The Central Bank as a Tax Farmer: Porfirian Mexico, 1880-89

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All sovereign governments face a commitment problem: how can they promise to honor their own agreements? There is, by definition, no higher authority that can force a government to comply with its obligations. This problem is most obvious in the case of sovereign debt. What keeps governments from simply repudiating their debts?

Sovereigns worry about the penalties they face should they repudiate their agreements. The loss of reputation is one such penalty. Unfortunately, history is replete with examples where reputation alone was not sufficient. New sources of credit, for example, have caused sovereigns to repudiate their debts with their former creditors. Threats which shorten the sovereign's time horizon, such as war or political instability, have also prompted sovereign defaults.[1] In point of fact, all but one of the newly independent Latin American countries defaulted on their debts during the nineteenth-century.[2] Mexico provides a canonical case. For every constitutional president between 1821 and 1876, there were four interim, provisional, or irregular presidencies, and the lifespan of the average administration scarcely surpassed eight months.[3] Mexico's revolving-door governments regularly repudiated or suspended payments on their domestic and foreign debts. Not even French troops, which occupied Mexico between 1863 and 1866, could force regular repayments.

In the 1880s, however, the new government of Porfirio Díaz broke the pattern. Despite renouncing its 1880 agreement with a French-and-Mexican-owned

[1] Douglass North and Barry Weingast, "Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth-Century England," *The Journal of Economic History*, Vol. 49, No. 4. (Dec., 1989), p. 807. (pp. 803-832.)
[2] Barry Eichengreen, "Historical Research on International Lending and Debt," *The Journal of Economic Perspectives*, Vol. 5, No. 2. (Spring, 1991), p. 150. (pp. 149-169.)
[3] Haber 1989: 21.

bank (the Banco Nacional de México, or Banamex), issuing illegal debts, and suspending its payments, the government succeeded in getting the *very same bank* to lend it new money in 1886 and underwrite its return to international credit markets in 1888. How did Mexico accomplish this feat?

This paper argues that the Mexican government, in effect, sold Banamex the right to extract rents from the rest of the Mexican economy in return for arranging the government's credit problems. Mexico's weak central government was incapable of raising the tax revenues necessary to fill its revenue needs. It was also limited in its ability to earn seignorage profits, since (lacking specie reserves) it could not keep paper money in circulation. Therefore, it contracted with wealthy French and Mexican bankers who would be able to take advantage of special privileges provided by the government. In return, these bankers kicked back a share of the rents in the form of cheap and plentiful credit. This deal was not easy to make, and ran into serious political obstacles, but it was made and it turned out (in the medium run, at least) to be very successful.[4]

This paper is constructed as follows. Section I details the history of Mexican debt defaults from independence until the 1880s. Section II discusses various models of how governments make credible commitments, and argues that they do not apply to the Mexican case. Section III discusses the government's credit crunch and default in 1883-85, and discusses the nature of the agreement with Banamex. Section IV quantifies Banamex's supernormal profits between 1884 and 1890. Section V concludes.

Section I

Mexico's debt problems started at independence in 1821, when the newly declared Mexican Empire recognized 30 million dollars worth of debts to domestic

[4] For the long run costs of this strategy, see Maurer and Haber (2002) and Maurer (2002).

merchants owed by the colonial government. The debts were never repaid.[5] The first Mexican Empire fell in 1823. In the following two years, the Mexican Republic contracted 32 million dollars of new debt in London. By 1827, it had suspended payments on the new debt.

The French government used Mexico's debt arrears as a pretext to intervene in 1862 and install Maximilian on the throne of a reconstituted Mexican Empire. Facing strong opposition from Benito Juárez's guerrilla forces, the French pulled out their troops in 1866. The second Mexican Empire fell within a year of the French withdrawal. The restored Republic under Benito Juárez refused to recognize any of the debts contracted under Maximilian. In addition, since the British government had supported the French intervention, the Restored Republic suspended payments on British debts, including those contracted before 1862. The government tried to maintain interest payments on the loans Americans had advanced to the rebel movement, but these debts amounted to only US$5 million, and the interest payments smaller still. By the 1870s, unmet interest obligations on the British debt alone had ballooned to US$120 million.[6]

Sebastián Lerdo de Tejada succeeded President Benito Juárez upon his death in 1872. Porfirio Díaz overthrew Lerdo in 1876. Porfirio Díaz willingly ceded the Presidential sash to Manuel González in 1880. (He would take it back in 1884.) While all three governments neglected the foreign debt, they all tried to amortize some of the debt owed to domestic creditors. Juárez bought back a small amount of the federal government's outstanding debt in 1868, paying 31 percent of its face value. This price was actually high: an 1870 report to Congress indicated that the 1850 convention bonds traded at a mere 8 to 9 percent of their face value, while more recent debts could be purchased for 15 percent.[7] In 1876, Porfirio Díaz's new government amortized debt with a face value of slightly over Mx$2.1

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[5] For the story of the colonial debt, see Carlos Marichal, *La bancarrota del virreinato: La deuda colonial del México borbónico, 1780-1810*. Mexico City.

[6] Carlos Marichal, "Financial Market Reform and External Debt," in Jeffrey Bortz and Stephen Haber (eds.), *The Mexican Economy, 1870-1930*, Stanford University Press (2002), pp. 95-96. (pp. 93-119.)

