# MEXICO AND THE GLOBAL FINANCIAL MARKET: CAPITAL FLIGHT AS A FACTOR IN NATIONAL ECONOMIC POLICY MAKING

*Stephen Zamora**

## INTRODUCTION

Over the past ten years, there has been a dramatic increase in the integration of international financial markets, having important implications for the regulation of financial institutions and national monetary policy.[1] Although attention has primarily focused on this phenomenon's implications for *developed* countries' economies, the effects of international financial integration on *developing* countries' economies has not been ignored.

My focus is international financial integration and the resulting current and future implications for Mexico due to its connection with the global financial market. For countries like Mexico, the external debt problem has monopolized much attention, even though the debt crisis is only one aspect of global financial integration.[2] While there is the hope that someday the debt crisis of the 1980s will be relegated to the history books, the creation of an integrated, global financial market is a phenomenon that is just beginning. In terms of overall effect, this phenomenon will influence Mexican policies to a much greater extent than the external debt crisis.

International banking has existed since the Middle Ages, and many aspects of the global financial market, such as placing deposits in overseas banks, or exchanging currencies, are not new. However, the growth in volume, scale, complexity, and speed with which today's financial institutions carry out these international activities

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* Professor of Law and Director of Mexican Legal Studies, University of Houston Law Center.

1. *See generally* R. PECCHIOLI, THE INTERNATIONALIZATION OF BANKING: THE POLICY ISSUES 85-125 (1983).

2. "The importance of financial markets in the transmission of economic influences from industrial to developing countries has grown considerably as a result of the increased levels of developing countries' external debt and the greater role of private creditors, especially international commercial banks." Goldsbrough & Zaidi, *Transmission of Economic Influences from Industrial to Developing Countries*, STAFF STUDIES FOR THE WORLD ECONOMIC OUTLOOK, (International Monetary Fund) July 1986, at 189.

is new.[3] Technological developments in computers and telecommunications systems, and institutional factors like the abandonment of fixed exchange rates, have contributed to the creation of the new phenomenon of a global financial market. As a result, financial flows unrelated to trade in goods and services have gained new importance in determining the strength or weakness of a country's international economic health.

The debt crisis is only one result of the increased integration of developing countries into the global financial market. After the initial shock of the debt crisis wore off, some people wondered what had happened to the dollars that had been borrowed by Mexicans, Brazilians and others. As we shall see,[4] a large percentage of these dollars went back to the United States in the form of capital flight. Some portion of Mexico's external debt (the exact amount is still a matter of debate) was used to finance overseas investments by Mexicans, rather than to finance productive capacity in Mexico. Mexicans and others tapped into the global financial network as investors, as well as borrowers.

The following discussion addresses the problem of capital flight[5] and whether it is likely to be a continuing feature of the Mexican economy. The Mexican government's policies in dealing with the threat of capital flight will also be briefly discussed. Capital flight, facilitated by the global financial network now being established, will become an even more important factor in government economic policies in Mexico, further diminishing autonomous decision-making that monetary officials wish to exercise.

## I. CAPITAL FLIGHT AND BALANCE OF PAYMENTS CRISES IN MEXICO

It is generally recognized that capital flight contributed to the Mexican balance of payments crisis of 1982.[6] However, there is dis-

3. *See generally* H. KAUFMAN, INTEREST RATES, THE MARKETS, AND THE NEW FINANCIAL WORLD 95-101 (1986); PECCHIOLI, *supra* note 1, at 16 *et seq.*

4. *See infra* notes 15-19 and accompanying text.

5. I realize that there is not complete agreement as to whether capital flight is a "problem," or whether it merely represents movements of capital that respond to other, "real" problems in the economy, and may therefore be beneficial by forcing solutions to those problems. For a discussion of the benefits of capital mobility, but also the disadvantages (especially for the short term) of capital flight, *see* H. Mayer, *The Theory and Practice of Floating Exchange Rates and the Role of Official Exchange Market Intervention* at BIS ECONOMIC PAPERS No. 5 (1982) 20-21, 39-41.

6. *See, e.g.*, N. BAILEY & R. COHEN, THE MEXICAN TIME BOMB 12 (1987); D. WYMAN, *The Mexican Economy: Problems and Prospects*, MEXICO'S ECONOMIC CRISIS: CHALLENGES AND OPPORTUNITIES 1, at 9-10 (Center for U.S.-Mexican Studies, Univ. Cal. San

agreement concerning the extent of that contribution and whether capital flight, or the threat of it, continues to be a problem.

In most countries, capital movements have become an increasingly important factor in the balance of payments and consequently, in determining exchange rates. As noted by Henry Kaufman, the senior economist at Salomon Brothers: "This trend toward greater capital mobility has several important policy implications. More than ever before, capital flows—not trade flows—are now the principal determinant of exchange-rate movements."[7]

This statement applies not only to the economies of capital-rich countries like the United States, West Germany or Japan; but also to countries such as Mexico. Mexico's 1982 financial crisis was not caused by a softening of oil prices, or by increased consumption of imported goods. Rather, it was caused primarily by forces related to capital flows—more precisely, by an increase in two types of capital outflows: (1) funds needed to service the increasingly burdensome number of foreign loans, and (2) funds sought by Mexican businesses and individuals as a hedge against the falling peso (i.e., capital flight).

