Report No. PID10045

Project Name	Mexico-Regional Private Sector Development... LIL
Region	Latin America and the Caribbean Region
Sector	Private Sector
Project	MXPE60577
Borrowers	Government of Mexico
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1. Country and Sector Background

The liberalization of trade and investment that began in the mid-1980s and Mexico's entry into NAFTA (the North American Free Trade Agreement) in 1994 were intended to achieve higher rates of economic growth by expanding the country's participation in dynamic external markets and facilitating access to high-quality inputs and technologies. Since the peso crisis of 1995, when the GDP contracted by 6.2%, the national economy has enjoyed a strong recovery in overall terms (averaging 5.4% annually). This growth has contributed to an annual expansion in employment of 4.0% over the past four years, compared to an annual increase of 3.9% of the economically active population (Instituto Nacional de EstadÚstica, GeografÚa, e Información, 2000). The rapid growth of the maquiladoras has fueled higher employment in urban areas, while agriculture has continued to drop as a source of work in rural areas.

Despite the wide-ranging economic reforms instituted in the country, the income distribution in Mexico remains among the most unequal in the world. Constraints to more balanced economic development include regional development, tight credit markets, and little access to existing business development service programs by micro and small businesses.

Uneven regional development. The country faces huge differences in the level of industrialization and in the decline of agriculture that have sharpened the divisions that exist between different regions. The central region, which includes the Federal District and the state of Mexico, accounts for nearly one-third of GDP despite the fact that it covers only 1.2% of the land area. Monterrey (Nueva León) and Guadalajara (Jalisco) are the leading industrial cities after the capital. The maquiladora industry in the border area has boosted employment. Tijuana in Baja

California, and Ciudad Juárez, in Chihuahua, have become important maquiladora cities. However, some states in the South still face with widespread poverty problems, due in part to inadequate transport and communications infrastructure and a lack of investment. Even within the Southern states, there are pockets of enclave economic development (such as the petroleum industry in southern Campeche, and tourism in coastal Quintana Roo).

This pattern of unequal regional development translates into increased poverty in many parts of the country. Mexico continues to have one of the highest Gini coefficients in the region, with the lowest decile of the population controlling 1.5% of the national income, and the top 10% with 42.8% of national income and consumption. Poverty indicators have been deteriorating in recent years. According to a survey in 2000, about 62% of the economically active population earns less than 2 times the minimum wages per day (the national poverty level, equivalent to US$7 per day). INEGI estimates that the minimum wage in real terms dropped 40.7% between 1994 and 1999, while the highest decile accounts for over 38% of the national wealth (2000 data). The number of people living below the poverty line in the 38 largest cities increased from 29 million to 38 million from 1994 to 1998. The vast majority of informal producers and traders in the project area are living under the national poverty line.

The states of Campeche, Quintana Roo and Yucatan are characterized by large numbers of microbusinesses, which face a general lack of access to affordable, reliable, appropriately designed financial services and timely market information. In Campeche, about 98% of total firms are microbusinesses. Based on the universe of 5,212 formally registered businesses in Campeche, the municipalities of Campeche and Ciudad del Carmen concentrated 88% of all the firms in the state. In Yucatan and Quintana Roo the firm-size distribution is also concentrated at the microbusiness level (97% of all firms).

Tight Credit Markets. Despite an easing in nominal interest rates, credit markets have become tight. Small and medium sized firms with traditional collateral to back loans are not able to obtain credit, given the banks' reluctance to increase exposure to such firms. A survey by the Banco de México, (the central bank) shows that only 33% of 500 companies surveyed had received bank credit in the third quarter ended September 30, 2000. This is well below the 39% that received financing in the third quarter of 1999. On an inflation-adjusted basis, interest rates for the best clients are now nearly 10% in real terms.

Small and microbusinesses have traditionally not qualified for bank loans, and have turned to development banks, particularly NAFIN, through arrangements with first-tier commercial banks. However, during the Peso Crisis of 1995, and the subsequent recovery in 1996-97, the volume of credit declined significantly from earlier levels. Development banks tried to compensate for the lack of credit that could be channeled through first-tier banks by providing loans directly. However, small and micro businesses have proven difficult for them to reach. The credit decline has continued uninterrupted since the end of 1994. The total amount of loans at the end of March 2000 was still 42% below the end of 1994 level, in real terms. Recent surveys have identified access to financial services as a key constraint to microbusiness growth.

