# Manuel Sánchez: The strengths and challenges of Mexico's financial system

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Mexico Financial Day 2011, CEO Roundtable, New York, 8 November 2011.

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It is a great pleasure to be in New York to speak at the Mexico Financial Day 2011 CEO Roundtable. I would like to thank the organizers of this conference for their kind invitation to be with you today.

As business leaders and investors, you are aware of the sharp asset price corrections and volatility that have characterized international financial markets during recent months. Two central concerns fueling the observed higher risk aversion seem to be the possibility of a catastrophic event in the European Monetary Union (EMU) and the fear of a global recession.

To a large extent, these worries reveal underlying problems stemming from the global financial crisis that began in 2007. The sequel to the crisis includes a protracted stagnation of the housing and credit markets in the United States, the failure and weakening of important financial institutions, and significant fiscal burdens in many countries. Also, sovereign and financial risks feed on each other in some nations in the euro zone, threatening to affect financial participants in other parts of the world.

It is fortunate that, this time, many emerging market economies do not exhibit notable intrinsic financial or fiscal fragilities. In particular, I would like to argue that the soundness of Mexico's financial system, along with its healthy fiscal position and low inflation, constitutes a fundamental strength of the economy, especially in the current adverse environment. However, in order to make a greater contribution to long-term economic growth, this system needs to develop further. Finally, Mexico's economic outlook is one of moderate growth with the main risks related to the evolution of the world economy. As always, my comments are entirely my own responsibility and do not necessarily reflect the views of the Bank of Mexico.

## The strength of the financial system

To function properly, any economy requires an efficient financial system with a fully operational infrastructure, developed markets, and competitive intermediaries. Because of their large role within the Mexican economy and notwithstanding the importance of other intermediaries, today I would like to focus on the commercial banks. As you know, the mission of these institutions is to attract savings, channel those resources to the most productive uses, and contribute to the supply of efficient payment systems. Their intermediation role is based on trust, which, in turn, requires that they manage risk adequately and hold sufficient levels of capital, provisions, and liquidity to absorb potential losses and respond to changes in the composition and duration of depositors' desired asset portfolios.

Mexico's banking system has performed these activities satisfactorily in recent years, and it fared notably well during the global financial crisis. In particular, the economic downturn of 2009 resulted in a contraction of lending, some deterioration of the quality of the loan portfolio, and additional provisioning needs. Yet past-due loan ratios stayed relatively low, perhaps with the exception of that of consumer loans. More importantly, banks remained profitable and well capitalized during the crisis and at all times exhibited adequate levels of liquidly and ample access to funding sources, which, by and large, are based on fairly stable retail deposits.

As economic recovery has taken hold, lending activity has resumed and the quality of the loan portfolio has improved. Bank solvency indicators remain strong, as reflected by capitalization levels, the significant proportion of Tier-1 capital within net capital, and high ratios of loan-loss reserves to past-due loans.[1]

The strong position of the banking system has been the result of improvements to the regulatory and supervisory framework, including stricter capital requirements and rules for provisioning of reserves based on expected rather than realized losses. It is also a consequence of lessons derived from experience. In particular, the financial crisis of 1995 dramatically revealed the need for banks to maintain appropriate levels of high-quality capital potentially able to absorb losses on an ongoing basis. It also taught the importance of well-developed and liquid financial markets in which economic agents can hedge and diversify their risks.

The reforms put in place during the last few years have helped Mexico fortify its financial system, revamp its supervisory practices, and develop its financial markets. The attainment of low inflation has allowed the emergence of long-term contracts, which include longer tenors for public and private debt in pesos at fixed nominal interest rates.

Hence, in marked contrast to the widespread practice in Mexico prior to 1995 and in the United States before 2008, mortgage products are mostly based on fixed nominal interest rates and do not allow for negative amortization. In addition, since banks enjoy highly profitable domestic opportunities in traditional lending, they were not attracted to taking exposures to the derivative instruments that became the amplifying vehicles of instability in the recent great financial crisis.

The soundness of Mexico's banking system represents an economic strength in the face of external shocks, but not because it could potentially shield the country against external financial volatility. In fact, asset price fluctuations, independently of their origin and extent, convey useful information to investors and market participants. For the exchange rate, flexibility helps prevent the build-up of unsustainable balance-of-payments disequilibria which in the past were common causes of currency and banking crises. In any case, hedge products are available for those who are less willing to bear risk.

The fundamental contribution of a sound banking system, especially in times of crisis, is that it does not magnify financial instability. Also, rather than acting as a drag on the economy, through continued intermediation and within limits, it can buttress the pace of economic expansion. In the case of Mexico, this support has been further reinforced by the continued health of public finances and low inflation.