The government dealt directly to staunch capital outflows in the first category, the servicing of external debt. It simply refused to make all payments called for under sovereign loans, and it used pressure—principally, the adoption of the FICORCA Program—to persuade foreign creditors to accept the rescheduling of payments due on private debt.[8]

Stopping capital flight was not so easy. At the outset, the government of President Lopez Portillo took the drastic step of imposing strict exchange controls to prevent Mexicans from acquiring foreign

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Diego, Monograph Series, No 12 (D. Wyman, ed. 1983)); *Mexico: Progress and Prospects*, WORLD FINANCIAL MARKETS, (Morgan Guaranty Trust) May, 1984, at 1; Zamora, *Peso-Dollar Economics and the Imposition of Foreign Exchange Controls in Mexico*, 32 AM.J.COMP.L. 99, 103 (1984).

According to R. LOONEY, ECONOMIC POLICYMAKING IN MEXICO 45 (1985), the deficit in errors and omissions, one measure of capital flight, jumped by 180% from 1980 to 1981:

| | *1976* | *1977* | *1978* | *1979* | *1980* | *1981* |
|---|---|---|---|---|---|---|
| Errors and omissions | -2454 | -459 | -18 | 703 | -1961 | -5506 |

Significant capital flight accompanied earlier financial crises, in the 1950s and in the mid-1970s. D. BROTHERS & L. SOLIS, MEXICAN FINANCIAL DEVELOPMENT 85, 87 (1966) (commenting on capital flight during the 1950s); D. LOONEY, MEXICO'S ECONOMY: A POLICY ANALYSIS WITH FORECASTS TO 1990 114, 118, 120 (1978) (commenting on capital flight at end of Echeverria *sexenio* in 1976).

7. H. KAUFMAN, *supra* note 3, at 88.

8. See the description of FICORCA in PORTAL, *The Restructuring of Mexican Private Debt*, 1 DOING BUSINESS IN MEXICO, Chapter 25-C (S. Lefler, ed. 1986).

capital for that purpose.[9] These controls were then relaxed, and a form of liberalized exchange control was adopted, which allowed Mexicans greater freedom in acquiring dollars and making international transfers.

### *A. What is Capital Flight?*

Capital flight is an unpopular subject, even among economists, who are accustomed to dealing with unpopular subjects. Not only is capital flight difficult to quantify, it is difficult to define. Economists differ as to what capital flight is, and to the data that should be used to quantify it. Some focus on the "errors and omissions" category of the balance of payments. This is a rough measure of unrecorded flows as well as of statistical errors. A negative figure for errors and omissions represents unrecorded capital outflows.[10] Others use a more expansive definition of capital flight, such as "the reported and unreported acquisition of foreign assets by the nonbank private sector and some elements of the public sector."[11] Another measure is the "sum of gross capital inflows and the current account deficit, less increases in official foreign reserves."[12] The Mexican Secretariat of Finance and Public Credit has been sufficiently annoyed by expansive definitions, and the results derived from them, that it recently published a pointed criticism of using such definitions in calculating capital flight.[13]

9. *See generally* Zamora, *supra* note 6.

10. *See, e.g.*, Goldsbrough & Zaidi, *Staff Studies for the World Economic Outlook*, *supra* note 2, at 182 (citing Cuddington, "Capital Flight: Estimates, Issues, and Explanations," an unpublished discussion paper (March 1985)):

> [s]ome rough estimates of capital flight can be made on the basis of the errors and omissions category in the balance of payments accounts. Cuddington (1985) has argued that the errors and omissions category plus certain sub-categories of the line item "other short-term capital, other sector" in the balance of payments accounts may be used to estimate capital flight.

For a clear discussion of definitional problems, *see* Khan & Ul Haque, *Capital Flight from Developing Countries*, 2-3 FINANCE & DEVELOPMENT Vol. 24 (No. 1) (1987).

11. *LDC Capital Flight*, WORLD FINANCIAL MARKETS, (Morgan Guaranty Trust) (March 1986) at 13. This same study translates this general definition into a formula, as follows: "the counterpart of the sum of net direct investment inflows, change in gross external debt, current account balance, and change in selected gross foreign assets [primarily foreign assets of monetary authorities and of banks]." *Id.*

12. *Mexico's Crisis Grows as Money and the Rich Both Seek Safer Places*, Wall Street Journal, Nov. 11, 1985, at 1.

13. *Precisiones sobre el calculo de la fuga de capitales*, EL MERCADO DE VALORES, Ano XLVI, Num. 21, May 26, 1986, at 516.

