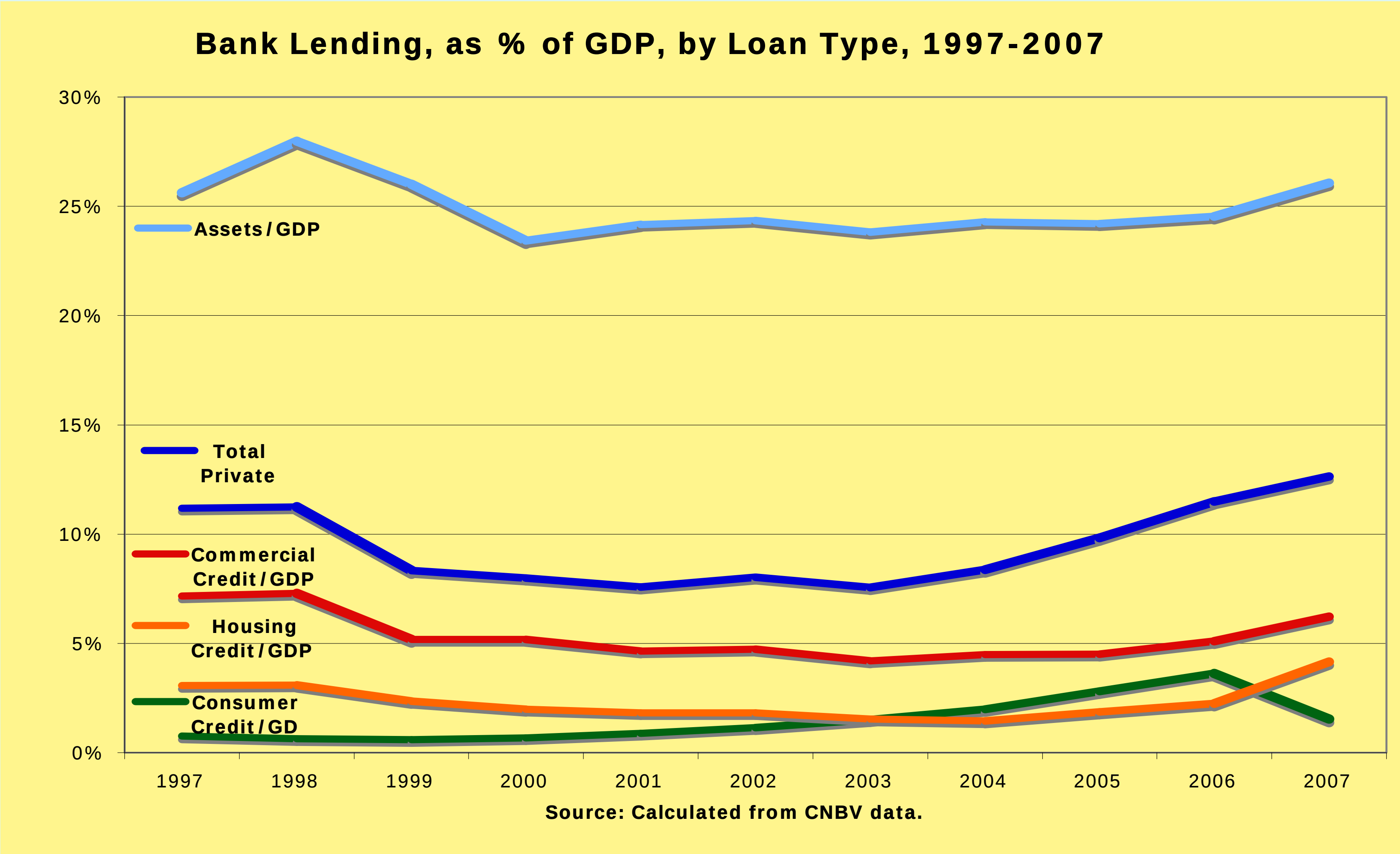
# It is small, even by Latin American standards