Limited local participation in Business Development Services (BDS) design While state governments often support microbusiness programs established by the federal government as part of their development plans, these programs are often developed with little input from the states of end users of BDS services. The market research and field interviews during Project preparation showed that microbusinesses are not well served by existing federal programs. There is a recognition that a more market-oriented and decentralized strategy is needed in Mexico, addressing the problem of collaboration.

Low levels of coverage of BDS programs for micro and small businessess. The current programs in Mexico have only reached a small share of the market and are largely unknown to the rest of the sector. This was confirmed during by the market demand study conducted for the State of Campeche. Both the recent work on federally-funded BDS programs in Mexico. The LIL will contribute to test a more decentralized approach in the role and management of publicly funded BDS programs by using information and communication technologies to evaluate lower-cost delivery mechanisms as well as piloting mixed public-private institutions to deliver BDS and microfinance.

Small number of private providers and limited service options. Private providers of BDS are few in the region. According to the market demand survey in Campeche, only 71 firms out of 331 hired consulting services in Campeche during 1999, primarily for accounting, taxes and integrated diagnostics services. The survey of firms in Campeche identified the main needs as training, information and advisory services in sales, business administration, marketing and production. However, these areas are not well covered by local or regional providers. In addition, despite national level improvements in ICT applications and accessibility, Yucatán lags far behind other parts of the country in ICT use.

2. Objectives

The objective of the project is to assist the Government of México and three states in the South (Campeche, Yucatan and Quintana Roo) to learn about the requirements of sustainable microfinance methodologies and to test the use of information communications technology (ICT) to deliver business development services (BDS) to a significant number of small and microbusinesses in a cost effective and sustainable manner.

3. Rationale for Bank's Involvement

The joint IBRD/IFC Mexico Country Assistance Strategy (CAS) was discussed by the Board of Directors in May 1999. The CAS has three strategic objectives - (i) removing obstacles to sustainable growth and maintaining macroeconomic stability in the context of globalization, (ii) social improvement (poverty reduction, education, basic health care, and rural development in marginal areas), and (iii) enhancing public governance (including the promotion of decentralization). The Latin America Region of the Bank has assigned project development to the Entrepreneurship for Poverty Alleviation team of the private Sector Development Department, since the EPA team has significant strategic and operational experience with infocenter development and microfinance institution development.

The objectives of this project will contribute to these three CAS objectives. The project will support the objective of removing obstacles to sustainable growth by promoting private sector-led strategies to microbusiness development, while building strong partnerships with state governments and NAFIN. Three of the four institutions providing microfinance services are private sector operations (Canacintra Quintana Roo is a private business association, Fondo Chetumal is a private fund, and the Beekeepers Association (APIS) is a private firm). The infocenters will also be private firms.

Fostering private sector development in less-developed regions is one of the strategies under the CAS. The project will help to remove impediments to private sector growth and to enhance competitiveness of local firms in the three states. This situation is more crucial for the states of Campeche, Quintana Roo and Yucatan, which have not developed substantial entrepreneurship competencies (especially in Campeche). Campeche based its economic development on oil exports, Quintana Roo on tourism and Yucatan on primary products (honey, henequen plantations, etc), which are enclave economies with little impact on the rest of the local economy.

The CAS calls for activities that promote significant poverty alleviation. The CAS notes that two-thirds of the rural population in southern states is considered poor, compared to one third nationwide. This persistent poverty has been linked to a lack of access to markets and productive assets, including market information, capital and technology. The choice of the target client population (urban and indigenous urban as well as rural clients) will also increase the poverty alleviation contribution of this project. Experiences from a wide range of microfinance institutions in Latin America and other regions clearly demonstrate that microfinance and microbusiness development support can make an important contribution to poverty alleviation. For instance, average loan size of the Finca Latin American village banking affiliates is only $120, indicating an ability to provide loans to the poor. Similarly, Accion International affiliates in Latin America provide solidarity group loans to market vendors, with initial loan size ranging from $50 to $100. These methodologies will be employed by the institutions to be supported by the project.

4. Description

The project has two components: (i) the Microfinance Component, and (ii) the Information Communications Technology-based Business Development Services for small/microbusinesses.

Microfinance Component. The microfinance component will build on pilot successes in three cases, and will assist one start-up microfinance institution. A commercially priced, performance-based credit line will be provided to three microfinance institutions (Buenaventura, Canacintra Quintana Roo, and Fondo Chetumal) to onlend to urban and rural microbusinesses. Performance criteria will include trends in profitability (after adjustments for subsidies), efficiency indicators, portfolio quality, and the level of outreach to low income clients. The component will also support an investment in a private firm (the Beekeepers Association of Yucatan, APIS) to onlend rural small scale honey producers.