### B. *Problems in Quantifying Capital Flight*

Quantifying capital flight is even more problematical than defining it. According to a recent International Monetary Fund (IMF) report, "[r]egardless of how broadly or narrowly one defines capital flight, assessing its quantitative importance is difficult because of the imprecision with which financial transactions are often reported in countries' balance of payments."[14]

The estimates of capital flight from Mexico for the period preceding 1982 have varied. The Wall Street Journal, citing World Bank estimates, reported that capital flight from Mexico during the period 1979-1982 amounted to 26.5 billion dollars, and noted that Mexico's Central Bank acknowledges that at least 33 billion dollars flowed out of the country from 1977 to 1984.[15] Ingo Walter estimates capital flight from Mexico, during 1980 to 1982, at about 26 billion dollars.[16] Walter estimates capital flight from Mexico during the period 1974-1982 at close to 40 billion dollars—an amount representing 43% of the net external debt incurred during the period.[17] According to Morgan Guaranty Trust, capital flight from Mexico during the last decade amounted to 50 billion dollars.[18] This figure does not seem outrageously high if one considers the capital flight at the end of the Echeverria regime, and leads Morgan Guaranty to conclude that had it not been for capital flight during the past decade, the gross external debt of Mexico would only be 12 billion dollars. This would be a quite manageable sum in comparison to the 97 billion dollars of debt actually incurred to the end of 1985.[19]

### C. *Capital Flight After 1982*

Capital flight did not stop after the crisis of 1982. It did slow slightly due to the high price and relative unavailability of dollars between 1982 and 1984. However, after 1982 the negative figures

14. STAFF STUDIES FOR THE WORLD ECONOMIC OUTLOOK, *supra* note 2, at 182. The economists at Morgan Guaranty Trust discuss several sources of uncertainty stemming from misreporting of transactions and "valuation effects [methods of placing value on foreign assets and liabilities]. *LDC Capital Flight*, *supra* note 11, at 13-14. The problems of measuring capital flight are also discussed in Khan and Ul Hague, *supra* note 10, at 3-4.

15. Wall Street Journal, *supra* note 12, at 1.

16. I. WALTER, SECRET MONEY: THE WORLD OF INTERNATIONAL FINANCIAL SECRECY 42 (1985).

17. *Id.* at 43. Kahn & Ul Haque, *supra* note 10, at 4, gives estimates of 29.4 to 32.7 billion dollars for the same period, depending on method of measurement.

18. *Growth and Financial Market Reform in Latin America*, WORLD FINANCIAL MARKETS (Morgan Guaranty Trust) (April/May 1986) 1 at 10 .

19. *LDC Capital Flight*, *supra* note 11, at 15.

continued in the errors and omissions line of the Mexican balance of payments. These figures can be interpreted as a rough measure of "hidden" or unrecorded capital flight.[20]

As Table I[21] shows, using the sum of net errors and omissions and other short-term capital as a rough indicator of capital flight, [22] the period after 1982 showed a continuation of short-term capital outflows. While the figures for net errors and omissions became smaller after 1982, recorded short-term capital outflows increased. The combined effect showed a continuing strain on the balance of payments for a country trying to save foreign exchange in order to service its external debt.

Further evidence of the continuation of capital flight from 1982 to 1985 can be seen in statistics published by the U.S. Treasury Department. Table II[23] shows the deposits in U.S. banks held by Mexicans.

Table II[24] shows a steady increase in Mexican deposits in the

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*Table I*

Selected Balance of Payments Statistics
(figures in millions of SDRs)

I. Net errors and omissions

| *1978* | *1979* | *1980* | *1981* | *1982* | *1983* | *1984* | *1985** |
|---|---|---|---|---|---|---|---|
| -104 | 501 | -2901 | -7054 | -4890 | -981 | -974 | -1410 |

II. Other short-term capital, other sectors

| *1978* | *1979* | *1980* | *1981* | *1982* | *1983* | *1984* | *1985* |
|---|---|---|---|---|---|---|---|
| -430 | -863 | 2151 | 3374 | -2013 | -4962 | -3801 | -1477 |

I. and II. combined

| *1978* | *1979* | *1980* | *1981* | *1982* | *1983* | *1984* | *1985* |
|---|---|---|---|---|---|---|---|
| -534 | -362 | -750 | -3680 | -6903 | -5843 | -4775 | -2887 |

* First two quarters of year only

Source: IMF, Balance of Payments Statistics Yearbook
Volume 37, Part 1, 1986, p. 434

21. *See supra* note 20.
22. *See supra* note 10.
23.

*Table II*

Deposits held by Mexicans in U.S. banks
(position at end of period, in billions of dollars)

| *1980* | *1981* | *1982* | *1983* | *1984* | *1985* | *1986** |
|---|---|---|---|---|---|---|
| 4.569 | 7.351 | 8.607 | 10.739 | 12.614 | 14.549 | 13.438 |

* period ending June, 1986

Source: U.S. Treasury Bulletins, Winter 1984, 1985, 1986

24. *See supra* note 23.