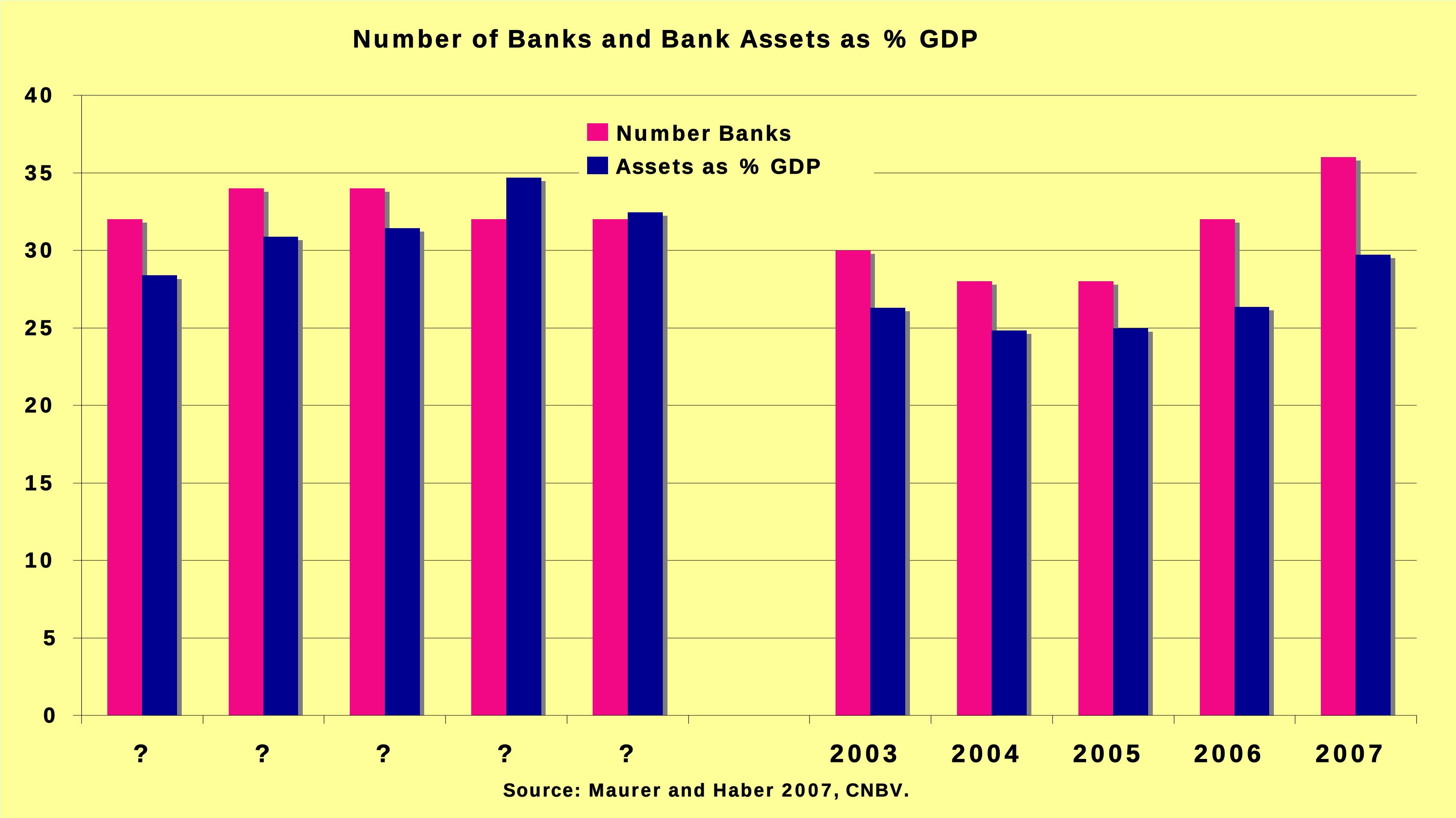
# And, it has not grown in the long run



