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# MEMORANDUM OF THE PRESIDENT

# OF THE

# INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

# AND

# THE INTERNATIONAL FINANCE CORPORATION

# TO THE

# EXECUTIVE DIRECTORS

# ON A

# COUNTRY ASSISTANCE STRATEGY

# OF THE WORLD BANK GROUP

# FOR

# THE UNITED MEXICAN STATES

May 13, 1999

Mexico Country Management Unit
Latin America and the Caribbean Region

**MEXICO–FISCAL YEAR**

January 1–December 31

**CURRENCY EQUIVALENTS**

(as of 15 April 1999)

| Currency Unit | = | Peso |
|---|---|---|
| 9.53 Pesos | = | US$1 |

**WEIGHTS AND MEASURES**

Metric System

**ABBREVIATIONS AND ACRONYMS**

| | |
|---|---|
| BANCOMEXT | Banco Nacional de Comercio Exterior, S.N.C. |
| BANOBRAS | Banco Nacional de Obras y Servicios Públicos, S.N.C. |
| CAS | Country Assistance Strategy |
| CFE | Comisión Federal de Electricidad |
| CMU | Country Management Unit |
| CNBV | Comisión Nacional Bancaria y de Valores |
| CONACYT | Consejo Nacional de Ciencia y Tecnología |
| CONALEP | Colegio Nacional de Educación Profesional Técnica |
| CONASUPO | Compañía Nacional de Subsistencias Populares |
| CSDL | Contractual Savings Development Loan |
| DIF | Sistema Nactional para el Desarrollo Integral de la Familia |
| DRD | Decentralization and Regional Development |
| ENIGH | Encuesta Nacional de Ingreso y Gasto de los Hajores |
| EXIM-J | Export-Import Bank of Japan |
| FOBAPROA | Fondo Bancario de Protección al Ahorro |
| FONHAPO | Fideicomiso Fondo Nacional de Habitaciones Populares |
| FOVI | Fondo de Operación y Financiamiento Bancario a la Vivienda |
| FOVISSSTE | Fondo de la Vivienda del Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado |
| GATT | General Agreement on Tariffs and Trade |
| GDP | Gross Domestic Product |
| GEF | Global Environment Facility |
| IDB | Inter-American Development Bank |
| IFC | International Finance Corporation |
| IMSS | Instituto Mexicano del Seguro Social |
| INFONAVIT | Instituto del Fondo Nacional de la Vivienda para los Trabajadores |
| ISSSTE | Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado |
| LCR | Latin America and Caribbean Region |
| LIL | Learning and Innovation Loan |
| NAFIN | Nacional Financiera, S.N.C. |
| NAFTA | North American Free Trade Agreement |
| NGO | Nongovernmental organization |
| OCDE | Organización para la Cooperación y Desarrollo Económicos |
| OECF | Overseas Economic Cooperation Fund |
| OED | Operations Evaluation Department |
| PAN | National Action Party |
| PRD | Party of the Democratic Revolution |
| PRI | Institutional Revolutionary Party |
| PROCAMPO | Programa de Apoyos Directos al Campo |
| PROCEDE | Programa de Certificación de Derechos Ejidales y Titulación de Solares Urbanos |
| PRONAFIDE | Programa Nacional de Financiamiento del Desarrollo |
| PSD | Private Sector Development |
| SAGAR | Secretaría de Agricultura, Ganadería y Desarrollo Rural |
| SECODAM | Secretaría de Contraloría y Desarrollo Administrativo |
| SECOFI | Secretaría de Comercio y Fomento Industrial |
| SME | Small- and medium-size enterprise |
| SRA | Secretaría de la Reforma Agraria |
| SSA | Secretaría de Salud |
| STPS | Secretaría del Trabajo y Previsión Social |
| UNDP | United Nations Development Programme |
| UNEP | United Nations Environment Programme |
| WBG | World Bank Group |

| IBRD | | IFC | |
|---|---|---|---|
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# MEXICO

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## COUNTRY ASSISTANCE STRATEGY

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# EXECUTIVE SUMMARY

i. The consolidation of Mexico's democratic process will make the period leading to the next presidential election increasingly uncertain on the political front, with natural implications for the economic and social life of the country. This calls for a reordering of emphasis both in the authorities' development agenda and in the World Bank Group's (WBG) Country Assistance Strategy (CAS). The core challenge is to articulate a socially sustainable macroeconomic adjustment to the deteriorated external conditions, while protecting and, where possible, advancing sectoral reform agendas that could foster long-term growth.

ii. The country counts on a substantial reform platform to meet that challenge. In recent years, progress has been achieved in many fronts (agriculture, short-term macroeconomic management, education). In other areas, the record is mixed (fiscal structure, finance, energy). In all sectors, and in spite of the political calendar (presidential elections are scheduled for mid-2000), one key factor favors sound policymaking—clear country awareness of remaining structural problems.

iii. Thus, this CAS, which, as its predecessor, has been jointly prepared by the IBRD and IFC, seeks to support the Mexican government's efforts in achieving three overall objectives: social improvement; removing obstacles to sustainable growth and maintaining macroeconomic stability in the context of globalization; and enhancing public governance. It envisages a combination of multi-sectoral analytical work (some of which will build a knowledge base for the next presidential administration) and financial operations (with IBRD's projected commitments reaching some US$5.2 billion through FY01, a third of which will be in the form of adjustment loans).