United States leading up to the crisis year of 1982; however, the drain continues after that year. Most of these deposits are held in the form of demand and time deposits by Mexican citizens and nonbanking companies. For example, of the 14.5 billion dollars held on deposit in 1985, approximately 12 billion dollars consisted of time and demand deposits, and certificates of deposit, held by people other than official institutions, and unaffiliated foreign banks.[25]

The U.S. Treasury is careful to point out that it only reports Mexican-source deposits that are identified as such by reporting banks. It is therefore probable that the actual figures for the increase in cash outflow to U.S. banks by Mexicans would be greater than these figures indicate if one added deposits made on behalf of Mexicans by U.S. citizens and others. For instance, as of December 1985, deposits held in U.S. banks by "persons" of the British West Indies totalled 43.4 billion dollars.[26] One can assume that many of these deposits came from offshore investment banks that were actually handling capital flight money from Latin Americans and others, including Mexicans.

These figures are more striking when one compares them with deposits held by Mexicans in their own banks. Morgan Guaranty Trust has estimated that Mexican non-bank deposits held abroad (in the United States and elsewhere) grew from 9.4 billion dollars in 1981 to 15.3 billion dollars in 1985.[27] Domestic banking deposits by non-banks were estimated to equal 35.8 billion dollars in 1985. Comparing the figures, Morgan Guaranty Trust calculated that the amount of money held by Mexicans in banks abroad amounted to 43% of Mexican held deposits. The estimate appears high, and the Secretariat of Finance and Public Credit has criticized Morgan Guaranty for playing loosely with such figures.[28] Using figures issued by the Mexican government for peso deposits held by the Mexican banking system in July 1985, and dividing them by the conservative estimate of 15 billion dollars held in foreign banks (at the exchange rate of 300 pesos to the dollar, as a rough estimate[29]), one finds that foreign deposits were 18.5% of domestic deposits. Because these figures for foreign deposits are conservative, and do not

25. Treasury Bulletin, Winter issue, Fiscal 1986, at 150.
26. *Id.*
27. *Growth and Financial Market Reform in Latin America, supra* note 18, at 10.
28. *Precisiones sobre el calculo de la fuga de capitales, supra* note 13, at 516.
29. INTERNATIONAL FINANCIAL STATISTICS, Vol. XXXVIII, No. 11 (International Monetary Fund) (Nov. 1985) at 16. This figure computed from July 1985 exchange rates for the dollar ($1.03) and the peso (P.291) per SDR.

include deposits held by others for the benefit of Mexicans, the actual percentage is probably somewhere between the Morgan Guaranty calculation of 43%, and the government measure of 18.5%.[30]

There is some evidence that this penchant for placing funds in U.S. banks may be in the process of being reversed. In Table II,[31] the figures for 1986 show a decline in Mexican deposits in U.S. banks. This reflects a concerted effort by the Mexican monetary authorities to foster interest rates that make short-term investments in pesos attractive to Mexicans who may wish to repatriate some of this capital. According to a recent report by Banamex, stability in the exchange market in the interim will be aided by "[e]xchange and monetary policies, whose objectives include encouraging domestic savings, thereby promoting a favorable climate for the repatriation of capital."[32] For example, holders of one-month promissory notes in Mexico, with real earnings of 23.32% in October 1986, could earn more than three times the real return for dollar deposits in any U.S. bank.[33] However, much capital still remains abroad. It may be that some of the funds moved out of U.S. banks have been used for stock purchases by Mexicans participating in the current stock market boom.

Swings of short-term capital between 1980 and 1986 have added to the disruption of the Mexican economy during the concurrent periods of balance of payment pressure. One of the theses advanced here is that the capital flight will continue to complicate, and to pose a serious threat to, the Mexican government's economic policies. The trend is towards increasing integration of a sophisticated international financial market thriving on the short-term movement of capital. If this is coupled with volatile interest rates, unstable currency markets, rising inflation, major shifts in stock prices, or other indicators, then the natural result is capital flight.

Some economists argue that capital flight is a good thing; that it compensates for other movements in the balance of payments, and forces governments to make the necessary adjustments to attract

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30. EL MERCADO DE VALORES, Ano XLVI, Num. 46, Nov. 17, 1986, at 1090.

$$\frac{\text{24,254 billion pesos in Mexican deposits}}{\text{300 (exchange rate)}} = \text{\$U.S. 80.8 billion}$$

$$\frac{\text{\$U.S. 15 billion foreign deposits}}{\text{\$U.S. 80.8 billion Mexican deposits}} = .1856 \text{ (approx. 18.5 percent)}$$

31. *See supra* note 23.

32. Banamex, REVIEW OF THE ECONOMIC SITUATION OF MEXICO, Vol. LXII, Number 732 (Nov. 1986) at 436-38.

33. *Id.* at 436.

the capital back. Nevertheless, even these commentators concede that capital flight is disruptive in the short-term, and requires the government to adopt policies specifically designed to reduce capital flight.