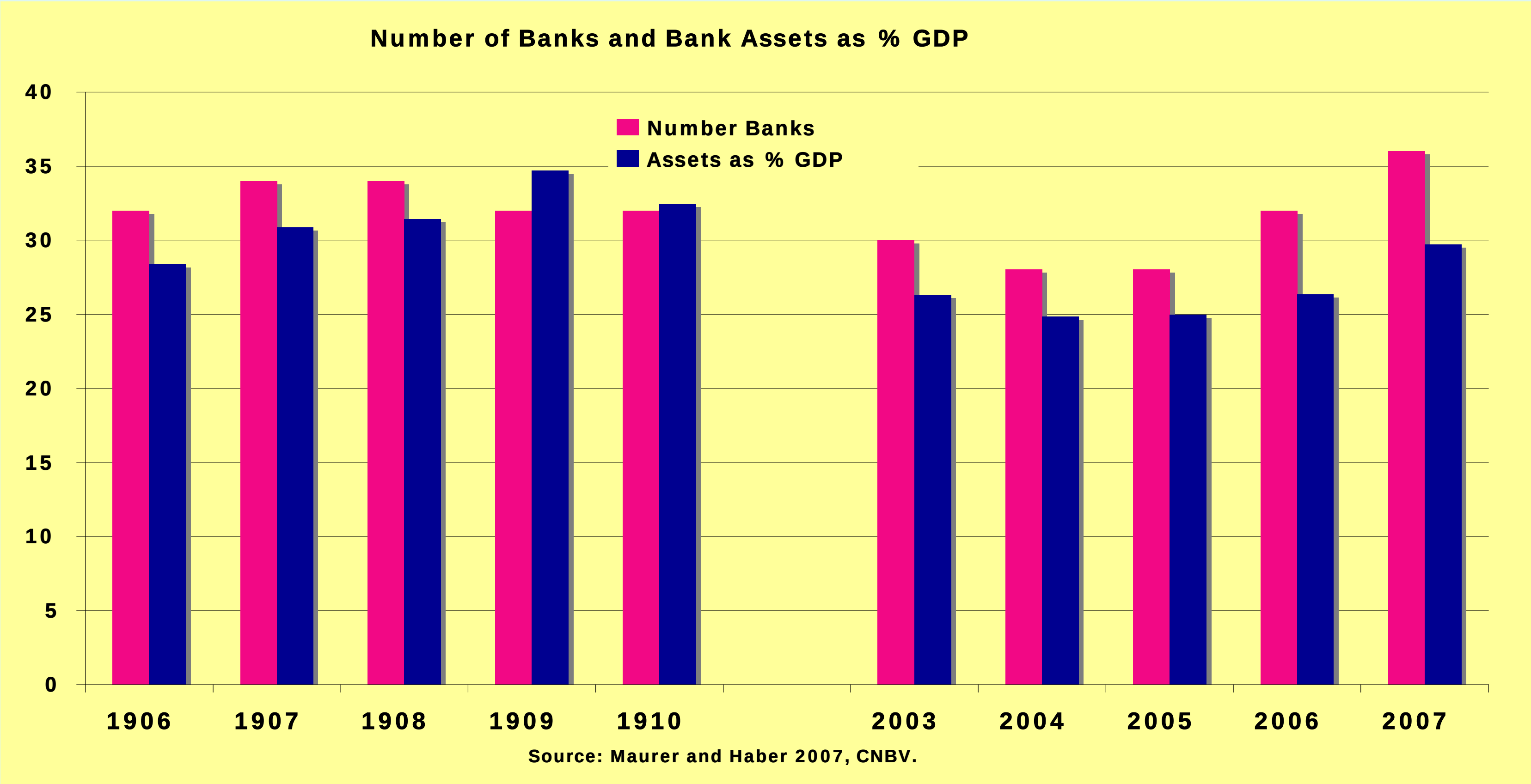
# Over the past decade credit growth, especially to businesses, has been flat