iv. Key among those operations is lending for social development (poverty reduction, basic education, basic health care, rural development in marginal areas, and so on). Efforts to support a faster, more efficient, more sustainable growth path will take the form of policy-based lending, investments, and analysis in the fiscal, financial, infrastructure, and agriculture sectors, coupled with extensive use of GEF-led activities for the protection of the environment. Finally, more effective public governance will continue to be fostered through lending and analysis in regards to decentralization (a rapidly accelerating process in Mexico), and through new support initiatives in the areas of tax administration, commercial dispute resolution, and governance mechanisms.

v. The proposed WBG program is kept flexible, however, with the institution's commitment to specific operations aligned with the likelihood of implementation of necessary policy reforms. This responds to lessons learned during the current and past CAS cycles in terms of country dialogue, portfolio management, decentralization of IBRD management, and IFC experience. Several important risks are implicit in this CAS (fiscal imbalances in the period leading to the presidential elections, macroeconomic and financial instability, unexpected deterioration in social conditions, lack of sufficient funding). Suitable risk-mitigating factors as well as encouraging general policy positions are fortunately in place.

vi. This CAS was drafted after extensive dialogue with and participation by the government and selective consultations with representatives of NGOs, the business community, unions, the banking industry, politicians, religious groups, academia, independent think-tanks, and the media (a special Consultative Country Meeting—*Reunión de Consulta*— was conveyed on April 15, 1999, to receive comments from those representatives).

vii. The following issues are suggested for Board discussion:

- Are the proposed assistance objectives and priorities appropriate given Mexico's forthcoming economic and political environments?
- Is the mix of financial and nonfinancial services planned in the CAS adequate, and does it reflect and exploit the WBG (IBRD and IFC) capabilities and comparative advantages?
- Are the strategy's implementation risks acceptable?
- Is the CAS sufficiently flexible to be able to respond to country circumstances and risks?

# MEMORANDUM OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT AND THE INTERNATIONAL FINANCE CORPORATION TO THE EXECUTIVE DIRECTORS ON A COUNTRY ASSISTANCE STRATEGY OF THE WORLD BANK GROUP FOR THE UNITED MEXICAN STATES

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## I. INTRODUCTION AND RATIONALE

1. The World Bank Group's (WBG) previous Country Assistance Strategy (CAS) for Mexico was discussed by the Board of Executive Directors on November 25, 1996 (Report No. 16135-ME), and its Progress Report was considered on March 6, 1998 (R98-49). The CAS objectives of sustainable growth, social development, and state modernization have proved fitting. A body of critical analytical work and an average US$1.1 billion annually in new lending commitments of improving implementation quality have been delivered under that CAS. More important, an enriched partnership has been forged with the Mexican government.

2. At present, however, a combination of sweeping domestic factors and a fundamentally altered external financial environment call for a reordering of emphasis, both in the authorities' development agenda and in the WBG's efforts to assist them. On the domestic front, the opening of the political spectrum, the rapid (and accelerating) decentralization process, the end of the presidential *sexenio*, persistent financial sector problems, security issues, and environmental degradation, among other matters, place policymaking in a more tightly constraining framework. Externally, the simultaneous collapse in international oil prices and turmoil in global financial markets have had, and are likely to continue to have, a major negative impact on Mexico's economy, especially on the living standards of the poor.

3. Because of that framework, and within it, the country is now faced with an immediate challenge—*to articulate a socially sustainable macroeconomic adjustment to the deteriorated external conditions, while protecting and, where possible, advancing sectoral reform agendas that could foster long-term growth*. This challenge will likely dominate public policymaking in Mexico over the next three years, and will be the overarching objective of the WBG's continuing assistance through FY2001.

4. This document presents a new CAS for Mexico. The proposed strategy, which, like its predecessor, integrates IBRD and IFC programs into one unified framework, is aligned with the government's own development programs and is dominated by three core themes—social sustainability, removing obstacles to sustainable growth and maintenance of macroeconomic stability in the context of globalization, and effective public governance.

5. At the outset, it is important to note that presidential elections will take place in Mexico in the year 2000, and that the WBG assistance strategy will need to be reassessed following those elections.

## II. POLITICAL AND ECONOMIC FRAMEWORK FOR THE WBG'S ASSISTANCE

a) The Political Context—Recent Developments and Prospects

6. Over the past years, the political situation in Mexico has become more complex. The new political environment was clearly shaped by the congressional elections of July 1997, which saw, for the first time in seven decades, opposition parties holding a majority in the lower house. This change, symbolic of an accelerating opening of the political process in the country, and elsewhere in the world, is profoundly altering the balance of power in the legislative branch and between the legislative and executive branches. Since the parliamentary elections of 1997, a number of partial elections (state governors and municipalities) have demonstrated a strengthening of the opposition parties, yet the party in power (the PRI) seems to have rebounded somewhat in the latest elections. This recent phenomenon may be partly attributable to a judicious selection of PRI candidates, perhaps the result of the opening of the democratic process within the party itself.