## II. Policy Options for Dealing with Capital Flight

In the fall of 1985, U.S. Secretary of the Treasury James Baker launched a program to deal with the external debts of developing nations. The "Baker Plan" encompassed three major elements: (1) restructuring the economies of indebted nations; (2) increased lending from the IMF and the multilateral development banks; and (3) increased lending by private banks.[34] In discussing the restructuring of the borrowers' economies, Secretary Baker specifically raised the issue of capital flight, and gave his solution to it:

> As a practical matter, it is unrealistic to call upon the support of voluntary lending from abroad when domestic funds are moving in the other direction. Capital flight must be reversed if there is to be any real prospect of additional funding.
>
> Policies to address these problems should include market-determined interest rates, wages and prices as well as further efforts to reduce inflation and budget deficits. We would also like to see:
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> [m]ore supply-side actions to mobilize domestic savings and facilitate efficient investment, by means of tax reform, labor market reform and the development of financial markets . . .[35]

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34. The basic Baker Plan is set forth in *Documentation Concerning Development and International Debt Issues* 25 International Legal Materials 412 (No. 2, March, 1986) [hereinafter *Baker Plan*].

35. *Id.* at 423.

The same notion—the need to restructure financial markets to attract repatriated capital—was raised, somewhat more stridently, by economists at Morgan Guaranty Bank. In a study of Latin American financial markets published last April, Morgan Guaranty focused on conditions in Argentina, Brazil and Mexico. The article criticized government intervention in financial markets in Mexico, which it found overly dominated by the federal government as the major borrower. The study criticized government controls on interest rates, the tax treatment of interest, and accounting rules ill-suited to an inflationary environment. *Growth and Financial Market Reform in Latin America*, *supra* note 18, at 3. The study concluded:

> Financial markets in Latin America are not performing their vital development role of eliciting higher savings and investing savings efficiently. And they are not geared up to attract significant reflow of residents' assets now held abroad.
>
> [I]t is important, therefore, that financial market reform be undertaken in the contest of wide-ranging reforms seeking to get all the key prices right.

### A. A Glance Back at Mexican Financial Policy

The call to restructure financial markets has not come only from abroad. Many Mexicans have been calling for reforms for decades. The desire for reform must be seen against the backdrop of a financial system which is heavily dominated by the government. The following analysis, taken from a 1978 study of the Mexican economy, characterized the monetary and credit policies of the Mexican government as follows:

> In Mexico, monetary policy has developed so that the government is now deeply involved in providing direct finance for a wide variety of structural, industrial, and commercial activities; in influencing the distribution of private banking funds to various sectors of the economy; in maintaining the solvency of the banking system and the individual banks; and in improving the financial markets . . . . The public ownership and control of Mexico's key financial intermediaries [note that this was written *before* the nationalization of the banks] affords the government considerable opportunity to influence the direction and content of economic behavior through monetary and exchange policy.[36]

A key element of this *dirigiste* policy was the use of a high reserve requirement to channel savings (termed *canalizacion)* captured by the commercial banking system to government projects at inexpensive rates of interest.[37] Even beyond this reserve requirement, credit allocation rules mandated by monetary authorities directed bank lending to priority, government-sponsored projects, leaving relatively little for free allocation of credit to the private sector.[38]

Capital markets in Mexico have also been dominated by the public sector. Historically, the Mexican stock exchange has not been important in mobilizing capital for Mexican enterprises. There have been few securities issued, and a marked lack of secondary trading. The capital markets have been dominated by fixed-interest bearing securities, and other securities, issued by the government—*Cetes* (treasury bills) and *Petrobonos*. According to one study, equity turnover on the Mexican Stock Exchange represents

36. LOONEY, *supra* note 6, at 27

37. *Id.* at 40-41. The high reserve requirement continues to be a mark of the Mexican banking system. *See Growth and Financial Market Reform in Latin America*, *supra* note 18, at 5.

38. *Growth and Financial Market Reform in Latin America*, *supra* note 18, at 5-6. According to this study, the freely lendable portion of new deposits fell to a low of 11% in 1985.

only about 10% of the total securities market; the remainder being represented mainly by petrobonos and treasury bills.[39] Mexican companies have consequently received the bulk of their capital from bank credits (including credits from *financieras*) and private placements.[40]

From the viewpoint of the Mexican investor, the available opportunities for portfolio investment were limited. They were especially limited with respect to investments offering a high rate of return. One could invest in *Cetes* or *Petrobonos*, both of which became less attractive as oil prices plunged. One could deposit money in the bank, at an interest rate controlled by the government. Alternatively, one could deposit money or invest in dollars in the United States, where high real rates of return were possible with little risk. The attractiveness of the last alternative was apparent, and capital flight was the result.

### *B. Recent Financial Policies*

The Mexican government has recently taken several steps to alter the above scenario. These steps indicate some sensitivity to the issues raised in the Baker Initiative, discussed above.[41] Nevertheless, there has not been a reversal in government financial policy in Mexico. The public sector, with its enormous financing needs, will continue to dominate credit markets.

Some of the policy changes undertaken by the Mexican government involve changes in the law; others do not. The following remarks are intended as a comment on certain policies, rather than as a comprehensive analysis of all government policies.