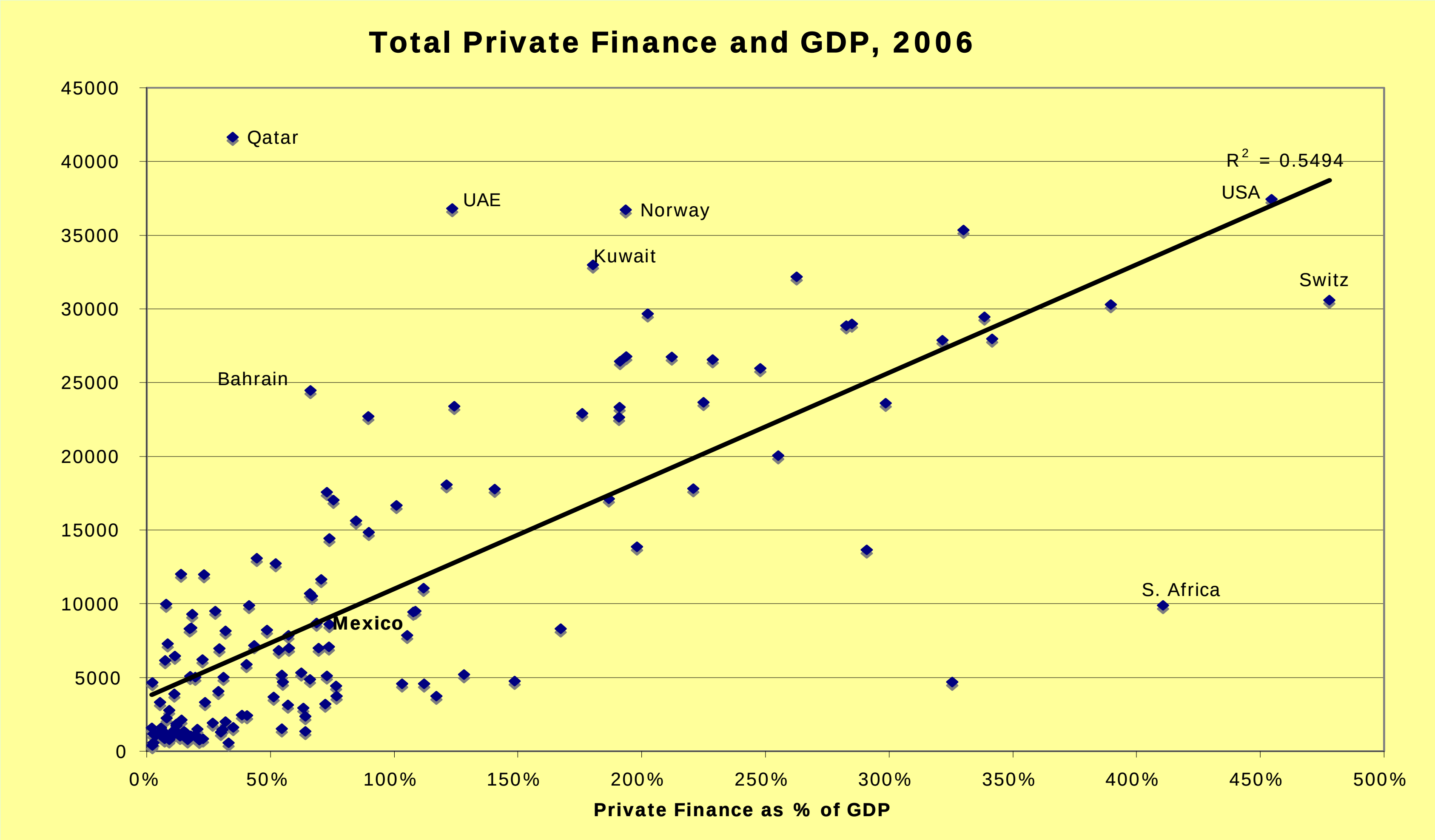
# Which five years of Mexican history resemble the past five, in terms of the size of the banking system relative to GDP?



# Answer:
# the last five years of the Porfiriato



# Why does this matter? Because economic growth and finance are positively correlated



# A consensus that finance *causes* growth

The evidence, from a variety of sub-fields of economics using a variety of methods, is that financial development plays a causal role in economic growth.

# Evidence from economic history

Holland, England, and the United States all experienced “financial revolutions” prior to their drive to rapid growth and world economic leadership (Rousseau and Sylla 2004; Sylla 2006, 2008).

# Evidence from cross-country regressions

Higher levels of financial development are positively associated with faster rates of physical capital accumulation and economic growth.  Financial development predicts subsequent growth (King and Levine 1993; Levine and Zervos 1998; Beck, Levine, and Loayza 2000).

# Evidence from studies of industries

Industries that are relatively more in need of external finance grow faster in countries with larger banking systems and stock markets (Rajan and Zingales 1998; Wurgler 2000).

Countries with greater financial development tend, over time, to specialize in industries that are finance-dependent (Fisman and Love 2004).

# Evidence from studies of the USA focusing on differences across states

States that were more permissive of branch banking during the period 1900-1940 had more intensively cultivated farms and faster manufacturing growth (Dehejia and Lleras-Muney 2007).

Changes in branch banking laws in the 1970s produced a jump in the rate of growth of state per capita income (Jayartne and Strahan 1996).

Allowing inter-state branching in the1990s increased the rate of business incorporation (Black and Strahan 2002).

# Studies of Italian provinces produce similar results

Guiso, Sapienza, and Zingales (2006) find that:

An individual's odds of starting a business increase by 5.6 percent if he moves from the least to the most financially developed regions of Italy.

He will also start a business at a younger age.

The ratio of new firms to population is 25 percent higher in the most financially developed regions of Italy.

Italy's most financially developed regions have faster GDP growth.