The negative effects of weak financial systems interacting with unsustainable public debt and escalating inflation can hardly be exaggerated.[2] These three elements were behind the Mexican crisis of 1995. Also, the negative feedback loop between the fiscal problems of some EMU member countries and the risk exposures of significant financial institutions are prominent causes of the current maladies in that region, which are threatening to further affect the rest of the world.

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1 For total commercial bank lending to the private non-financial sector, the past-due loan ratio fell from 4.4 percent at the peak of the crisis to 3.2 percent in September 2011. The capitalization ratio was 16.2 percent of which 87 percent was Tier-1 capital in August 2011, the average coefficient of liquidity coverage has been above 100 percent in the course of 2011, and the reserve coverage ratio of non-performing loans was 181.2 percent in August 2011.

2 This point has been extensively documented by Reinhart, C. M. and K. S. Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press.

## Challenges for the financial system

Beyond its key role of contributing to economic stability, Mexico's banking system faces challenges in order to more deeply contribute to long-term economic growth. Perhaps the most crucial task for the system is to increase its scale and scope, as standard indicators of penetration, such as bank loans to GDP, are low compared to those of other economies. It is well documented that financing and economic growth are positively correlated, and causation seems to run from the former to the latter.[3]

But credit expansion may not necessarily be desirable unless it is done prudently. In particular, risk management should not be traded away for size, as the impetus could be short-lived and the banks' contribution to stability and growth could easily evaporate or become negative. For example, the ratio of bank loans to GDP in 1994 reached levels more than twice as high as the current ones, but poor origination and servicing led to disastrous consequences.[4]

Also, the development of the banking system should be carried out at the initiative of the participating financial firms in a highly competitive environment. In particular, it should not depend on credit targets set under the influence of government authorities. Such an approach proved to be a contributor to the excessive risk-taking in mortgage lending to the crisis in the United States.

Moreover, competition has its own benefits, including a wider variety of financial products and services at lower prices. A larger scope of competitive activities can be expected to cover broader geographic areas, incorporating underserved communities or remote and low-income communities not served at all. The different types of non-bank banks and niche financial intermediaries that Mexican regulation currently allows, such as multiple-purpose financial institutions (sofomes) and popular financial institutions (sofipos) play a complementary role by contributing to making basic financial services accessible to previously unbanked regions and families.

Two additional recent developments promise to be an important means of financial inclusion in Mexico. One is the incorporation of retail stores as bank agent premises. Retail stores can facilitate the population's access to basic financial transactions, such as deposits, withdrawals and bill payments. In fact, using them is an efficient way to expand the banks' distribution channels to communities in which it is not profitable to open a branch or even to maintain an ATM. Agent premises have already equated in size the commercial banks' branch network.

A second emerging development is mobile banking using cell phones to conduct basic transactions. Cell phones in Mexico are a common means of communication for rich and poor alike and have seen an exponential rate of expansion. As of August 2011, the number of mobile phones reached almost five times that of fixed telephone lines in the country.[5]

In any case, the future progress of banking activities will have to occur within an efficient and well-balanced regulatory and supervisory framework for financial institutions. This is all the more important given the extreme complications the world economy is suffering from the

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[3] See Levine, R. (2005), "Finance and Growth: Theory and Evidence", in P. Aghion and S. Durlauf (eds.), *Handbook of Economic Growth*, edition 1, volume 1, chapter 12, p.p 865–934, The Netherlands: North Holland.

[4] Commercial bank credit to the non-financial private sector as a proportion of GDP was 30.4 percent in December 1994 and 13.9 percent in September 2011.

[5] As of August 2011, the number of commercial bank branches was 11,552, while the number of banking agents was 12,260; a total of 41 percent of municipalities, accounting for 5.4 percent of the total population, still did not have bank branches, ATMs or banking agents; Mexico counted 96.4 million mobile phones and 19.2 million fixed telephone lines.

financial excesses that led to the global financial crisis. At the same time, regulation should not inhibit the innovation and flexibility necessary for the banking system to accomplish its mission.

As I said, Mexico has made substantial improvements on regulation and supervision. However, the agenda for financial authorities needs to embrace the further enhancement of micro-prudential standards for banks, such as capitalization and liquidity requirements; macro-prudential measures to detect early systemic risk factors and counteract them; and the design of an expedient bank resolution mechanism.[6]

## Economic outlook

During the third quarter of 2011, the Mexican economy continued the process of recovery that began two years earlier. In particular, during July and August, the latest months for which full production data are available, the General Indicator of Economic Activity (IGAE), a monthly GDP proxy, exhibited a year-on-year average rate of growth of 3.8 percent, slightly higher than the corresponding figure in the previous quarter.