*1. Exchange Controls*—There have been relatively few adjustments in the liberalized exchange control regulations adopted by the government of President de la Madrid in late 1982 and 1983.[42]

39. L. KEMP, THE WARDLEY GUIDE TO WORLD MONEY AND SECURITIES MARKETS 237 (1984).

Alex Hoagland estimated in 1980 that, in 1977, transactions in common stock constituted only 3.4 percent of total stock market transactions on the Mexican Stock Exchange, although the figure increased in later years. Hoagland, *Company Formation in Mexico* at J-33 (Lloyd's Bank International 1980).

40. *See* LOONEY, ECONOMIC POLICYMAKING IN MEXICO, *supra* note 6, at 73; and LOONEY, MEXICO'S ECONOMY: A POLICY ANALYSIS WITH FORECASTS TO 1990, *supra* note 6, at 34.

41. *See supra* note 35 and accompanying text.

42. *See generally* Gomez-Palacio, *Mexico's Foreign Exchange Controls: Two Administrations — Two Solutions. Thorough and Benign*, 16 INTER-AMERICAN L. REV. 268 (1984); V. Pando, *Legal Aspects of Mexican Exchange Controls*, 18 INT'L LAW. 309 (1984);

Under those regulations, the purchase of foreign exchange for foreign investment, either short- or long-term, must be carried out on the free exchange market, at exchange rates that now approach 2000 pesos to the dollar.[43] Theoretically, the dollars are available, and capital transfer is possible through the banking system. For the time being, the government appears to be committed to a policy of using interest rates, rather than strict controls, to limit capital flight.

One interesting change in the exchange market involves the appearance, for the first time, of a forward market in pesos authorized by the Banco de Mexico.[44] Until now, only banks were permitted to carry out forward exchange transactions or other currency hedging transactions. The addition of exporters and importers to these operations signifies recognition that currency hedging is necessary under current exchange market conditions to protect international traders. However, the refusal to allow the public at large to use such transactions represents the continued fear that unregulated forward exchange markets could be used to speculate against the peso.

*2. Interest Rate Policies*—No major legislative changes to restructure capital markets have occurred in Mexico. However, the government has taken several steps to enhance the attractiveness of securities and to promote the development of an equity capital market. It remains to be seen whether these steps will be sufficient to re-orient the government-dominated system to provide viable sources of private capital to businesses and attractive placements for private investors.

One change has affected the levels of interest rates available on bank deposits and securities in Mexico. Authorities in Mexico have been criticized for their failure to keep interest rates at a positive

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Zamora, *supra* note 36.

43. Since there is now a very small spread between the free and controlled exchange rates, there is little left of the original government policy of shunting non-priority demand for foreign exchange into a separate, more disadvantageous market that would reduce demand.

44. In December 1986, the Banco de Mexico announced the creation of a forward market, [*mercado de coberturas cambiarias a corto plazo*] that would allow importers and exporters of goods to cover foreign exchange risks by entering into forward exchange transactions. Diario Oficial Lunes, 15 de diciembre de 1986, at p. 24. Guidelines for these operations were to be adopted by those banks (the major Mexican financial institutions) that were permitted to carry out these transactions, with the implication that they would make them available to exporters and importers only. One might ask the question whether such a market could be used as a disguised form of active speculation against the peso.

real level, competitive with returns in other countries.[45] This appears to have changed. Interest rates on bank deposits and on short-term promissory notes have registered impressive real rates of return during 1986.[46] However, nominal interest rates must be raised to provide such real rates of return. Inflation in Mexico last year reached 110%.[47] The effects of raising interest rates to achieve real rates of return in such an inflationary environment makes the government's task of stabilizing growth even more difficult.

3. *Tax Amendments*—As interest rates moved into triple-digits, deductions by businesses for interest expenses also soared. Until recently, Mexican tax law allowed companies to deduct interest expenses as long as the borrowed funds were used for business purposes.[48] This resulted in an over-reliance on raising capital through debt, rather than through equity, such as the issuance of new stock. Large interest deductions contributed to a decline in corporate tax revenues paid to the government, from 2.7% of gross domestic product in 1980 to 1.4% in 1986.[49]

The government responded in 1986 by adopting a major amendment to the income tax law, introducing inflation indexation to the business tax. Under amendments to the *Ley del Impuesto Sobre La Renta*,[50] deductible interest expenses will be calculated by subtracting the inflationary component of the total from the interest paid. Thus, if inflation is 100%, interest payments of 110 million pesos will result in a deduction of only 10 million pesos. The drastic nature of this and other tax amendments caused the government to phase in the change over a period of three years.[51] Nevertheless, the reform will force many companies to forego borrowing from banks or from issuing debt instruments. Theoretically, it will make them raise capital by issuing shares to the public. This remains to

45. *See Growth and Financial Market Reform in Latin America*, *supra* note 18, at 8-9.

46. Banamex, REVIEW OF THE ECONOMIC SITUATION OF MEXICO, *supra* note 32, at 435-37.

47. *Id.* at 461. The Banco de Mexico, in January, 1987, reported that consumer prices soared 105.7% in 1986. *Mexico Prices in Record Rise*, New York Times, Monday, January 12, 1987, at 29.