[7] Carmagnani 1994: 231.

million at 25 percent of par.[8] In 1876, private financiers held debt with a face value of 45 million pesos: the market value of this debt was closer to 11 million pesos.[9] These discounts, and a perceived need to curry some sort of favor with the nation's domestic creditors, prompted the Díaz government to continue the debt amortization program, which rose from 256,000 pesos in the 1876-77 fiscal year to Mx$1.1 million in 1879-80.[10]

Unfortunately, the government's need for credit had not disappeared. Díaz needed to equip a federal army capable of facing down threats from regional challengers. He also needed to pay the army enough to keep its loyalty. The federal government lacked the resources to effectively tax Mexico's impoverished economy. Mexico's per capita GNP (in 2001 dollars) was only $456 in 1877.[11] Foreign trade was the only sure source of revenue, but the country's small economy generated little international commerce.

In the long-term, Mexico's new leaders believed that constructing railroads would open Mexico's economy to foreign investment, prompt economic growth, increase trade and allow Mexico to easily repay its obligations. Railroads were considered key because Mexico had no decent navigable waterways, and half of all roads were unsuitable even for beasts of burden. Unfortunately, constructing railroads required federal subsidies. Mexico's first railroad did not open until 1873, and by 1877 the country still enjoyed only 400 miles of track, of which 18 percent used mules instead of steam engines to pull the trains.[12] Railroads involved large amounts of sunk capital, required long time-horizons, and demanded detailed knowledge of the local terrain, economic conditions, and prospects for future growth. They also required a great deal of specialized engineering and management skills, and in addition, depended upon continued

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[8] SHCP 1878: 113-18.
[9] SHCP 1878: 113-18. Also cited in Carmagnani 1994: 230.
[10] Colegio de México 1971: 7.
[11] See Coatsworth (1978). The figure in 1950 dollars as computed by Coatsworth was $62. We have recalibrated Coatsworth's 1950 estimates by changing the base year of the index to 2001.
[12] Coatsworth 1981: 35.

political stability. In this sort of environment, few private investors were prepared to risk substantial amounts capital without federal subsidies.[13] The Mexican federal government, therefore, found itself trapped in fiscal a Catch-22. Without railroads, there would be little economic activity to tax; without subsidies, there would be no railroads. This was implicitly recognized by Mexico's foreign creditors in 1878, when they agreed link the renewal of debt service and the possible conversion of the foreign debt on more favorable terms to future railroad growth. In the words of the Finance Secretary, Matías Romero:

> It does not appear too hazardous to assert that, if railroads were constructed in the center of the country, and between the principal towns … in order to have access to both oceans, the nation would receive an impulse such that its wealth would be sensibly augmented, and with it the income of the Federal Treasury, which would admit of the punctual payment of the interest on the national debt. The creditors of the country appear to have recognized the truth and force of these considerations.[14]

A money market of sorts existed in Mexico City. The federal government regularly issued what were called customs certificates. These certificates entitled the bearer to physically go to a specific customhouse and collect a stated amount. Gross short-term borrowing in this way rose precipitously between 1876 and 1882. (See Table 1.) It should be kept in mind that this was indeed *short-term* borrowing: most of the funds were paid back in under a year, and net long-term borrowing (defined as taking on more short-term obligations than were paid back during any given fiscal year) was zero until 1882.

[13] CITE JLAS ARTICLE

[14] Matías Romero, *Report of the Secretary of Finance of the United States of Mexico of the 15th of January 1879 on the actual condition of Mexico and the increase of commerce with the United States, rectifying the report of the Hon. John W. Foster, Minister Plenipotenciary in Mexico.* New York, p. 40.

Table 1: Gross short-term federal borrowing
(1000s of current pesos)

1872-73	$	4,402
1873-74	$	3,328
1874-75	$	4,181
1875-76	$	3,819
1876-77	$	4,742
1877-78	$	9,686
1878-79	$	11,464
1879-80	$	13,951
1880-81	$	2,399
1881-82	$	16,423
1882-83	$	16,369
1883-84	$	30,563
1884-85	$	89,090
1885-86	$	115,057
1886-87	$	79,651
1887-88	$	129,932
1888-89	$	63,708
1889-90	$	49,444
1890-91	$	61,060
1891-92	$	34,380
1892-93	$	58,987
1893-94	$	40,823
1894-95	$	39,751

Derived from the *Cuadros de Información Hacendaria, 1825-1970.*

This money market, however, was very thin and speculators in it were wary of the government's promises. It was insufficient to meet the government's needs. In the 1882-83 fiscal year, for example, railroad subsidies totaled 7 million pesos, almost a quarter of the federal budget. Other parts of the budget, particularly spending on the federal army, similarly ballooned. By 1882, federal spending had risen almost threefold. (See Table 2.)