Buenaventura and Fondo Chetumal represent typical microfinance institutions, using solidarity groups to reach rural communities and market vendors. Canacintra (Camara de la Industria de Transformacion) in Quintana Roo is a business association that will provide credit of up to 80,000 pesos (about $8,280) to members, complementing the business management training courses it already provides. Canacintra did an excellent job of recovering bad debts from the 1994 Peso Crisis, and meets the NAFIN criteria for non-bank financial institutions. APIS is a private honey products association, which provides supplier credit and a technologically advanced input package to shareholders who are also rural small scale honey producers. The value of the shares exceeds the value of the typical loan, making it a low risk operation. Each institution has been reviewed by microfinance specialists and will be qualified using the existing NAFIN rules for non-bank financial institutions (with the exception of APIS, which will be a direct NAFIN investment).

In addition to the credit line, the component will provide access to international best practices and tools (such as business planning and financial projections tools, internal and external audit best practices, financial analysis and risk management for MFIs, delinquency management techniques, management information systems and technologies to increase efficiency) to assist the four institutions move from pilot operations to full scale microfinance activities. This capacity building effort represents critical learning for the microfinance institutions, the private firm, and the NAFIN Project Management Unit and other local state and private institutions. The project will serve as a resource center, making use of course materials and tools that have been field-tested by the Consultative Group to Assist the Poorest (CGAP).

ICT-based BDS Services Component. The ICT-based BDS Component will develop four infocenters to connect small and microbusinesses to new market opportunities by putting them in direct contact with new clients and suppliers in local and more distant markets, and to new sources of technology and technical assistance. The development of the necessary local content and applications to achieve these links represent a challenging learning agenda. However, the component will take advantage of Bank project experiences in Guatemala, El Salvador, and Peru, as well as a NAFIN e-commerce initiative. These experiences will enable the component to efficiently provide local content and applications that match the needs of small and microbusiness operators and promote firm growth and profitability.

5. Financing	Total (US$m)	$8.3 million
Government		$2.6 million
(NAFIN		2.0 million)
(Local Governments		0.6 million)
IBRD		$4.7 million
IDA		na.
Private sector		$1.0 million

6. Implementation

Project Management Unit. The Project Management Unit (PMU) is located in the National Development Bank (Nacional Financiera-NAFIN) in its Direccion Adjunta de Fomento. In addition, NAFIN will be the financial

intermediary for this LIL (see requirements for procurement in this role, presented below). The PMU will oversee all administrative, financial, procurement, disbursement, and logistical aspects of project implementation. The PMU will also prepare reports, coordinate reports from participating institutions, and be responsible for the mid-term review and other , evaluations. NAFIN has already allocated an adequate budget for the PMU to manage financial reporting, monitoring and evaluation. The PMU will have a coordinator for the project and two lead specialists (one for each component), as well as an accountant with experience in financial management issues.

The core responsibilities of the PMU will include the following:
- Carry out the Project Launch Plan
- Prepare annual project action plans with inputs from the participating institutions in each component, which will be reviewed by the Bank
- Prepare semi-annual procurement plans
- Prepare quarterly Project Monitoring and Evaluation Reports on execution and learning against the agreed learning and performance targets
- Help to identify sources of technical assistance as required by the participating institutions
- Hold a project mid-term review by June 30, 2003
- Insure general project coordination between the various private and public sector actors
- Prepare the borrower's portion of the Project Implementation Completion Report in coordination with participating agencies, financial institutions, and private firms.

To support the PMU at NAFIN headquarters, NAFIN staff in each state have already been assigned to the PMU. There will also be a regional PMU office in Campeche. The regional office's main function will be to consolidate information on disbursements, reports, monitoring and evaluation from all participating institutions participating in each state. The Regional Coordinating Unit will be accountable for supervision and monitoring of the subprojects that have been approved under the project, as well as the reports which meet the requirements of NAFIN and the Bank (especially regarding financial management issues). This unit will also document the lessons learned from the different project activities, since it will be in ongoing contact with executing institutions (the MFIs and infocenters).