7. The political life of the country is already strongly influenced by the prospect of the presidential election scheduled for mid-2000. The end-of-sexenio syndrome, Mexico's political transition at the end of each president's six-year mandate, is already evident, and is expected to accelerate as the election approaches. For all practical purposes, the race for the successor to President Zedillo has already started, and several candidates from within each party are running for their respective party nominations. These developments are dominating the current political environment in Mexico, and there is an unusual amount of uncertainty as to the possible outcome, unlike the previous election, where the PRI candidate was generally expected to win.

8. This uncertainty on the political front is further complicated by the uncertainties of the relationships between the executive and the legislative branches dating from the 1997 parliamentary elections. Neither side is yet accustomed to the new paradigm. Several reform packages (for example, in the financial sector) have been delayed in Congress by the failure to reach a compromise (albeit, constitutional requirements have recently driven a last-minute compromise agreement on the financial sector and the 1999 budget between the opposition-led Congress and the administration). Working out these new relationships will necessarily take time, and during that time, the policy agenda is likely to move at a reduced pace. Combined with the political calendar leading to the 2000 election, the relationships between Congress and the administration may imply little progress on the fundamental policy agenda until at least a few months into the new administration—that is, by the beginning of 2001.

9. Concomitant to the general opening of the country on all fronts, and as a result of the political dynamics of the last two years, the process of decentralization, initiated only timidly and piecemeal some years ago on a sectoral basis (for example, in education), has taken on increasing momentum. This process is still under consideration and partly driven by political negotiations between Congress and the administration (this was evident in the last-minute arrangements reached with opposition parties during the 1998 budget discussions, a process repeated at the end of 1998 for the 1999 budget). The process of decentralization, however, is now clearly irreversible, and it is creating an entirely new set of power relationships among the federal, state, and municipal levels. The full implications of this new situation are yet to unfold, but they will probably lead to fundamental changes in the way the country operates for the next two decades.

10. The pressures for change in Mexico have created new expectations in the people and opened considerable opportunities for progress in the political, social, and economic development of the country. They have also brought forward issues of governance, as well as greater attention to social problems and to the specific demands of the poorest sectors of the population.

11. For the immediate future—leading to the presidential elections—the most important and urgent element has been the recently concluded discussion of the 1999 budget, which has seen strong opposition by the two main opposition parties (PAN and PRD) to the administration's proposal. Predictably, political negotiations and compromises have led to a substantially modified budget, largely influenced by political expediency.

12. In summary, the consolidation of the democratic process will make the period leading to the next presidential election increasingly uncertain on the political front, with natural implications for the economic and social life of the country. It is against this background that the proposed CAS is being formulated and will be implemented.

b) Recent Economic Developments

13. Following an encouraging recovery from its 1995 banking crisis (see box 1), Mexico's economy has been negatively affected by the simultaneous collapse in international oil prices and turmoil in global financial markets. Through a combination of conservative fiscal policy, monetary tightening, and a flexible exchange rate regime, however, the country has fared relatively well thus far compared with the rest of Latin America. Mexico responded to the global crisis with three consecutive fiscal adjustments during 1998 (jointly worth about 1 percent of GDP) and, more recently, with a stern austerity budget for 1999 (see below). Monetary policy was tightened on several occasions during the year (at the temporary cost of annual interest rates on government paper of over 45 percent). Although the exchange rate depreciated substantially (by about one-fifth since the beginning of 1998) and inflation for the whole of 1998 may turn out to be higher than previously anticipated (18.6 percent p.a.), output still grew by 4.8 percent over the same year, with a balance of payments current account deficit of 3.8 percent of GDP, acceptable figures given current international standards. Exchange rate flexibility achieved the important goal of preventing a depletion of foreign exchange reserves and dampening contagion-driven losses of confidence. As will be explained later, this success in short-term macroeconomic management remains to be matched by a solution to more fundamental, structural issues: i) macro imbalances, notably the need to increase non-oil fiscal revenues (and reduce the ensuing fiscal dependency on oil reserves), strengthen the capital adequacy of the banking industry, and avoid recurrent current account financing risks; and ii) the need to have a broader cross-section of the private sector participating in the process of modernization and growth.

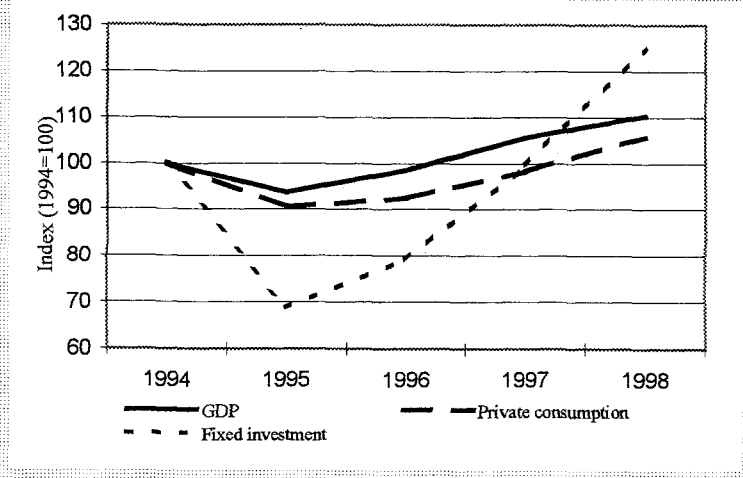
14. Critical to the World Bank's mandate, the Mexican government has, up to now, made particular efforts in combining fiscal austerity with protection of the so-called "social expenditure"[1] (now largely decentralized at the state level). Since 1995, this expenditure has increased as a percentage of GDP (and stands at about 9 percent), in real terms (by a cumulative 27 percent), and as a proportion of total programmable expenditures (from 53 to 61 percent).