48. Ley del Impuesto Sobre la Renta, Article 24, para. VIII, discussed in *Business Operations in Mexico*, BNA TAX MANAGEMENT PORTFOLIO, Vol 136-4th (1984) at p. A-12. *See also* Hoagland, *supra* note 34, at D-9.

49. Banamex, *Review of the Economic Situation of Mexico*, *supra* note 32, at 455.

50. *Decreto que reforma, adiciona y deroga diversas disposiciones de la Ley del Impuesto Sobre la Renta*, Diario Oficial, Miercoles, 31 de diciembre de 1986, at 53 *et seq.*

51. *Still-Developing Tax Reform Looks Bad for Business*, American Chamber of Commerce of Mexico, MEXICO UPDATE, Vol. V, No. 2, November 15, 1986, at 3.

be seen, however. Mexico does not have a tradition of broad public ownership of shares in corporations. Small- and medium-sized corporations have not tended to use the stock market to raise capital. Public ownership would dilute the power of the many closely-held corporations in Mexico. Furthermore, issuing shares on the Mexican Stock Exchange requires registration and filing of information with the National Securities Commission,[52] which many companies may be reluctant to do.

4. *New Debt Instruments*—The Mexican government recently launched a program to offer more attractive public debt instruments to attract investors away from U.S. Treasury bills and other dollar-denominated securities. In August, 1986, the Mexican government announced a new government security—the *Pagafe* (*Pagares de la Tesoreria de la Federacion*)—to join the *Petrobonos* and *Cetes* already on the market.[53] The *Pagafe* is to be sold at a discount of its face value, for which it can be redeemed in six months. The key is that the *Pagafe* will be denominated in dollars, providing a hedge against the continued slide of the peso. However, the *Pagafe* will be payable in Mexico in pesos rather than dollars.

Thus far, the *Pagafe* experiment has been unsuccessful. The initial offering in August of 1986 proved disappointing in volume, and even after raising the discount rate, nobody was willing to purchase *Pagafes* in November. The reluctance seems to be based on the government's guarantee to pay *Pagafes*, in pesos, at the controlled exchange rate applicable at the time of redemption—a rate managed by the government and therefore distrusted by some investors.[54]

5. *Debt-for-Equity Swaps*—Under debt-for-equity swaps, foreign creditors of public sector agencies can immediately receive pesos equivalent to the full amount of the foreign-currency denominated loan, if used for approved purposes in Mexico. One approved purpose under this government-sponsored program includes the purchase of state enterprises that the government wishes to privatize. In addition, private debtors, such as Grupo Alfa, have con-

52. M. ACOSTA ROMERO, DERECHO BANCARIO: PANORAMA DEL SISTEMA FINANCIERO MEXICANO 788 (3d ed. 1986).

53. *Caracteristicas definitivas de los Pagafes'* EL MERCADO DE VALORES, Ano XLVI, Num. 34, Aug. 25, 1986, at 816.

54. *Pagafe Makes Humble Exit; Called First Failure of the PAC*, American Chamber of Commerce of Mexico, MEXICO UPDATE, Vol. V., No. 2, Nov. 15, 1986, at 9.

vinced foreign creditors to exchange a portion of outstanding debt for shares in the corporation.

Debt-for-equity swaps are likely to retain only temporary significance, without a change in the foreign investment laws of Mexico limiting foreign ownership.[55] Mexican officials appear to view the program as a temporary mechanism to attract foreign investment, and many expect the program to become gradually more restrictive.[56]

*6. The Stock Market Boom*—The *Bolsa Mexicana de Valores* has recovered from the post-1982 slump to share some of the worldwide euphoria experienced as a result of the strong performances registered on stock exchanges in London, New York, Tokyo and elsewhere. In 1986, investors in the Mexican stock market earned *real* rates of return in excess of 100%, a figure that is expected to level off to the 25% range in 1987.[57] Phenomenal increases in share prices (the *Bolsa* index has risen 705% since September, 1985[58]) have been recorded. The gains have not been achieved by any government-organized restructuring; there have been no major changes in the laws regulating the capital markets. These gains have been recorded simply because the shares of companies traded on the *Bolsa* were seriously undervalued.

The Mexican stock market boom must be put into perspective. The operations of the Mexican Stock Exchange are of small volume in comparison with the size of the economy.[59] Only 100 different stocks are listed, and only 40 of these are considered to be very marketable. The daily trading volume is valued at barely 6 million dollars.[60] Thus, the recent reawakening of investor interest cannot by itself be taken as an indication of a broad awakening of free-market capitalism.

This brief summary of government policies and non-policies (which is not intended to be comprehensive) indicates a moderate shift in the direction of restructuring financial markets along the

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55. *See generally* J. BARRERA GRAF, LA REGULACION JURIDICA DE LAS INVERSIONES EXTRANJERAS EN MEXICO (1981); Hoagland, *supra* note 39, chapters B and C.