The government, therefore, decided to create a bank that could fill its borrowing needs. The resulting Banco Nacional Mexicano was a product of astute international diplomacy on the part of the Mexican government. Emilio Velasco, a lawyer from northern Mexico acting in the employ of the federal government, used his contacts with Gustavo G. Godowa, the Polish publisher of the Mexican publication *Le Nouveau Monde*, to open negotiations with the Banque Franco-Egyptienne over the establishment of a bank that would serve as the primary financial agent for the federal government.[15] After a year of discussions, an agreement was signed in August 11th, 1881, between Edouard Noetzlin, the Banque Franco-Egyptienne's representative in Mexico, and the Finance Ministry. The agreement established the bank as the federal government's chief financial agent, and stipulated that its banknotes would be the only ones recognized by the federal government for tax purposes.[16] Most of the new bank's capital came from overseas, and it established a peculiar two-headed management structure, where, on paper, the "Junta de París" supervised the day-to-day activities of the Board of Directors in Mexico.[17]

Table 2:

Year	Total spending	Railroad subsidies	Military
1876-77	$ 14,592	$ -	$ 9,639
1877-78	$ 17,925	$ 82	$ 8,220
1878-79	$ 16,849	$ 573	$ 7,281
1879-80	$ 20,804	$ 1,364	$ 7,266
1880-81	$ 23,795	$ 1,001	$ 6,099
1881-82	$ 31,128	$ 3,602	$ 5,870
1882-83	$ 49,287	$ 12,322	$ 12,752
1883-84	$ 58,861	$ 11,025	$ 11,597
1884-85	$ 54,928	$ 12,957	$ 10,724
1885-86	$ 42,122	$ 4,727	$ 10,088

Derived from the *Cuadros de Información Hacendaria, 1825-1970.*

The Banco Nacional Mexicano was not the only bank in Mexico, however. Four other formal credit institutions existed in 1881. One was a small bank founded by American immigrants in the frontier state of Chihuahua. The second was the Banco de Londres, México, y Sud-América, a branch of a British bank

[15] Ludlow 1986: 303.
[16] Ludlow 1990: 985, and Martínez Sobral 1911: 27.
[17] Ludlow 1986: 321.

that had operated in Mexico since 1864. The bank issued banknotes, but lacked any specific authority to do so.[18] The third was the Nacional Monte de Piedad (Montepío), or National Pawnshop. The Montepío began operations during the colonial era, with the aim of advancing small amounts against goods presented to it as guarantees, much as an ordinary pawnshop functions today. [19] On September 6th, 1879, Governor José Ceballos of the Distrito Federal proposed to President Díaz that the Montepío be permitted to discount commercial paper and issue "deposit certificates" that could be turned in for specie by the bearer, and were indistinguishable from banknotes. President Díaz agreed to Ceballos's proposal, and the Monte de Piedad began operating as a bank on October 1st, 1879.[20]

The fourth bank was founded as a direct response to the establishment of the Banco Nacional Mexicano. Once the Banco Nacional's French owners committed their capital, a group of enterprising Mexican merchants decided to found their own bank, claiming that it was their "patriotic duty" to invest in a "free" bank in order to stop Mexican capital from leaving Mexico "to increase other nations' prosperity."[21] Ironically, most of the merchants who subscribed to the Banco Mercantil's stock had been born in Spain. The only member of the Banco Mercantil's board without substantial foreign ties was the bank's lawyer, Indalecio Sánchez Gavito, who also served as a director of the Montepío.[22] The Banco Mercantil hoped for the federal government's support and business, claiming that competition between different banks would benefit everybody.[23]

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[18] The bank claimed its authority from Article 4 of the Constitution of 1857, which guaranteed that "all men are free to practice the profession, industry, or occupation that conveniences them, believing it useful and honest." Labastida 1889: 64.
[19] Labastida 1889: 73.
[20] Labastida 1889: 74.
[21] 8/29/81, *Actas de la fundación del Banco Mercantil Mexicano*, AHBNM.
[22] Ordinary session, 9/17/84, *Actas de Consejo*, vol. 1, AHBNM.
[23] 3/18/82, *Actas de la fundación del Banco Mercantil Mexicano*, AHBNM.

Section II

Why would the simple act of chartering a bank aid the government in solving its credit problem? After all, the owners of the new bank faced the same uncertainty as other creditors. The government could as easily choose to suspend payment on bank debts as on bond issues.

Lending to sovereign governments faces a very large problem: if the sovereign reneges, there is no third party that can enforce repayment. Of course, in the 19th century "sovereign" governments were not always all that sovereign: foreign powers could and did invade and occupy other nations to collect their debts. In fact, President Benito Juárez's refusal to honor the debts of the previous Conservative government in 1861 prompted the French Intervention.[24] That adventure, however, turned into a fiasco after the end of the American Civil War. The French withdrew in 1866, and Maximilian's empire collapsed soon after. The only power that might be capable of forcing the Mexican government to repay its debts after 1866 was the United States, but there was no evidence that the American government had any interest in doing so. Therefore, the only recourse creditors had to induce repayment was the threat of denying future credit.

This, of course, implies that sovereign debtors face near-impermeable credit ceilings. The logic, taken from Eaton, Gersovitz, and Stiglitz, is that lenders will not lend more than the value of the largest credible penalty that they can impose on the borrower, which is in this case the present value of any future borrowing.[25] Figure 1 illustrates the problem. In period 1, the lenders decide how much to lend. In period 2, the sovereign decides whether to repay. In period 3, the lenders then decide whether to punish the sovereign. If P is the present value of

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[24] Bazant 1991: 43.
[25] See Eaton, Gersovitz, and Stiglitz 1986.

future borrowing, then the sovereign will renege whenever the value of his current debt, D, plus interest payments exceeds P. More briefly, if $D(1 + i) \geq P$ then the sovereign will default. As Eaton, Gersovitz, and Stiglitz pointed out, if "there is no penalty, one observes no lending rather than a rash of loan-contract violations."[26] In other words, if lenders have severe doubts about the life expectancy of any particular regime, then they won't lend, because the present value of future borrowings will be very close to zero.

