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Privatization, competition, and supercompetition in the Mexican commercial banking system ☆

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Abstract

Much literature before and after the privatization of Mexico's commercial banking system in 1991–1992 argued that the system was collusive and noncompetitive and would likely continue to be for years. Banks would collude to underloan so that – at least in comparison with what would happen in a competitive system – they could overcharge. Because a parallel literature on lending after bank privatization suggests that the problem is often not too little, but too much, we resolved to test for competitive behavior in the Mexican banking system. Using an empirical approach developed by Shaffer (Econom. Lett. 29 (1989) 321, J. Money Credit Bank. 25 (1993) 49, Federal Reserve Bank of Philadelphia, Working paper no. 93-28R), we find a structural break in the middle of the privatization period that signals the start of an episode of what Shaffer calls "supercompetitive" behavior. In such a supercompetition, banks run at levels of output where marginal cost exceeds marginal revenue. This behavior is consistent with a struggle in which banks take losses now because they think the market share they get in the bargain offers a positive present value of expected future return. The behavior can also be consistent with just the sort of banking crises that ensued in Mexico.

JEL classification: G21; D4; L11; F34

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> Mr. Pereguna...suggests that after privatisation in 1991–92 most banks abandoned common sense in a race to sign up customers and expand their credit base.
>
> Financial Times, London Edition. 15 October, 1996

1. Introduction

A major theme in the literature of privatization is that the benefits are much abridged if a government monopoly is simply replaced by a private sector monopoly or oligopoly (Hanson, 1994). Variations on this theme surfaced in many discussions of Mexico's bank privatization of 1991–1992, in which controlling interests in Mexico's 18 government-owned commercial banks were sold to financial groups—chiefly organizations that already dominated the nation's securities industry. [1]

A near-universal concern was that years might pass between when Mexico's banking system was privatized and when its performance might approach most standards of competitiveness. Although Mansell Carstens (1993) argued that privatization would raise some measures of efficiency, she also suggested that spreads between banks' cost of funds and interest rates on loans could remain high for years—in part because the high degree of oligopoly power in the provision of bank services would likely continue. [2] Bazdresch and Elizondo (1993) developed similar themes and—consistent with other authors—viewed Mexico's high interest rate margins as indicative of anti-competitive market power.

An important reason for many observers' pessimism about competition in Mexican banking was the market's heavy concentration. Gavito et al. (1992) developed the anti-competitive implications of concentration in the Mexican commercial banking system while Gavito and Trigueros (1993) argued that "some additional measures would be useful to induce greater competition" in it.

Market indicators suggested that, in fact, the new banks' purchasers themselves expected not to face very intense competition. Gruben et al. (1994) suggested that the high price-to-book ratios paid for the banks signaled that the new

[1] Mexico's commercial banks had been nationalized in 1982 under the presidential administration of Jose Lopez Portillo. Under the administration of Miguel de la Madrid Hurtado (1982–1988), so-called nonbank functions of the bank were allowed to be performed by private sector institutions. The 1991–1992 privatizations of the Carlos Salinas de Gortari administration (1988–1994) were part of a series of radical reforms in the financial services industry that actually began in 1987 during the de la Madrid Hurtado administration (1982–1988).

[2] At the time of the nationalization of the Mexican commercial banking system in 1982, there had been 60 Mexican banks, of which 58 were nationalized. In order to capture perceived economies of scale, Mexico reorganized the commercial banking industry—merging the 58 commercial state-owned banks into just 18. Although the industry had been consolidating prior to 1982 in any case, these new mergers represented a significant increase in industry concentration. Indeed, at the time of privatization, the three largest banks accounted for nearly three-fifths of total assets in the commercial banking system, while the three largest US banking organizations at that time held about one-seventh of US commercial bank assets.