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MEXICO: Country Assistance Strategy Report, Bank Restructuring Facility Adjustment Loan, and Third Basic Health Care Project

Mexico at its current juncture is very much a country in rapid transition – undergoing profound economic, social and political changes. There are strong expectations on the part of Mexicans that the recent political transformation will lead to a more open, participatory and transparent governmental process. Initial signs on this are encouraging, with the appointment of a broad-based and pluralistic cabinet and an open discussion in Congress on the rights of indigenous peoples in Chiapas. Nevertheless, there is a difficult reform agenda ahead, including addressing corruption and moving towards a more decentralized economic and political system.

On the fiscal side, while the much-awaited tax reform bill has not been introduced, as Congress has decided to delay debate of the bill until the fall, tax reform remains a crucial pillar of the government's fiscal agenda and rightly so. It is critical to raising the government's tax revenues, which were estimated at 14 per cent of GDP in 2000, the second lowest among the 85 countries ranked by Standard & Poors. Higher tax revenues are necessary to help fund planned increases in spending on education, social services and infrastructure, as well as help restructure PEMEX (the state-owned oil monopoly) and reduce the government's dependence on oil revenue. On the structural side, banking sector reform (including the sale or merger of financially distressed institutions) is ongoing and further bank consolidation is planned. It is encouraging to note that the Bank and Fund Staff recently reviewed Mexico in the Financial Sector Assistance Paper (FSAP) and concluded that the reform efforts have been leading to positive results and that Mexico's financial sector is now in good shape.

Mexico will likely approach the IMF in the fall for a Contingent Credit Line. The CCL is designed to provide countries with strong economic policies a precautionary line of defense against balance-of-payments problems that might arise from international financial contagion. In our view Mexico appears to be a very good candidate for a CCL.

Previous years of strong growth had allowed Mexico to make very good progress in poverty reduction, with national poverty levels falling to 50 per cent of the population over the 1984-1994 period. However, this figure masks the fact that while major gains were made in reducing urban poverty, rural poverty actually increased over the period. Moreover, the macroeconomic crisis of 1994-95 completely reversed the poverty reduction process. As growth

recovered, poverty began to fall again but only gradually and remains widespread today.

In terms of the Bank program, the **CAS** approved by the Board in June 1999 focuses on social sustainability, growth and macroeconomic stability, and effective public governance. The discussion of the next CAS is tentatively scheduled for May 2002 which will allow time for the new administration to fully define its medium-term development strategy and identify areas of comparative advantage for Bank assistance. In the meantime, the existing CAS objectives remain highly relevant and we believe should continue to guide the Bank program. The focus on supporting major reforms through adjustment lending and investment operations to get at the roots of poverty remains critical. It is important that the IFC continue to maintain its high selectivity, focusing on financial sector development, SMEs and "frontier" sectors that are relatively new to private firms.

Like the Bank, we are encouraged by the record so far of the new president and his team in building consensus and beginning to address Mexico's economic, social and political challenges. Managing this situation will not be easy, however. Even following on the remarkable growth experience during periods of the last decade, poverty remains widespread, major structural reforms are pending, no single party dominates Congress and public expectations of a more open, participatory and transparent governmental process are high. There are also the difficult and urgent problems of fighting corruption and moving towards a more decentralised economic and political system.

Country Assistance Strategy Progress Report

We support maintaining the CAS as envisaged through to May 2002. The Bank's strategy, by addressing key areas such as continued fiscal and financial sector reform, decentralization, wider access to credit, the needs of the rural poor, and development in the Southern states, will usefully contribute to the reform agenda and poverty reduction. In addition, the Bank is exercising a welcome degree of selectivity by focusing on areas where it has comparative advantage such as improving tax administration, bank restructuring and assisting states in managing their new fiscal responsibilities. While the Mexican authorities have very ambitious plans, it is appropriate that the Bank limit itself to those areas where it can be most effective. We agree with the Bank that while there are risks to the CAS, these risks are manageable.

We also agree with the Bank that both caution and optimism are in order regarding the outlook for Mexico's economy in 2001. While continuing high oil prices may help alleviate some of the constraints on the economy, Mexico's economic prospects will be closely tied to those of the U.S. which is the market for nearly 90 percent of Mexican exports. If a slowdown in the Mexican economy is protracted, the central bank may need to consider easing monetary policy further to help stimulate domestic demand. Mexico's proven record of sound macroeconomic management in recent years bodes well in this situation. It is also reassuring that Mexico has been fairly well insulated from the financial turmoil in Argentina, due to investors' apparent "flight to quality" within Latin American assets. The *peso* has appreciated almost 8 per cent since

the beginning of this year, while domestic interest rates have continued to decline.

It is encouraging that Mexico is now recovering some of the gains in poverty reduction made during the 1984-94 period, following the devastating setbacks of the 1994-95 crisis. We note, however, that even during that earlier period, while overall levels of poverty declined, rural poverty increased. Moreover poverty remains widespread in Mexico, particularly in the rural areas and southern regions. We urge the Mexican authorities to work towards articulating a clear poverty reduction strategy, developed with the meaningful participation of civil society, with a focus on health, education and the social sectors, but also on agriculture and rural infrastructure.

With regard to education, we are very encouraged that primary education coverage exceeds 90 per cent in Mexico. We would be interested in knowing the regional distribution of this coverage, and whether the coverage reflects the enrolment of both boys and girls.

Bank Restructuring Facility Adjustment Loan (BRFAL)

The proposed US $505 million Bank Restructuring Facility Adjustment Loan (BRFAL) follows a previous such loan of an identical amount approved in December 1999. We fully support this loan as it will help to improve the functioning of the financial sector, strengthen its ability to withstand external shocks and lend to the private sector, and broaden access to micro, rural and SME loans. It will further promote regulatory reforms supported by the previous BRFAL loan, and help to finance the bank restructuring/resolution program as full deposit insurance is phased out.

Significant progress has already been made in strengthening the financial sector, supported by the previous bank restructuring loan. Although Mexico's financial sector is considered to be in good shape, we would be interested in the Bank's perspectives on the financial health of state-run development banks.

Finally, we note that Bank exposure in Mexico is projected to peak at US$12.7 billion in FY04, which compares with the Bank's portfolio concentration limit of US$13.5 billion for any single borrower. We agree with the Bank that this exposure should be monitored carefully and that the implications for the Bank's strategy in Mexico be treated more fully in the upcoming CAS.