Credit boycotts face another problem, even if creditors believe that the government will be relatively long-lived. Boycotts hurt lenders almost as much as they hurt borrowers. The government will be denied credit, but its creditors will be denied the opportunity to make profitable loans.[27] With a multiplicity of lenders, the government can default on some while continuing to borrow from others. In fact, the government has no incentive *not* to default on any single lender. After all, the marginal value of the last loan the government takes at the prevailing interest rate was presumably zero, and therefore so is the cost of default and alienating that particular creditor.[28]

Of course, lenders are presumably alert to this sort of thing, and watchful for defaults on debts owed their compatriots as well as themselves. Therefore, one would expect lenders to become wary if the government began defaulting on only some of it debts, and refuse future credit. Unfortunately, individual refusals do the government little damage, while a full boycott is not credible in the absence of some enforcement mechanism. This is because the government can then offer extraordinarily good terms to violators. The more restrictive the boycott, the greater the government's assumed need for loans, and the more credible its offers of good terms for violators. This means that the value of the punishment

[26] Eaton, Gersovitz, and Stiglitz 1986: 488.
[27] Bulow and Rogoff 1989, find exact page.
[28] Weingast 1997: 215.

multiple lenders can levy on the government will be low, and so will be its credit limit.

Therefore, by concentrating its borrowing in a single institution, the government can raise the amount of pain caused by a default, since a single borrower will have no problem imposing a credit boycott. The result, in theory, is an increase in the government's credit limit and ability to borrow. Unfortunately, this solution is also problematic.

The rub is that the government had no binding reason to limit its borrowing to a single creditor. In the absence of the rule of law or some other constitutional mechanism binding the government to its agreements, the government will happily pledge to give one creditor a monopoly over lending, and then surreptitiously seek out additional creditors. That is indeed precisely what happened after 1884.[29]

Section III

Between 1883 and 1885, the Mexican government openly reneged on its agreement with the Banco Nacional Mexicano. It surreptitiously borrowed from a widely dispersed group of creditors, ran up a huge debt, and finally suspended payments. In light of the models discussed in Section II, this behavior should not be surprising. Many of the trunk lines had already been constructed by 1884, and as the year drew on it became increasingly obvious that President González lacked the political support he needed to keep himself in power. The government's incentives turned towards default.

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[29] Mexico in the 1880s is not the only example of this. Phillip Hoffman found that the 17th century French monarchs often played various lenders off against each other, defaulting on one while borrowing from another. When lenders developed new ways to coordinate their punishments under Louis XIV, the amount the French government could borrow *increased*. Similarly, the recent Latin American debt crises follow the pattern, where the largest problem the banks faced was coordinating their actions in the event of a default. These and other examples can be found in Weingast 1997: 229-230.

What is surprising about this episode is not that the government defaulted, but that it managed to regain its access to credit so quickly. The owners of the Banco Nacional Mexicano not only failed to reduce their exposure to Mexico: they invested new capital in the penurious federal government. After a brief interruption, the government continued to pay the army and subsidize the railroads. In 1888, the Banco Nacional de México (the successor to the Banco Nacional Mexicano) would underwrite Mexico's return to the international credit markets.

The government's fiscal problems first manifested in 1882, when federal spending began to outpace revenues. (See Table 2.) Changes in tariff rate schedules helped keep the deficit fairly constant in 1883-84, despite continuing increases in federal expenditures, but the respite was only temporary. The government began issuing customs certificates faster than it redeemed them. It also demanded advances from the banks. In May 1883 the Banco Nacional Mexicano lent the federal government 150,000 pesos, followed in November by an additional loan of Mx$700,000 in exchange for Mx$1,000,000 in customs certificates due six months later.[30] The government agreed to an usurious effective annualized interest rate of 104 percent on the loan.[31] By mid-1884 the government had mortgaged 60% of the port of Campeche's customs revenues, 84% of Veracruz's, and 90% of Matamoros's and Tampico's.[32] Promises of future railway subsidies grew even faster than direct outlays.[33]

Growing deficits caused foreign railway investors to begin to doubt that the government could cover its subsidy promises. Therefore, they ceased investing

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[30] Marichal 1995: 348. The Mexican merchant houses involved in the deal included Bermejillo Hermanos, Benecke Sucursales, Félix Cuevas, Gutheil y Compañía, Ramón G. Guzmán, Lavie y Compañía, and Antonio de Mier y Celis. See Contract #1, Syndicate "Ordenes del Pacífico," *Libro de Contratos Originales de Empréstitos*, 1883-1914, AHBNM.

[31] The implicit interest rate on this loan was calculated as $(1{,}000{,}000/700{,}000)^2 - 1$.

[32] SHCP 1884: 70-79.