1. Education, health, social security, labor, rural and urban development, and basic food supply and social assistance.

**Box 1. Mexico's Recovery from the 1995 Crisis**

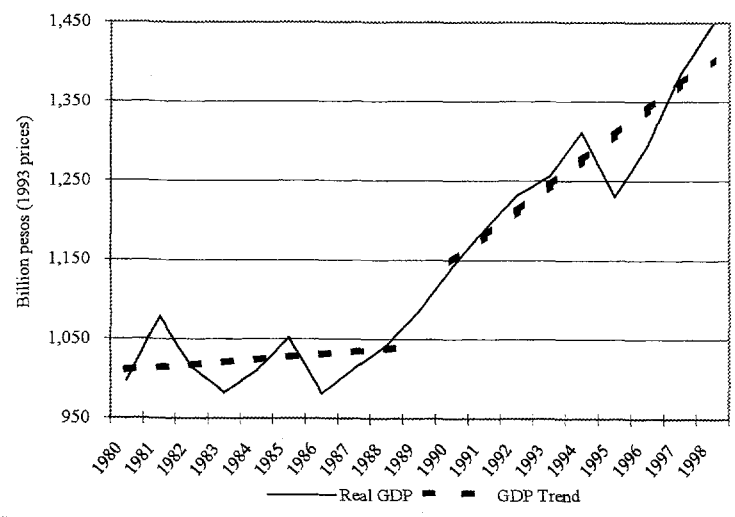
The Mexican economy grew out of its 1995 recession at remarkable speed (over the past three years, the annual real rate of growth averaged 5.6 percent). By the end of 1996, real GDP had regained its pre-crisis level, as did private investment and consumption in 1997. The three aggregates continued their fast expansion during 1998, especially private investment (figure 1).

Figure 1. Economic Activity




The 1996–98 expansion in output did not amount to a break in its long-term trend. Yet it put the economy back on a trend that was *already* steep and represented a major long-term improvement over the previous decade (figure 2). Between 1980 and 1989, Mexico's GDP grew at about 0.3 percent annually in real terms. Even factoring in the effect of the 1995 crisis, that rate is vastly outpaced by the 2.5 percent real growth observed since 1990. There is no doubt that the comprehensive economic liberalization and reform program that Mexico launched in the late 1980s and early 1990s created a positive structural break in the output's trend. However, that long-term acceleration of growth is somewhat shadowed by an average annual population and labor force growth of 1.9 and 3.0 percent, respectively. It also must be noted that total domestic bank lending to the private sector continued to decrease during the 1996–98 expansion period, while foreign capital flows significantly increased (see paragraphs 2–6 in Annex B10). This suggests that the recent growth has come more from large firms that have access to external financing than from the rest of the corporate sector.

Figure 2. Mexico: Economic Growth



This socially sustainable macroeconomic adjustment is a key priority in the recently approved budget proposal for 1999. Despite a further deterioration in oil prices[2] and the rejection by Congress of the administration's proposal of a new tax on telephone services, the approved budget keeps a moderate fiscal deficit target of 1.25 percent of GDP (the same as in 1998). Increases in other taxes (most notably on domestic gasoline sales) and reductions in nonpriority public expenditures and inefficient subsidies (such as for tortilla) allow for the maintenance or expansion of social expenditures. It should be noted, however, that the preservation of aggregate social expenditure budgets, while welcome, requires further improvements in the mechanisms to ensure the efficiency, sustainability (especially in capital expenditures), or impact monitoring of those budgets.

15. Mexico has no IMF program, but it is currently negotiating a two-year Stand-by arrangement. Some US$5 billion worth of IMF lending is due to be repaid during 1999. Because the government is unlikely to replace that lending with private financing, there is a strong likelihood that a program with the IMF will be put in place during 1999. This program will allow the IMF to effectively roll over a substantial part of its Mexican credits and, as explained later, the WBG to provide further adjustment operations for Mexico.

## III. MEXICO'S DEVELOPMENT CHALLENGE: SOCIALLY SUSTAINABLE ADJUSTMENT AND GROWTH

16. This section provides a summary of the key economywide and sectoral issues that are likely to dominate Mexico's development agenda over the next two to three years, and of the government's policy efforts to address them. This sets the stage, and provides the rationale, for the presentation in the next section of the WBG strategy to support those efforts.

17. The overall picture that emerges in this description shows a country (and a government) facing both a sudden deterioration of its external environment and a political period that will increasingly limit the room for reform. It also shows authorities who are well-aware of the need to adjust the economy to the new external framework, but rightly try to achieve that adjustment in a way that protects the poor. Their record across sectors, especially since the 1996 CAS, is mixed—advanced in some areas (agriculture, short-term macro management, and education) and pending in others (fiscal structure, finance, and energy). In all sectors, the quest for socially sustainable adjustment and growth translates into three deeply interrelated goals that guide the presentation below:[3] social sustainability, removing obstacles to growth and maintaining macroeconomic stability in the framework of globalization, and more effective public governance.

a) Social Sustainability

18. Differences in income and wealth, especially along regional, gender, and occupational lines, have proved persistent and have led to a growing need for social inclusion among significant portions of the Mexican population (see box 2). In recent years the authorities have

2. Oil-related revenues account for about a third of the federal government's total revenues.
3. The interrelated nature of these challenges, and of the policies needed to address them, cannot be overemphasized. For example, while environmental concerns are critical to the sustainability of growth, they are also critical to poverty alleviation, because much of the degradation of natural resources directly affects poor rural populations.

responded to that persistence with an overall rationalization, decentralization, and enhanced targeting of assistance programs for the most vulnerable and, more fundamentally, with a renewed effort to give the poor three critical long-term tools to overcome poverty—education, basic health, and support for the rural economy. The WBG has closely monitored and supported this process.