Even though in August the level of the IGAE surpassed that of June, different economic indicators suggest that the rebound is losing steam. For example, the increase in activity in July was followed by a contraction in August. This fall occurred both in the industrial and service sectors, which account for approximately 95 percent of total output. The lower activity was partly compensated for by a significant rise in agricultural production, mainly as a result of government support programs for re-sowing land after harvest losses due to bad weather in the first quarter of 2011.

Deceleration was clearer in industrial production, which seems to reflect a quarterly reduction of manufacturing exports to the United States, the destination of almost 80 percent of total non-oil exports. The contraction of shipments to Mexico's northern neighbor was concentrated in non-automotive products, although automotive sales to that market saw growth that was somewhat attenuated.

Additionally, domestic demand growth has apparently begun to slow down. Retail sales during July and August suggest that consumption probably increased at a declining rate. On the other hand, although gross fixed investment in July continued expanding at a significant pace, imports of capital goods during the third quarter fell.

In all, third-quarter GDP quarterly growth was probably similar to or a little lower than that of the preceding three months. However, slowing could become more evident in the coming quarters, should consensus forecasts turn out to be correct, at least approximately. For example, in the October survey of analysts' expectations conducted by the Bank of Mexico, annual GDP growth is forecast to decline from 3.7 percent in 2011 to 3.2 percent in 2012. Relative to what was forecast a year earlier, expected growth is slightly higher for 2011 but almost a full percentage point lower for 2012.

It is worth noting that, although less than ideal from the point of view of social wellbeing, projected growth for 2012 is not negligible. In fact, it surpasses the expected growth of advanced economies as well as the somewhat disappointing, average yearly expansion of the Mexican economy during the last decade, even after excluding the 2001 and 2009 recessions.

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[6] The Bank of Mexico has performed stress tests for short-term macroeconomic shocks affecting financial variables and for a long-term credit stress shock. These exercises show the banking system is resilient to extreme disturbances. For further details, see Bank of Mexico, *Reporte sobre el Sistema Financiero*, October, 2011.

Certain currently positive factors, such as the strong upturn in formal employment and bank lending to the private sector, particularly to the consumer and small- and medium-sized enterprises, may be expected to continue supporting domestic demand in the coming months. However, since the downward revision in growth prospects for 2012 was mainly a reflection of substantial cuts in the forecasts for U.S. industrial production, a deeper-than-expected deceleration in that country would necessarily translate into further downward adjustments for Mexico's growth forecasts.

Finally, monetary policy continued to be oriented toward the 3 percent annual inflation target, which the Bank of Mexico established at the end of 2003. As you know, the policy overnight interest rate has been maintained at 4.5 percent since August 2009. This stance has proved adequate, as inflation has been gradually converging to the central bank's objective. In particular, during 2011, inflation has remained substantially close to albeit above this benchmark, averaging 3.4 percent.

In the future, the Bank of Mexico will have to continue monitoring the various risks that may potentially impede further progress in the consolidation of price stability. This commitment is its main contribution to economic certainty, which is of paramount importance, especially during these times of financial turbulence.

In an inflation-targeting regime, what really matters for the guidance of monetary policy is future inflation and how this relates to the policy objective.[7] In this sense, I believe that the main risk to the consolidation of price stability is the stickiness that various measures of expected inflation have persistently shown. On the basis of some analysts' surveys, average expected inflation for several time horizons, including medium- to long-term, continue to be above the target. Also, the break-even inflation implicit in the bond market has remained close to 4 percent.

The anchoring of these expectations around the inflation target remains an important challenge to monetary policy. I expect that this anchoring will be achieved through the maintenance of a consistent monetary policy, and that the Mexican economy will continue on the convergence path to the inflation target in an environment of economic growth.

## Concluding remarks

Mexico's financial system, along with its healthy fiscal position and low inflation, constitutes a fundamental strength for the economy in the face of adverse external conditions. This strength has been the result of improvements in the regulatory and supervisory framework as well as in firms' management models. On the other hand, the banking system faces important challenges in order to more deeply contribute to long-term economic growth. Perhaps the most important endeavor is for the system to prudently increase its scale and scope within a competitive environment.

Mexico's economic outlook is one of moderate growth at a rate that surpasses that of advanced nations but with the main risks coming from those economies. Inflation is likely to remain subdued, sustaining its convergence to the permanent 3 percent target. Nevertheless, the Bank of Mexico will have to continue monitoring the risks that may hinder progress toward the consolidation of price stability.

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[7] For a seminal exposition of inflation targeting, see Bernanke, B.S., T. Laubach, F. S. Mishkin and A.S. Posen, (1999), *Inflation targeting: lessons from the international experience*, Princeton, N.J.: Princeton University Press. Taylor, J. B. (1993) exposes a simple interest rate rule for price stability, see "Discretion versus Policy Rules in Practice", *Carnegie-Rochester Conference Series on Public Policy* 39, p.p. 195–214.