[33] Marichal 1995: 348.

their capital. Imports of manufactured iron and steel products used primarily in railroad construction provide a rough-and-ready measure of the decline in investment. After rising from US$1.3 million in 1880 to US$4.2 million in 1882, they fell to US$3.8m in 1883, slid to US$2.4m in 1884, plunged to US$1.2m in 1885, and bottomed out at US$904,554 in 1886.[34]

The fall in foreign investment occurred at a bad time, because Mexico was hit by a fairly serious crop failure in 1884. With the government gobbling up domestic sources of credit, foreign capital inflows drying up, and specie flowing out to pay for increased imports of basic foodstuffs, rural bankruptcies multiplied. Mexico was caught in a vicious cycle: the government's deficit caused credit to become scarce. This slowed business activity, which caused Mexico's imports to drop, which lowered the government's tariff revenue. That, in turn, increased the fiscal deficit, thereby worsening the credit crunch and exacerbating the crisis. Banks essentially ceased lending.[35] In fact, the crisis brought down the Montepío.[36]

At the beginning of 1884, the government requested a loan of five million pesos from the Banco Nacional Mexicano, just enough to cover the federal deficit for the 1883-84 fiscal year. The Banco Nacional could not meet this demand from its own resources.[37] The solution was to engineer the merger of the Banco Nacional and the Banco Mercantil into a new bank called the Banco Nacional de México (henceforth, Banamex). Edouard Noetzlin arrived in Mexico in February 1884 to begin the negotiations over the merger. Noetzlin met with President González, who suggested that General Porfirio Díaz be placed in charge of the

[34] Since they were not taxed, the decline in these imports did not affect the government's fiscal situation.
[35] Ordinary sessions, 3/28/83 and 4/4/83, *Libro de Actas del Banco Nacional Mexicano*, AHBNM.
[36] Labastida 1889: 76.
[37] Ordinary session, 1/24/84, *Libro de Actas del Banco Nacional Mexicano*, AHBNM.

government's team. Noetzlin had a good relationship with Díaz, and the two quickly came to an agreement.[38]

The agreement gave Banamex an official monopoly over all lending to the federal government.[39] In addition, the bank was exempted from all federal taxes, except the stamp tax, while the government promised to subject the other banks to a 5% tax on their banknote issues. Banamex also received the right to issue up to three times the amount of its reserves in notes, which it could back with federal government bonds in addition to specie. Its competitors were limited to a ratio of two pesos in notes for every peso of vault specie.[40] In return, Banamex opened a four million peso credit line for the government, and soon agreed to federal demands for more. By the middle of 1884 the federal government owed Banamex Mx$5,686,559.[41] By September, the bank had lent the government an additional two million pesos.[42] Banamex officials conferred worriedly among themselves, noting in ominous terms that despite the fact that the Progreso, San Blas, and Mazatlán customhouses sent over half their revenues directly to the bank, the debt was being liquidated at a minuscule rate.[43]

Banamex, acting as the government's official bank, was also charged with engineering Mexico's return to European capital markets. Banamex agreed to underwrite a conversion of Mexico's outstanding debt into £6,000,000 of sterling-denominated bonds at lower interest rates. Unfortunately, the "Noetzlin contract" ignited a political firestorm back in Mexico City when the Finance Secretary presented it to Congress in October 1884, arriving smack-dab in the middle

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[38] Carlos Marichal, "Financial Market Reform and External Debt," in Bortz and Haber, *The Mexican Economy, 1870-1930*, p, 101. (pp. 93-119)

[39] Ludlow 1986: 332.

[40] Labastida 1889: 99.

[41] Ordinary session, 7/1/84, *Actas de Consejo*, vol. 1, AHBNM.

[42] Banamex loaned the government an additional two million pesos, at 7%, in October, premised upon the receipt of the Noetzlin loan. Ordinary sessions, 9/30/84 and 10/7/84, *Actas de Consejo*, vol. 1, AHBNM.

[43] Ordinary session, 8/12/84, *Actas de Consejo*, vol. 1, AHBNM.

of President González's quiet campaign to keep Porfirio Díaz from reassuming the presidential sash. Several Congressional deputies backed the contract, arguing that it would reduce the nation's dependence on American capital. Others, however, bitterly opposed it, objecting especially against the massive £1.3 million—roughly 20%—commission charged by Noetzlin and Banamex. As Carlos Marichal has pointed out, these commissions were probably intended to cover the government's seven million peso debt to Banamex.[44] Nevertheless, before a final vote could be taken, hundreds of students took to the streets chanting, "Die, Manuel González! Die, Noetzlin!" Two people were killed and hundreds injured in the resulting riot.

Neither González nor Noetzlin died, but the contract did. Mexico City was in the midst of bitter in-fighting over who should succeed Manuel González as president. Porfirio Díaz presumably had little incentive to help his protégé-cum-opponent resolve the country's credit problems. Díaz regained the presidency, and upon assuming office in 1885 he informed Noetzlin that both the contract and commission were dead letters.[45]

As one might expect, the failure of the Noetzlin contract caused Mexico's economic crisis to flare up again. Banamex charged the government an effective interest rate of 39.4% on a 300,000 peso advance made to make loan payments due in New York in January 1885.[46] Customs revenues failed to recover. In March the government borrowed an additional Mx$1,094,201 from Banamex through the interest expedient of not paying money orders drawn on New

[44] Marichal 1995: 351-52.
[45] Communication from Dublán to Noetzlin, 1/21/85, in Castillo 1903: 54-57.
[46] Calculated from data in the ordinary session, 1/13/85, *Actas de Consejo*, vol. 2, AHBNM. The price of silver fell in 1884-85, causing the peso to depreciate strongly, falling from 89¢ (US) to 85¢. It would continue to fall without respite until 1888, when it would pause at 75¢ before beginning to decline again in 1892.