**Box 2. Poverty and Inequality in Mexico**

Poverty in Mexico remains a very formidable challenge, one that worsened following the 1995 economic crisis (box table 1). According to consumption measures adjusted for underreporting, one-fifth of the urban population and more than half of the rural population was poor in 1996. About half of the extreme poor are found in the agriculture sector, while significant shares of the moderately poor are distributed in the services (a fifth) and agriculture sectors (a third). Poverty is much more prevalent among the indigenous than the non-indigenous population. After controlling for other household characteristics such as education, occupation, geographic location, and demographics, female-headed households also face a higher probability of being poor than male-headed households.

The richest decile of the population in Mexico accounted for approximately 44 percent of household expenditures in 1996, and the poorest decile for only 1 percent. Income distribution is slightly more unequal in urban than in rural areas.

Box Table 1. Share of the Population Below Poverty Lines, 1984–96 (percent)

| | Headcount Index of Poverty | | | | | |
|---|---|---|---|---|---|---|
| | Urban | | Rural | | National | |
| | Unadjusted | Adjusted | Unadjusted | Adjusted | Unadjusted | Adjusted |
| Extreme Poor | | | | | | |
| 1984 | 21.38 | 4.18 | 48.02 | 15.18 | 31.17 | 8.23 |
| 1989 | 18.13 | 3.29 | 41.83 | 12.74 | 27.04 | 6.91 |
| 1992 | 16.79 | 3.26 | 44.66 | 16.31 | 24.42 | 6.83 |
| 1994 | 10.95 | 1.31 | 49.78 | 16.78 | 21.46 | 5.49 |
| 1996 | 18.16 | 2.79 | 60.47 | 23.97 | 29.72 | 8.58 |
| All poor | | | | | | |
| 1984 | 54.00 | 22.97 | 74.75 | 41.83 | 61.55 | 29.90 |
| 1989 | 50.70 | 19.98 | 69.32 | 36.44 | 57.84 | 26.28 |
| 1992 | 49.14 | 19.49 | 73.26 | 41.47 | 55.74 | 25.50 |
| 1994 | 40.64 | 14.13 | 78.82 | 48.09 | 50.97 | 23.32 |
| 1996 | 53.25 | 19.12 | 84.84 | 53.80 | 61.88 | 28.60 |

*Notes*: The poverty measures presented are consumption- (rather than income-) based. The extreme poor are those who cannot afford to buy a basic food basket that would enable them to meet their nutritional needs. The moderately poor can pay for their food, but they cannot afford other basic needs. The category "all poor" is the sum of the extreme and moderately poor. Total population of Mexico at last count was 92.6 million. As point of reference, the extreme poverty lines in urban and rural areas, respectively, were, in 1996 Mexican pesos, 317. 77 (about US$42 in 1996 prices) and 313.33 per month per person, while the moderate poverty line is equivalent to twice the extreme poverty line for urban areas, and 1.75 times that line for rural areas.

A comprehensive analysis of the role that rural-urban migration and other facts may have played in Mexican poverty dynamics is provided in the WBG forthcoming Poverty Assessment for Mexico.

The ratio of urban to rural population in Mexico was 1.72 in 1984, 1.61 in 1989, 2.65 in 1992, 2.69 in 1994, and 2.66 in 1996.

*Source*: World Bank staff estimates on the basis of ENIGH surveys.

19. PROTECTING THE MOST VULNERABLE. More than 75 percent of Mexico's population lives in urban areas, which means that, in absolute terms, the largest number of poor live in, or close to, cities. However, the poverty of those who live in rural areas is more acute (and the usual

remedies are less available to them). These characteristics are a major determinant in the design and implementation of social sector programs, especially the safety nets that are essential in times of economic crisis. Mexico has a long history of commitment to social protection programs, and a large number of them. The management quality of these programs has been mixed, however, and their targeting efficiency needs assessment and is likely to require improvement. More reliance on individual choice and a larger proportion of cash support (compared to unconditional in-kind donations) are called for, as is further decentralization of decisionmaking to better adapt to the needs of the beneficiaries and to local circumstances. This, in turn, will require strengthened institutional capacity at the state and municipal levels, and increased involvement of nongovernment agencies and civil society.

20. GIVING THE POOR BETTER ACCESS TO EDUCATION. Building the human capital of the poor remains a central goal of the Mexican government. Despite substantial gains in the 1980s and 1990s and a near-universal primary school enrollment, the search for quality and efficiency in basic education continues, particularly in the poorest states (and, within these, in rural indigenous areas), where boys' and girls' drop-out and repetition rates are the highest, and preschool coverage, cognitive achievement, and absorption in secondary education are the lowest.