# Why does financial development matter for growth?

Better allocative efficiency.

Makes capital available to entrepreneurs (Black and Strahan 2002; Guiso, Sapienza, and Zingales 2006).

Encourages entry of new firms (Haber 1991, 1997, 2003; Maurer and Haber 2007; Cetorelli and Gambera 2001; Cetorelli and Strahan 2006).

Allows small firms to grow faster (in industries characterized by small firms for technological reasons). (Beck, Demirguç-Kunt, Laeven, and Levine 2007).

# If finance is so good for growth why don’t we see more of it?

Answer: in order to create a banking system three thorny problems have to be solved.

1. Bankers must be protected from expropriation by the government.
2. Depositors and outside shareholders must be protected from expropriation by bankers.
3. Bankers must be able to enforce contract rights with debtors.

# Solving these problems requires the creation of institutions

1. To solve problem of government expropriation, institutions must be created to align incentives of the government and the bankers (limit government; or create privileges to compensate bankers for risk).

2. To solve problem of monitoring, institutions must be created that align the incentives of depositors, outside shareholders, and directors (corporate governance, prudential regulation, limited liability, deposit insuranc).

3. To solve problem of contract enforcement, institutions must be created that align the incentives of debtors and bankers. These allow bankers to damage a borrower’s reputational collateral (credit reporting) or repossess his physical collateral (property registers, commercial and bankruptcy law, efficient police and courts).

# All of these institutions involve the government, which:

- Allocates bank charters.
- Supervises and regulates the banks.
- Enforces bank accounting standards.
- Adjudicates and enforces debt contracts.
- Runs the deposit insurance system.

# This creates a dilemma:

- Any government strong enough to regulate banks and adjudicate contracts is also strong enough to expropriate the banks and assets represented by loan contracts.

# Worse, the government is not a disinterested party

It simultaneously borrows from the banks and regulates them.

It simultaneously enforces contracts, and it taxes the assets and income represented by those contracts.

It simultaneously enforces contracts, and needs the political support of the parties to the contract.

# This means that there is wide scope for opportunistic behavior

Governments can:

Allocate bank charters to cronies.

Not enforce the rights of minority shareholders.

Permit lax accounting standards.

Refuse to enforce debt contracts against political allies.

Use its powers of regulation to expropriate the banks--particularly through reserve requirements.

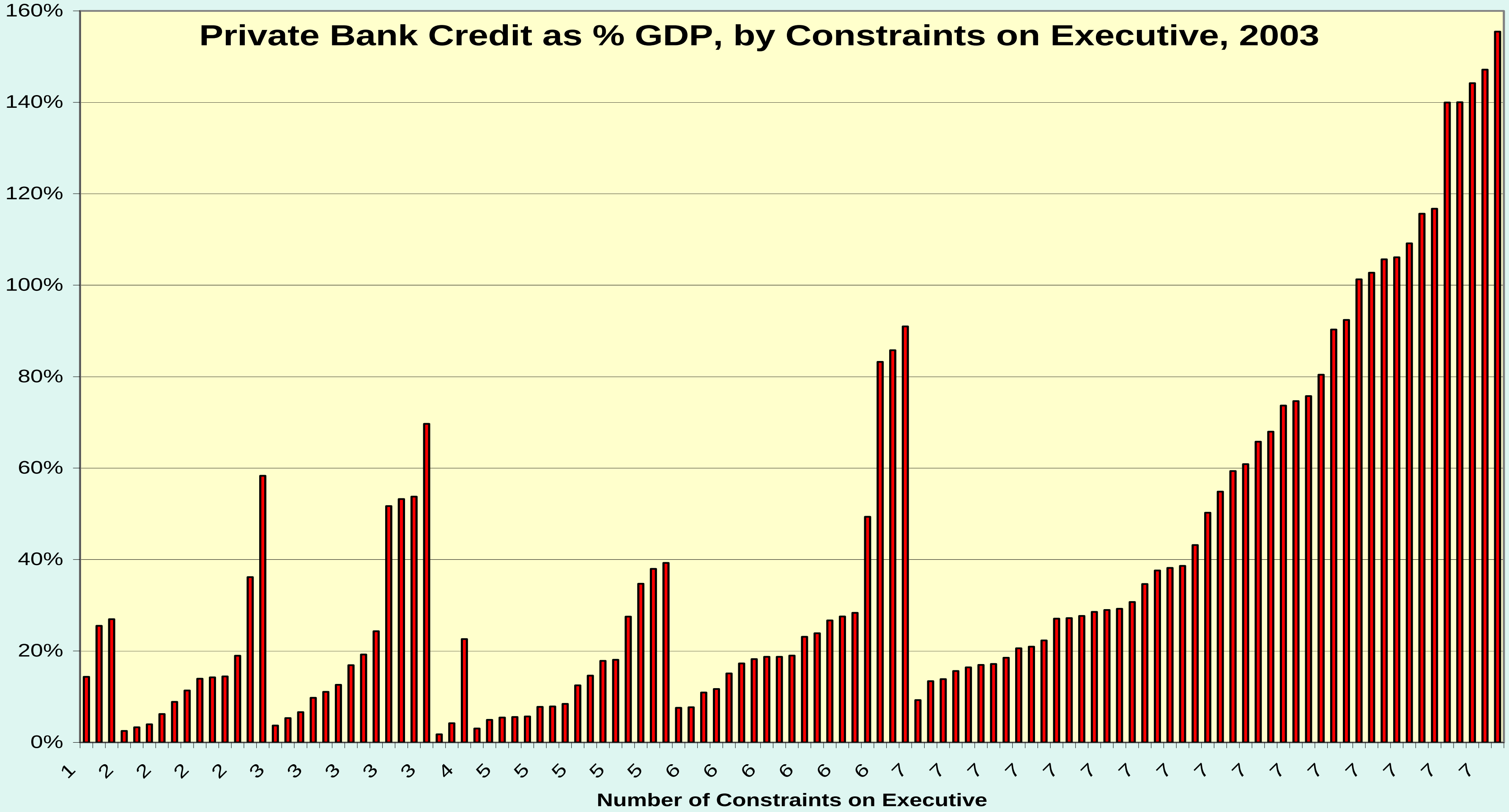
Use its knowledge of private contracts to tax and expropriate private parties.