York.[47] In April the bank's board approved a 300,000 peso "emergency" loan to the government.[48]

Table 3

	Column A		Column B		Column C	
	Specie reserves		Banknotes in circulation		Deposits	A/(B+C)
Jan-85	$	5,311	$	5,798	$	9,404	35%
Feb-85	$	5,179	$	6,172	$	8,977	34%
Mar-85	$	4,969	$	5,997	$	9,366	32%
Apr-85	$	4,750	$	5,744	$	9,340	31%
May-85	$	4,553	$	6,011	$	9,136	30%
Jun-85	$	2,862	$	4,713	$	9,029	21%
Jul-85	$	3,252	$	4,524	$	8,428	25%
Aug-85	$	3,459	$	4,463	$	8,197	27%
Sep-85	$	3,966	$	4,767	$	7,219	33%
Oct-85	$	4,228	$	5,235	$	7,472	33%
Nov-85	$	5,317	$	5,611	$	7,930	39%
Dec-85	$	5,615	$	6,275	$	7,661	40%

Source: *Economista Mexicano*, various.

The government's fiscal situation continued to worsen, and on June 22nd, 1885, Díaz's Finance Secretary, Manuel Dublán, announced what the contemporary financial press called a "coup-d'état": the suspension of all interest payments on short term debt.[49] Banamex was left high and dry, and faced a very serious bank run. (See Table 3.) Deprived of credit, the government was forced to halt all subsidy payments and slashed the salaries of state employees 10 to 15 percent.[50] In return for balancing the budget, and after much debate, Banamex "agreed" to give the government until June 1886 to resume payments on its debts. In point of fact, the bank had little choice: the government was unwilling to restart payments any earlier. The fig leaf from Banamex's board was impor-

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[47] Ordinary session, 3/2/85, and extraordinary session, 3/4/85, *Actas de Consejo*, vol. 2, AHBNM.
[48] Extraordinary session, 4/22/85, *Actas de Consejo*, vol. 2 AHBNM.
[49] Marichal 1995: 352-53.
[50] Marichal 2002: 103-104.

tant, however. By agreeing to pretend that the bank was granting the government an extension, it managed to protect the government's credibility vis-à-vis other potential creditors.[51]

Within a year, Banamex reopened the government's credit taps. In November, the government and Banamex hammered out an arrangement that the government would agree to dedicate 10 percent of all customs revenue (after July 1st, 1886) to repaying its debts to the bank.[52] Within a year, the bank had opened new credits to the federal government.[53] In 1888, the bank aided the government in converting its outstanding foreign and domestic debts into new bonds paying a much lower interest rate. In 1893, it underwrote the federal government's return to the international money market.

Why did the bank choose to aid the federal government? After all, Banamex had been seriously burned by the government's suspension of payments and the subsequent bank run. Why risk good money after bad? Banamex had three reasons. First, the bank's special privileges, enforced by the federal government, promised it a high stream of revenues not from the federal government, but from its business with all its other clients in Mexico. When the bank's existing advantages proved insufficient to induce its aid, the government often responded by authorizing new privileges. (See Section IV.) Second, the government had promised Banamex a monopoly over the issue of banknotes. Since other banks existed that were already issuing banknotes, Banamex needed the federal government's active support to insure its monopoly. Third, in return for its profitable privileges, Banamex would be the agent for the federal government in converting its outstanding foreign debt into new bonds at a lower interest rate. This business could provide a lucrative opportunity to earn commissions.

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[51] Ordinary session, 6/2/85, and extraordinary session of 6/19/85, *Actas de Consejo*, vol. 2 AHBNM.
[52] Ordinary session, 9/29/85, vol. 2 AHBNM.
[53] Ordinary session, 11/23/86, vol. 2 AHBNM.

In short, the federal government promised to compensate Banamex for the risk it undertook not through higher interest rates on its own debt, but by enabling Banamex to extract rents from the rest of Mexico—and from the country's old creditors.

Section IV

How high were Banamex's profits? The answer is: extremely high. (See Table 4.) According to the monthly balance sheets the federal government required Banamex to publish, the bank earned an average return on equity of 24 percent. By 1888, the bank's owners had earned back their entire initial eight-million peso investment.

These profits came from Banamex's lending to private enterprises, most of which were connected to its own directors. The bank enjoyed a number of advantages over its competitors. First, Banamex was the official financial agent of the federal government, which meant that almost all tax payments and disbursements passed through its hands. In addition, Banamex held all deposits made as guarantees of government contracts. This provided the bank with a secure source of liquidity and the directors considered it an important competitive advantage, since they collected a 3 percent commission on all the funds they handled for the government.[54] When the government tried to alter this arrangement, the bank's directors protested vociferously, and the government backed down.[55]

In some cases, Banamex was actual given the right to collect taxes directly: in 1888, all the revenues from the Veracruz customhouse and national lottery were turned over to the bank.[56] In 1893, Banamex was granted the right to the reve-

[54] Ordinary session, 7/25/88, vol. 3, AHBNM.
[55] Ordinary session, 9/13/87, vol. 3, AHBNM.
[56] Ordinary session, 7/25/88, vol. 3, AHBNM.

nues from all federal excise taxes on alcoholic beverages in return for a loan of £267,500 to pay for railroad subsidies.[57]

Second, the Banco de Londres y México was the only bank besides Banamex permitted to branch across state lines. This meant the they could enjoy economies of scale and diversify their risks in a way that the smaller banks, dependent on their local economies, could not. The federal government protected Banamex from new startups, authorized by state governments, by federalizing all bank chartering in 1884.[58]