21. The challenges in educational quality faced by the authorities are formidable. Chief among them are the enhancement in the professional quality of teachers and improvement in pedagogic supervision (a problem compounded by an inadequate supply of textbooks, infrastructure, teaching materials, and relevant curricula); the development of institutional capacity for the states to deliver, supervise, evaluate, and increasingly to design education programs in the midst of the decentralization process (which could conceivably lead to the empowerment of the schools themselves); and the establishment of an effective role for the federal government in setting national strategic directions, goals, priorities, quality standards, and pedagogical/administrative legal norms and regulations. Beyond primary education, the authorities will also need to articulate, in the near term, a broad strategy to reform upper-secondary and technical education (an endeavor they plan to undertake with WBG assistance). The average member of Mexico's labor force has no more than eight years of schooling, and only one in four workers receives basic job training. More fundamentally, given the government's own limited fiscal resources and the growing demand for improved education services at all levels, at the crux of Mexico's overall education challenge is the identification of alternative mechanisms to finance service provision.

22. MAKING BASIC HEALTH ACCESSIBLE TO ALL. Mexico has made steady progress toward reforming its health sector. However, one of every ten citizens remains without access to basic health services and, predictably, the lack of access is highest among the poor (including, critically, among poor women in their reproductive years). Coupled with increasingly limited fiscal resources, this poses four main sectoral challenges over the coming years—improved equity; improved quality of services; containment of cost escalation; and reduced fragmentation of the system.

23. The government's strategy to address these challenges is based on successive reforms of the principal public sector health suppliers and a regulated opening to private participation.[4] The *Secretaría de Salud* (Mexico's Ministry of Health, SSA) reform is already well under way, with

4. Only about 5 percent of the health coverage (but 45 percent of total health expenditure) is provided by the private sector.

special focus on access for the poor. The first phase in the reform of the Mexican Institute of Social Security (*IMSS*) is also proceeding, with the introduction of a managed competition framework based on the separation of financing from provision, the introduction of contracting, the decentralization of management, and a major institutional development effort. The third main public institution in the provision of health care, the Public Employees Social Security System (*ISSSTE*), remains to be reformed. Finally, and in line with the gradual introduction of competitive stimulus in the sector, the authorities have started to develop a regulatory framework for private sector participation aimed at minimizing risk avoidance strategies, improving the quality of care, and expanding consumer choice.

24. ATTENDING TO THE NEEDS OF THE RURAL POOR. As will be explained later, over the past decade Mexico's rural sector has undergone major structural reform that enhanced its capacity to compete in a more internationally integrated economy. Increased productivity, however, has not yet translated into better living standards for the rural poor, especially rural indigenous populations. Two-thirds of the rural population in the southern states is considered poor (compared with one-third nationwide). Four out of every five indigenous people—who, as a group, account for a third of Mexico's poor—are considered poor. The high incidence and persistence of poverty among the indigenous population raises issues of equity, social inclusion, and access to markets and to productive assets—land, labor, capital, infrastructure, and technology. If left unattended, this inequity may affect the social balance of Mexican society by polarizing the development agenda. It also challenges conventional government programs to improve their efficiency and their levels of acceptance, and to find ways to address indigenous issues in a fashion that is consistent with cultural preferences, traditional community authority structures, and local knowledge and needs. There is also increasing willingness on the part of the indigenous people to take ownership of their living and physical cultural heritage, and recognition by the government of the opportunities to involve them more closely in the preservation of that heritage (archeological sites, tourism-related activities, handicrafts, oral traditions, and traditional natural resources management practices).

b) Removing Obstacles to Sustainable Growth and Maintaining Macroeconomic Stability in the Framework of Globalization

25. Until the current turbulence in the international financial and oil markets materialized, the Mexican economy was growing apace (5.2 and 7 percent in 1996 and 1997, respectively). Even with that turbulence, the expected growth rate for the whole of 1998 is 4.6 percent, and for 1999, 3 percent. Part of that growth was driven by the recovery from the 1995 recession that followed the banking crisis of that year. But a large part was the product of ongoing liberalization and reform (see box 1). Although those growth levels could be considered acceptable in view of the worsening external circumstances, growth in the Mexican private sector remains uneven, driven primarily by large, export-oriented firms with linkages to the rest of the economy. Because of its impending employment and poverty-reduction needs, however, Mexico cannot afford a marked deceleration in growth, nor can it forgo the benefits of reforms that could remove the remaining obstacles to a higher, more equitable growth path, as will be explained below. The Private Sector Strategy (PSS) in Annex B10 provides more detailed discussions on private sector priorities for Mexico, particularly on impediments to higher, equitable growth.

26. The government has therefore been keen to tap into four main areas where policymaking can facilitate the economy's adjustment to the new external environment, and simultaneously

enhance its growth prospects (financial markets, private sector development, infrastructure provision, and the rural economy); maintain a viable macroeconomic framework; and make that growth environmentally sustainable.