# The institutions governing finance are influenced by the political institutions

If the government is not limited:

1. Bankers demand compensation for expropriation risk through special privileges and barriers to competition.
2. The population has incentives to hide their assets, which interferes with the creation of property and commercial registers designed to enforce debt contracts.
3. The population has incentives not to invest in institutions that make contracts easier to enforce--efficient courts and police--because those institutions can be used to expropriate.
4. Minority shareholders and depositors demand high rates of return in order to deploy their wealth in banks.

# Evidence for the political institutions view from cross sectional data



# The relationship holds in cross-section and over time within countries

**Regressions of Private Credit/GDP on Political Institutions, 1960-2005**

Robust T Statistics in Parentheses

| | Pooled OLS | OLS with Country Dummies |
|---|---|---|
| **Constraints on Executive** | **0.048**<br>**[6.53]*** ** | **0.015**<br>**[5.39]*** ** |
| Constant | 0.073<br>[3.35]*** | |
| Observations | 3428 | 3428 |
| Number of countries | 131 | 131 |
| R-squared | 0.18 | 0.73 |

* significant at 10%; ** significant at 5%; *** significant at 1%

Driscoll-Kraay Standard Errors (Robust to AR1 serial correlation)

# The institutions underpinning the Mexican financial system were not an exception to this rule

Mexico’s banking institutions evolved over a 100 year period of authoritarian government. This gave rise to a banking system characterized by:

1. Barriers to entry (competition limited). Particularly in the privatization of the1990s.
2. Weak institutions to assess risk (no credit bureaus until the 1990s, and are still weak).
3. Weak institutions to repossess collateral (property registers incomplete and poorly organized).
4. Weak institutions to enforce contracts (inefficient bankruptcy laws, courts, and police).

# Innovative programs in the past decade to mitigate these weak institutions

Mortgages can be written as bilateral trusts instead of as liens on property.

SOFOLES have broadened the credit market, particularly for housing and automobile purchases.

Government agencies (SHF) have served as second tier lenders and guarantors of contracts.

Retail giants allowed to operate banks (e.g. Walmart).

# What should Mexico do?

1. Increasing number of banks—a partial solution.
2. Improving property rights—a more complete solution.
3. But improving property rights is a slow process: Contract enforcement requires changes to a broad range of institutions—property registers, courts, police, and beliefs.

# And all of this will be expensive

The implication is that creating a more efficient banking system will require tax reform.

And that may create an opportunity for Mexico, because one underexploited source of taxation is real property. A reform of the property tax system can be linked to clearer titles.