Third, the government Banamex promised Banamex a monopoly over note issuance. [59] Issuing paper money based on a fractional specie reserve can be extremely lucrative. At the interest rates prevalent in the Mexican commercial paper market at the time, each note issued earned an approximately 18 percent return.[60] The Banco de Londres y México used its political influence to prevent Banamex from exercising its monopoly, but Banamex still enjoyed a great deal of protection from competition. In 1888, under pressure from powerful state governors, the federal government granted concessions for fourteen new banks. These concessions worried Banamex, although only half of the new concessions allowed their holders to issue banknotes. [61] The financial press, however, was more sanguine. When the Banco de Sonora opened its doors in 1889, the *Economista Mexicano* observed that "the Banco de Sonora has not been conceded the innumerable franchises and exemptions that the privileged Banco Nacional de México enjoys."[62]

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[57] Contract #28, *Libro de Contratos Originales con el Gobierno Federal*, AHBNM.

[58] Labastida 1889: 67-68. The same law also authorized the federal government to tax banknote issues. The government promised Banamex that it would impose a 5 percent levy on the issues of all its existing competitors, but a political outcry forced it to renege on this promise.

[59] Ordinary sessions, 1/20/85 and 1/27/85, *Actas de Consejo*, vol. 1., AHBNM.

[60] Cite *The Power and the Money*, p. 27.

[61] Extraordinary session, 10/26/89, *Actas de Consejo*, vol. 3, AHBNM.

[62] *Economista Mexicano*, 9/14/89. Dublán also granted several charters for "bancos agrícolas e industriales." In 1889 he handed out seven concessions in San Luis Potosí, Jalisco, Guanajuato, Puebla, Veracruz, Zacatecas,

Table 4

	Profits	Dividends	Equity, end of period	Assets, end of period	Return on equity	Return on assets
1884*	1,241	800	8,441		16%	
1885	1,690	1,600	8,531	22,467	20%	8%
1886	1,699	2,200	8,630	29,347	20%	6%
1887	2,416	2,200	8,846	32,467	28%	7%
1888	3,022	2,800	9,068	36,355	34%	8%
1889	3,117	2,800	9,385	38,533	34%	8%
1890	3,454	2,800	10,039	41,550	37%	8%
1891	3,456	2,800	10,695	42,144	34%	8%
1892	3,232	2,800	11,127	46,684	30%	7%
1893	3,630	3,200	11,557	42,921	33%	8%
1894	4,138	3,400	12,295	50,480	36%	10%
1895	3,847	3,400	12,742	55,742	31%	8%
1896	4,068	3,600	13,210	65,883	32%	7%
1897**	3,804	3,600	14,414	71,688	29%	6%

* The 1884 figure is only for the second half of the year.

** In 1897, the bank called in one-million pesos in capital from its shareholders. The profit figures have been adjusted accordingly.

The new banks proved little competitive threat. None of the seven enterprises denied the right to issue banknotes ever opened their doors. [63] Of the additional seven banks, which were allowed to issue notes, three failed and none of the others were allowed to branch outside their home state. Nor were they allowed to issue more capital without the explicit permission of the Finance Secre-

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and Yucatán. Manuel Saavedra, a political ally of Dublán's, received the San Luis Potosí concession on August 6th. The Veracruz concession went to an American, George Wilson, while the others went to prominent Mexican businessmen. (Labastida 1889: 106-10.) The Puebla concession went to Tómas Iglesias, who succeeded in persuading the government to both allow his bank to branch nationally and to issue mortgage bonds in overseas markets. (*Contrato celebrado entre el Sr. Lic. Manuel Dublán...y el Sr. Tómas Iglesias*, 8/29/89, reproduced in Labastida 1889: 447-49.) In 1890 Dublán handed out another concession for a bank in Coahuila. (*Economista Mexicano*, 5/3/90 and 6/7/90.)

[63] *Economista Mexicano*, 9/14/89. Dublán also granted several charters for "bancos agrícolas e industriales." In 1889 he handed out seven concessions in San Luis Potosí, Jalisco, Guanajuato, Puebla, Veracruz, Zacatecas, and Yucatán. Manuel Saavedra, a political ally of Dublán's, received the San Luis Potosí concession on August 6th. The Veracruz concession went to an American, George Wilson, while the others went to prominent Mexican businessmen. (Labastida 1889: 106-10.) The Puebla concession went to Tómas Iglesias, who succeeded in persuading the government to both allow his bank to branch nationally and to issue mortgage bonds in overseas markets. (*Contrato celebrado entre el Sr. Lic. Manuel Dublán...y el Sr. Tómas Iglesias*, 8/29/89, reproduced in Labastida 1889: 447-49.) In 1890 Dublán handed out another concession for a bank in Coahuila. (*Economista Mexicano*, 5/3/90 and 6/7/90.) Banamex did not view these concessions as much of a threat. Minimum capital requirements for these banks were extremely high, and they were denied the right to issue banknotes, meaning the bancos agrícolas could not effectively compete against the banks of issue.

tary (who always said no) and their note issues were very carefully monitored.[64] While there was no legal restriction, as a practical matter their banknotes failed to circulate outside their home state.[65]

Fourth, Banamex was given control over the federal mint. In 1893, in return for a loan of 2.5 million pesos, Banamex was granted administrative control over the federal mints, giving them access to a new source of seignorage revenue. Banamex promised to continue kicking back to the government what it had previous earned from the mints (which came to 4.41% for silver pesos and 4.618% for gold), but (correctly) believed it could run the operation much more efficiently.[66]