56. Orme, *Swaps spur foreign investment in Mexico*, Financial Times of London, January 5, 1987, at 18.

57. Barbash, *Investors Flock to Booming Stock Market*, The Mexico City News, January 19, 1987.

58. Stockton, *Stock Frenzy Grips Mexico*, New York Times, Tuesday, January 13, 1987, at 32.

59. *See supra* notes 39-40 and accompanying text.

60. *Investors Flock to Booming Stock Market*, *supra* note 57.

lines called for by the Baker Initiative. The Mexican financial system continues to be dominated by the public sector. However, the government has a heightened perception of the need to create an attractive investment climate to keep Mexican investors interested in keeping their capital in Mexico.

## CONCLUSION: THE RESTRUCTURING OF FINANCIAL MARKETS WILL NOT PREVENT CAPITAL FLIGHT

An axiom of international economic theory holds that the three principal objectives of international monetary policy—(1) autonomous control over domestic monetary policy; (2) free movement of capital and goods; and (3) stability of foreign exchange and financial markets—are unlikely to be achieved at any one time.[61] The most that monetary authorities can hope to achieve is two of the three goals at once. For example, if monetary authorities set domestic policies with a view solely to local needs (the first objective), and allow capital and goods to move freely (the second objective); then fluctuations in foreign markets may either drain capital or flood the country with it. The result is disruption of stability of foreign exchange and capital markets (the third objective).

This is a useful axiom with which to assess the effect of capital flight in Mexico. Under current conditions, Mexico has moved towards achieving free movement of capital and goods, the second objective. Rigid exchange controls failed to cut off capital flight and were abandoned. The import-substitution policies of earlier administrations have been replaced by an emphasis on export promotion and trade liberalization, as evidenced by Mexico's entry into the GATT.

The trick comes with the trade-off between the first and third objectives. The Mexican government appears to be leaning in favor of the third objective, concentrating on stability of exchange rates and of financial markets. This may seem surprising at first, when one considers the drastic fall of the peso. However, this has been a gradual, controlled slide, with peso devaluation keeping in step with the rate of domestic inflation. Financial markets have also become somewhat stabilized—at least as stable as one can hope for in an economy with triple-digit inflation.

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61. *See* T. PADOA-SCHIOPPA, MONEY, ECONOMIC POLICY AND EUROPE 106-107 EEC, Brussels (1985); D. LLEWELLYN, INTERNATIONAL FINANCIAL INTEGRATION 3, 1984 (1980); Goodhart, *Has the Time Come for the UK to Join the EMS?*, THE BANKER, February, 1986, at 26, 28.

Autonomy over domestic monetary policy is what has been sacrificed. Mexican government authorities have found themselves on an inflationary ride that has gradually been building for ten years. It would be nice to get off the roller coaster and to adopt policies that would quickly put the brakes to inflation. But how does one achieve this, when it is necessary at the same time to keep real interest rates high so that Mexicans don't send their money abroad? The government's policy of promoting high rates of return has made controlling inflation even more difficult.[62]

This is only one example of the autonomy which Mexico loses by having to adopt policies in reaction to events beyond its borders. To ignore such events in planning domestic policies—to overlook the level of interest rates in the United States, or movements in the New York stock market—produces the risk of destabilizing capital flows.[63]

Returning to the question of capital flows, even if Mexico totally restructured its financial industry, offering a wide scope of investment opportunities to attract Mexican savers, the threat of capital flight would persist and must remain a factor in government decision-making. The growth of an increasingly integrated global financial market assures this result. The development of highly-liquid capital markets around the world; and the readily available investment services allowing Mexicans to tap into foreign markets, will facilitate both the outflow and the inflow of capital.

Government officials in the United States should be more sensitive to the dilemma facing nations like Mexico, which must dance to tunes composed in Washington, Tokyo, London, and Bonn. When the United States undertakes policies to attract capital by increasing interest rates, or abolishes the withholding tax on interest earned by foreign residents, it may severely disrupt the plans of Mexican monetary authorities. The United States tends to coordinate such actions with a group of only ten countries. We could do

62. I realize that high interest rates are supposed to result in lower rates of borrowing, and should be deflationary. However, if there is a perception that high rates of interest can be passed along to consumers, then companies will continue to borrow. Because Mexican companies have operated in a protected environment due to import-promotion policies, they have been able to earn high rates of profit on sales, and for that reason have been willing to continue borrowing.

63. Of course, Mexico is not alone in its dilemma. As a leading U.S. economist has recently pointed out, our own sensitivity to interest rate developments abroad has soared. Kaufman, *supra* note 3, at 179. Yet the United States has a good deal more leverage over these matters than does Mexico, and because of the size and diversity of our economy the United Stated maintains more freedom of action. Mexico, pushed to the wall on several fronts—inflation, external debt, etc.—has little margin for maneuver.

more to involve Mexican officials in consultations over policies that will affect capital flows to the United States. If we fail to do so, it weakens the force of our complaints over unilateral actions taken by debtor countries such as Mexico.