Comments

Liliana Rojas-Suarez: Issues relating to the participation of foreign banks in Mexico are as relevant today as they were after the Tequila crisis of 1994–95 when the country's financial system collapsed. At that time, the Mexican authorities had few options but to recapitalize their broken system by liberalizing the participation of foreign banks into the system and allowing the free movement of cross-border capital flows. However, after a decade and a half of liberalization and following the effects of a global financial crisis, a number of academics and analysts have begun to question whether the laws governing the behavior of foreign banks need to be modified.

Guillermo Ortiz, former governor of the Central Bank of Mexico, is perhaps the most visible figure calling for reforms. Based on two observations that (a) out of profits, subsidiaries of foreign banks pay about three times more dividends than domestic banks, and (b) subsidiaries of foreign banks in Mexico are much better capitalized than their parent houses, Ortiz calls for regulation to control the dividend payments by subsidiaries of global foreign banks operating in Mexico and/or to mandate the compulsory listing of these subsidiaries on the local stock exchange. The central claim underlying this proposal is that if smaller proportions of banks' profits are transferred abroad, credit to Mexican residents (firms and households) would increase, thus supporting higher economic growth.[1]

Assessing these types of proposals requires rigorous empirical analysis. For example, to what extent does the behavior of foreign banks (provision of credit and interest charged) differ significantly from that of domestic banks? The paper by Haber and Musacchio makes some important contributions that help answer these questions.

A first, and crucial contribution, is that they have put together a comprehensive data set that, as they state, "allows us to follow banks in time, regard-

1. At 23 percent, Mexico's credit to GDP ratio stands as one of the lowest in Latin America.

less of changes in name or ownership." This is indeed very valuable in the context of the deep transformation in bank ownership structure that has taken place in the Mexican banking system since 1997 because of the large number of mergers and acquisitions as well as the establishment of new foreign banks. Before the construction of this new data set, it was extremely difficult for analysts to follow the activities of Mexican banks (and, therefore, the evolution of bank-specific financial variables) since a number of institutions changed names repeatedly. As a result, bank-level empirical research in Mexico has been severely limited. I believe that the Haber-Musacchio paper can help correct this deficiency. To this end, however, it would be most helpful if the authors' data set were made publicly available (either for free or for purchase depending on legal restrictions on the distribution of these types of data).

The second important contribution is that armed with a fresh database and standard econometric techniques, the authors effectively shed light on the differing behavior of domestic and foreign banks. While the paper deals with a number of endogenous financial variables (especially net interest margins), a key finding is that switching from domestic to foreign ownership did not increase credit. Instead, in the cases where estimation of a model specification yielded statistically significant coefficients, the conclusion was that the *switch* translated to a reduction in loan volume.

The authors venture (without proof) that the inverse relationship between foreign ownership and the provision of credit might result from Mexico's weak property rights (a well-known argument advanced by La Porta, López-de-Silanes, and Zamarripa 2003). While this might be a factor, I am not convinced that it is the dominant one. I can envisage an alternative explanation; namely, that the authors' experiment did not differentiate between two very different time periods within the sample. The first period, comprising the last years of the 1990s and the beginning of the 2000s, when the process of internationalization of the troubled domestic banks was still in place, the Mexican authorities had not yet consolidated the reform of their banking regulatory and supervisory framework, and foreign banks were subject to stricter oversight rules on their lending practices (from supervisors in their home countries) than domestic banks. In the second time period, running from about 2003 to 2007, Mexico's supervisory framework improved significantly and the largest Mexican banks were all foreign. Thus, in the first time period foreign bank supervision was stronger than domestic supervision, and, therefore, foreign supervisory practices were the *binding constraint* for subsidiaries of foreign banks (but not for domestic banks). This ceased to be the case in the second time period. Whether these large differences across time periods in the quality

of bank supervision in Mexico (relative to that in the countries of origin of the bank subsidiaries) played a major role in explaining the authors' results is an issue that deserves further research. In my view, the authors' hypothesis that the lackluster provision of credit following the entry of foreign banks results from a more prudent behavior of foreign owners can hold true for the first time period, but not necessarily for the second. In the second, this result could very well be attributed to decisions taken by the parent house, which, in turn, reflected developments in the home country.

Indeed, the authors' results regarding the provision of credit by foreign banks combined with developments in banking supervision around the world lend some support to Ortiz's arguments. In the pre–global crisis period (comprising most of the second period described above), as the quality of banking oversight improved in Mexico and other Latin American countries, it deteriorated in large parts of the developed world, including those countries in which the parent houses of the Mexican banks' subsidiaries were established. Ortiz might be right in that given current important differences in bank soundness between a Mexican subsidiary and its parent house, there is an incentive for excessive dividend payments by the Mexican subsidiaries of global banks: under current circumstances, what is optimal for the parent bank might be suboptimal for the host country. However, capital controls of the nature suggested by Ortiz are neither the only nor the best policy alternative to align incentives between the operations of foreign banks and those of Mexico's policymakers. While Mexican banks (domestic and subsidiaries of foreign banks) are currently better capitalized than the parent houses of the foreign subsidiaries, this situation might reverse in the future due to unforeseeable events. Therefore, proposals to protect the soundness of subsidiaries of foreign banks should not focus on the current economic cycle. In a recent paper, Galindo, Izquierdo, and I have laid out alternative recommendations that do not depend on the economic and business cycles of the home and host countries.[2] Additional research is certainly needed to reach clearer conclusions and policy recommendations. Nonetheless, the Haber-Musacchio paper has helped to pave the way.

2. In Galindo, Izquierdo, and Rojas-Suarez (2010b), three types of policy actions to protect the solvency of subsidiaries of foreign banks are advanced: (a) the establishment of adequate ring-fencing arrangements; (b) the development of early-warning systems regarding transfers from a subsidiary to its parent house above certain predetermined thresholds consistent with protecting the solvency of the subsidiary; and (c) the implementation of stricter agreements of collaboration between home- and host-country supervisors.