Fifth, Banamex was able to use its position as the government's official financial agent to reap enormous profits from underwriting the government's early debt conversions and later re-entry into international financial markets. In a long series of negotiations between 1886 and 1888, the Mexican government used Banamex as an intermediary to negotiate the conversion of its outstanding debts. In 1886, the government succeeded in getting its British creditors to agree to write off its outstanding interest arrears. Domestic claims with a face value of 57 million pesos were converted to 3% bonds worth approximately 25 million pesos, payable in silver pesos. In 1888, Banamex arranged a massive European conversion loan. The proceeds from the new loan were used to pay off the government's existing debt to Banamex and buy up Mexico's outstanding foreign obligations at 40 percent of their face value. The country's creditors agreed to write off 37 percent of Mexico's foreign debts, for a net saving of £8.7 million.[67] Banamex captured a substantial portion of these savings. The bank received a

[64] Cite Ch. 4 of *Politics of Property Rights* --- free advertising.
[65] Cite *The Power and the Money*.
[66] Ordinary session, 3/21/93, *Actas de Consejo*, vol. 3, AHBNM, and Contract #27, *Libro de Contratos Originales con el Gobierno Federal*, AHBNM.
[67] Marichal 2002: 105-107.

commission worth 0.5 percent on the entire value of the operation.[68] In addition, it received 18 percent of the profits from underwriting the sales of the new bonds in Europe. This amounted to 29 percent of Banamex's total profits for 1888.[69] Noetzlin took an additional private commission worth one million pesos. In fact, the underwriters' profits were so high that the *London Times* severely criticized the transaction. "The only explanation," they wrote, "is that the Mexican government are greatly harassed by the persistent demands of the National Bank of Mexico to repay loans which are of long standing."[70]

What the *Times* did not understand was that the transaction was win-win for all the parties involved. The government got to reduce its outstanding debt and begin rebuilding its reputation on international debt markets, Banamex got to divest itself of the government's outstanding debt and earn high profits on the transaction, and Mexico's foreign creditors got to exchange debts that would never be repaid for lower debts that might be—and, *ex post*, were—repaid. Later debt issues, in 1889, 1890, 1892, and 1893 followed the same pattern. In 1892 and '93, for example, the government found it difficult to place its bonds in Europe. In these cases, Banamex underwrote the loan, buying the entire bond issue from the government, waiting as long as a year to re-sell them on the European market. [71]

Conclusion

Mexico faced a severe dilemma in the 1880s. The government needed to finance an army, build a railroad net, and bring political stability to the country.

[68] Extraordinary session, 3/21/88, *Actas de Consejo*, vol. 3, AHBNM

[69] Marichal 2002: 107. The first tranche of £3.7 million was purchased by the underwriting consortium at 70 percent of par and sold at 85, while the second tranche was purchased at 85 and sold at 92.

[70] Cited in Marichal 2002: 108-109.

[71] These loans were to finance railroad construction across the Tehuantepec peninsula and drainage works in Mexico City. Marichal 2002: 110.

This required a great deal of money. Unfortunately, the government's ability to extract taxes from Mexico's poor economy was highly limited. Without taxes, the government could not pay tax collectors; without tax collectors, the government could not collect taxes.

The only way to square the circle was to borrow. Unfortunately, in order to borrow, Mexico needed to solve the commitment problem. Since the government had come to power in a military coup in 1876 and still faced strong opposition, no one believed it would be long-lived. In addition, Mexico had a long history of debt defaults. The government tried to create a credible commitment by giving one credit institution a monopoly over lending to itself. The logic was that the monopoly lender would have the ability to apply a credible credit boycott against the government. That would increase creditors' ability to punish the government in the event of nonpayment, and therefore paradoxically allow the government to borrow more. Therefore, the government helped established the Banco Nacional Mexicano in 1880.

Unfortunately, the government could not implement this solution effectively. Without any internal institutions to limit its behavior, the government borrowed from third parties and eventually wound up defaulting on its debt. Its need for funds remained, but it remained unable to extract significant rents from the economy.

The solution was to contract with an institution that was, with government aid, capable of extracting such rents. The government could not issue banknotes, because with no specie reserve it could not force anyone to accept them. Banamex's wealthy French and Mexican owners, however, could. The government could not run the mint efficiently. Banamex, however, could. The government lacked the capital to enter the banking business. It could, however, grant lucrative special privileges to someone who did. It short, the government could sell a stream of rents to wealthy private parties in return for credit. These rents compensated Banamex for the risk of doing business with an unstable government.

The arrangement was suboptimal in some abstract economic sense.[72] It was not, however, necessarily bad for Mexico. Given Mexico's political chaos and lack of credibility, it is not clear that any alternative strategies would have been feasible. The government it could barely keep up the payments on its existing debt, let alone contract new debts at the usurious rates that would have been necessary to compensate creditors for the risk of lending to Mexico. Foregoing new credit would have also meant foregoing the construction of a national rail net (and a strong federal army), which would have resulted in more of the same political instability and economic stagnation that had plagued the country since Independence. Historical contingency made the second-best solution the only feasible solution. While clearly inefficient and bad for the country's long term economic growth, the political generation and distribution of rents to a select group of wealthy financier was better than the realistic alternative of continued chaos.

[72] For more on the economic cost of Banamex's rent-seeking, see Noel Maurer, ARTICLE IN BORTZ AND HABER.