27. IMPROVING THE EFFICIENCY AND TRANSPARENCY OF THE FINANCIAL SECTOR. Following two eventful decades (nationalization in 1982, privatization in 1991–92, a credit boom in 1992–94, a full-fledged crisis in 1995, and a domestic credit crunch since 1995), Mexico's banking system is faced with two broad issues—a *stock* problem, associated with the implications for bank capital adequacy of FOBAPROA's pending liabilities adjudication and asset disposal, and, until recently, with the confidence-diluting effect of the political stalemate in the search of a solution; and a *flow* problem, associated with the incentive framework for banking activity (especially in deposit protection and loan guarantees, with their implications for moral hazard; disclosure standards; bank-borrower interaction; bankruptcy enforcement; securitization; and, fundamentally, the status of the commercial judicial system). Those two problems, paired with the development of other nonbank institutions and markets (notably, stock and pensions), comprise the core of the government's challenge in the financial sector.

28. The authorities have thus far addressed the challenge with a mix of institutional reform (for example, through the consolidation in 1995 of financial markets' regulatory authority in a single entity,[5] and its subsequent institutional development program, which the WBG partly funded) and legal amendments (as through changes in the Law on Credit Institutions that facilitated the entry of foreign investors into the banking industry). These are initial steps in a large policy reform agenda, albeit steps that fall short of the related goals envisaged in the 1996 CAS and its 1998 Progress Report. Their implementation so far has been largely lacking (for example, long delays in the establishment of IPAB, the new savings protection institute), as it has been impaired not only by political realities, but also by the government's roles as owner (of development banks) and regulator/supervisor (through the SHCP, its subordinated technical agency; the CNBV; and, to a lesser extent, the *Banco de Mexico*), and by the resulting fragmentation and limited independence of the regulatory function. As a result, the domestic banking sector is still in fragile condition, undercapitalized, and unable to fulfill its expected role. Beyond banking, the need to further develop nonbank financial institutions (leasing, factoring) is a priority. These institutions could provide greater access to capital for middle-market companies and SMEs, and thus help increase their productivity and foster more equitable growth for the Mexican private sector. Enhanced disclosure standards and better protection of minority shareholder's rights remain as major impediments to stock market development and capital markets in general, while more flexible investment rules for private funds and reform in the retirement saving schemes for public sector workers are the key policy issues in the pension area. Overall, there is a broad consensus among national and foreign observers that resolution of the problems of the banking sector is a key priority for the sustainable development of Mexico.

29. REMOVING IMPEDIMENTS TO PRIVATE SECTOR DEVELOPMENT (PSD). The Mexican private sector has displayed an increasingly bifurcated structure. A dynamic and growing export sector, made up of internationally competitive conglomerates (including *maquiladoras*), coexists with often inefficient, inward-oriented, small and medium-size enterprises (SMEs).[6] This structure, in which the exporting sector has yet to expand its limited linkages to the rest of the

5. The National Commission for Banking and Securities (CNBV).
6. SMEs include enterprises with fewer than 250 employees. This group is responsible for approximately half of the industrial and service GDP and at least 70 percent of total employment.

economy, while the SMEs fail to create sufficient employment or to contribute to productivity growth (primarily because of their lack of access to financial markets and to managerial and technical resources), is at the heart of the government's challenge in PSD—how to extend the efficiency gains brought about by trade liberalization to the overall economy. That extension would not only be good economics, it would also help address the large regional disparities between a vibrant, export-oriented private sector in the north and center of the republic, and a very weak, SME-dominated private sector in the southeast.

30. The government initially sought to respond to the uneven development of Mexico's private sector with a large array of federal and state industrial promotion programs, sponsored by both public agencies (SECOFI, STPS, and CONACYT) and publicly owned development banks (BANCOMEXT, NAFIN, and BANOBRAS).[7] More recently, the authorities put forward two major initiatives to restructure both industrial policy (*Programa de Politica Industrial*) and promotion (mainly through its decentralization). Those initiatives have not yet fully produced the expected results. At the local level, however, several state governments have implemented effective development partnerships with the private sector (Aguascalientes, Nuevo Leon, Guanajuato, Jalisco, and Chihuahua). More fundamentally, a pending agenda of policy impediments to PSD is likely to occupy all levels of government in the near future. That agenda includes competition policy, contract enforcement, bankruptcy law and implementation, corporate governance mechanisms, and privatization in selected sectors (such as electricity), among other concerns.

31. ENSURING THE PROVISION OF QUALITY INFRASTRUCTURE. While Mexico's overall infrastructure coverage is broadly adequate (but uneven and with some exceptions, such as wastewater treatment and coverage in isolated, poor rural areas), the authorities still face an array of first- and second-generation issues. For example, in the energy sector, the public-sector-owned National Electricity Company (CFE), which already serves 96 percent of the population as a constitutionally protected monopoly, is experiencing problems to cater, in quantity and quality, to a rapidly growing demand (7 percent per annum) for its services (some of which are provided on a subsidized basis, as in agriculture).[8] The government is aware that access to outside financing will require major structural reform in CFE and in its other energy concerns, and it has very recently, and somewhat belatedly, taken an encouraging step of proposing to the Congress constitutional amendments to allow private investment in the entire power sector. Reforms are more advanced in the transport sector. Privatization of ports, the national railway, and airports has taken place or is being implemented. Equally important, these privatizations have been accomplished within the context of an improved legal and regulatory framework.[9] In some sectors (including petrochemicals), progress has been slow, and in others privatization is simply not envisaged (hydrocarbons).