7. Sustainability

It is expected that the infocenters will attain financial sustainability by generating enough revenue, through user fees, to fully cover operating costs and equipment. A preliminary financial simulation model demonstrated that the break-even point for an infocenter will be 24 months.
For the microfinance component, the financial sustainability of the Buenaventura program was carefully assessed during pre-appraisal by reviewing the financial statements and reviewing the management systems. With the help of an experienced consultant, the management team used the Microfin financial projections model and available data to project client demand, dropouts, operating costs and likely financing costs. This

analysis concluded that Buenaventura is likely to become financially self-sufficient within five years. Canacintra Quintana Roo will be undertaking portfolio development and management for the first time in five years. However, its projections indicate that, given low costs and past experience in loan enforcement, Canacintra should be able to cover all costs within three years. Fondo Chetumal is currently producing a business plan, whicih will include financial projections and a target for full financial sustainability. This target is likely to be met in the fifth year of operations, when the program estimates that it will be serving 4,000 clients.
In the special case of APIS, this private firm has shown in the pilot phase that it can be profitable to complement a technical inputs package with financial services to small beekeepers in Yucatan. APIS management demonstrated the company's profitability during pre-appraisal. APIS has shown that financial services to small shareholders can increase the supply of high quality honey products for export.

8. Lessons learned from past operations in the country/sector

Microfinance Component

Matching Microbusiness Needs and Constraints. There is a longstanding history of supply-led rural finance programs and subsidized credit initiatives in the country - yet none have led to the sustainable provision of financial services to rural enterprises. The services supported by RMMP will be demand-driven, since qualifying rural MFIs will have already demonstrated an ability to sell their products to rural clients. To qualify, they will have to show a growing client base with repeat borrowers and low drop-out rates. In addition, the institutional development component can support the MFI's market research and new product development activities to insure a match with rural microbusinesses (in terms of amounts, repayment schedules, collateral requirements, and characteristics of savings accounts, when offered).

Interest Rates. Small farmers and rural entrepreneurs can pay rates of interest on loans that are higher than commercial rates. Rural entrepreneurs want access to credit - it does not have to be subsidized to be attractive. Most microbusinesses pay informal credit providers a rate of interest that far exceeds the commercial rate, due to the lack of competition in rural markets. MFIs therefore provide a very important service, even if they charge an interest rate of 25% to 40% above the commercial rate of interest.

While the institutional set-up is not critical, there are key characteristics of sustainability that will be reviewed.. Sustainable MFIs and rural finance institutions share five characteristics - (i) loan products that fit the cashflow of borrowers, (ii) a combination of appropriate incentives and sanctions, (iii) a credible system for loan contract enforcement, (iv) financial management systems that enable managers to track loan quality, costs, productivity and other key performance indicators, and (v) a vision of commercial viability that is shared by the board of directors, general manager and staff. As financial institutions, they also have adequate loan loss provisioning procedures, adequate loan loss reserves, and annual independent audits to insure prudent management of resources.

In accordance with OP 8.30, international best practices (including guidelines established by the Consultative Group to Assist the Poorest, CGAP), the participating rural MFIs will also have the following characteristics, or be able to reach satisfactory levels within a reasonable period of time: (a) adequate profitability, capital, and portfolio quality, (b) acceptable levels of loan collections; (c) appropriate capacity for assessing and supervising subprojects; (d) capacity to mobilize domestic resources; (e) adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled FIs are involved); and (f) appropriate prudential policies, administrative structure, and business procedures

ICT-based BDS Component

For ICT-based BDS, the lessons of international experience suggest that, in order to improve the coverage and quality of non-financial services relevant to the needs of micro and small businesses (mirobusinesses), the government should facilitate the growth of a more decentralized, private sector-driven BDS industry.

9. Program of Targeted Intervention (PTI) N

10. Environment Aspects (including any public consultation) issues:

This project has been given a C rating as a result of the Environmental Assessment. The Environmental Data Sheet was signed on November 20, 2000. Precautions will be taken to insure that institutions participating in the project comply with standard Bank requirements.

11. Contact point:

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Survey by Desarrollo Empresarial de Campeche, 1999 and Market Demand Survey in Campeche, 2000. Derived from recent economic and sector work has highlighted some of the key policy and institutional issues affecting the Peninsula of Yucatan and Mexico's economic performance (Grupo de Economistas y Asociados (1998). "Proyecto de Fomento a la Competitividad de las Micro, Pequeñas, y Medianas Empresas en México: Coordinación General del Proyecto." BDS Project report prepared for SECOFI and the World Bank, January 28; Hallberg, K. (2000) "A Market-Oriented Strategy for Small and Medium-Scale Enterprises.".

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