32. In the urban services sector, the disparity in the institutional capacity of the state and local governments, under whose regulatory jurisdiction the recently accelerated decentralization process has placed those services, has not contributed to encourage private participation and financing. In housing, the four public institutions that have traditionally controlled—with mixed results—the social-interest housing finance market (FOVI, INFONAVIT, FOVISSSTE, and

7. There were 56 federal SME assistance programs, and hundreds of additional ones at the subnational level.
8. While the WBG counted CFE among it first clients in the late 1940s, it has had no business relationship with the other pillar of Mexico's energy sector—the National Oil Company (PEMEX).
9. Significant privatization has also taken place within the telecommunications sector, and a telecommunications regulatory agency was established and is functioning. All this was done with WBG support, as indicated in the 1996 CAS.

FONHAPO) are being restructured, with the objective of both improving access for low-income populations and fostering development of capital markets.

33. The above pattern of first- and second-generation issues across subsectors forms the background for the government's efforts to meet its three overarching infrastructure-related challenges—urbanization, competitiveness within NAFTA, and decentralization. Mexico is both a highly urbanized country and a country with a high rate of urbanization. Northern border cities and peripheral enclaves around metropolitan areas (such as Mexico City) are estimated to be growing at about 7 percent yearly, taxing not only the capacity of existing urban services (notably, those related to water) but also the urban centers' "livability" (creating environmental degradation and posing challenges to civil security). This is of special concern to the urban poor (the majority of Mexico's poor live in cities), whose access to housing is, at best, limited. At the same time, Mexican enterprises will increasingly require higher-quality infrastructure services, especially in electricity, highways, and roads, if they are to effectively compete in, and profit from, NAFTA. Achieving that quality will call for a new approach to pricing and subsidization, financing, private participation, and capacity building among regulatory institutions at both the national and subnational levels. Finally, it is precisely at the subnational level that an increasing number of key infrastructure decisions will be taken in the coming years. There is no doubt that the orderly implementation of the decentralization process will become a critical determinant of the feasibility and efficiency of infrastructure investment programs.

34. FOSTERING AGRICULTURAL PRODUCTIVITY AND EFFICIENCY IN THE RURAL SECTOR. Over the past ten years, Mexico's rural sector has been the subject of sweeping reforms. They led to the emergence of a largely liberalized, market-oriented, and private-sector-driven rural economy. The government switched from distortionary commodity price subsidies to direct income transfers through the PROCAMPO program. It also embarked on the revision of the regulatory framework for land tenure (1992) and a subsequent land titling program (PROCEDE-1995), permitting *ejido* land transactions. The largely successful transfer of irrigation districts to the water users has formed the basis for the development of water markets. At the same time, the inclusion of the agricultural sector in international trade negotiations through the GATT and NAFTA agreements has created the basis for progressive exposure to global forces and the additional adjustments that will follow. Finally, the recent elimination of the tortilla subsidy has permitted the completion of the reform agenda in the maize sector by relinquishing the intervention of CONASUPO (which was, in turn, dismantled).

35. These important reforms permitted the establishment of a sound policy framework and fostered efficiency, but the performance of the sector has been lagging and growth has stagnated. While commercial agriculture has largely benefited from the reforms and has responded positively to the devaluation of 1994, the large *ejido* sector is going through significant adjustment, increasingly integrating into the nonfarm economy, diversifying income sources, and pursuing greater labor market participation and migration. Promoting agricultural productivity, fostering employment and micro-enterprise development in rural areas while accompanying the progressive integration of the sector to the rest of the economy are the main challenges of the rural development agenda.

36. The rural economy is poised for a sustainable enhancement in its productivity and performance, but a number of second-generation reforms will need to be pursued and constraints removed to respond to the challenges posed by international competition, the need to diversify the productive pattern, and the compelling responsibility to address equity issues. The incentive

framework for the sector shows declining real prices and negative nominal protection coefficients stemming from uncompetitive and segmented markets, and high marketing margins, storage, and transaction costs. Also, the low level of farmers organization hinders their capacity to better integrate in the production-marketing chain and in the rest of the economy. Improving the performance of financial services to the rural population remains one of the major issues facing the development of the sector. The shallowness of both formal and informal rural financial markets hinders the modernization of the sector and movement to more lucrative, non-farm activities. The development of more efficient factor markets (land, water, and warehousing) could also be fostered through a better regulatory and legal framework, facilitating secure transactions and offering better collateral possibilities. Public programs should enhance smallholder access to basic services, information, technology, and technical assistance and improve efficiency in the delivery of basic infrastructure and, when necessary, of seed capital for investments and innovation.

37. ASSURING A VIABLE MACROECONOMIC FRAMEWORK. As explained earlier, the Mexican authorities have handled the effects of the deterioration in the external environment with an effective mix of social policy protection and cautious fiscal and monetary management. This leaves the country well-placed to address internal sources of potential macroeconomic instability, which is necessary for rapid long-term growth as well as to make the country less vulnerable should external conditions worsen. There are several such possible sources including the volatility of oil prices, the slim effective tax base, the maturity structure and servicing cost of the consolidated public sector debt, the accelerated depletion in the stock of public infrastructure, various contingent fiscal liabilities, and the still unbalanced relationship between domestic and external savings. These are areas the government has watched carefully, but it is now time to design and implement precautionary policies. At stake is not only the growth-enhancing effect of sound domestic macro policy, but also the critical signaling role that such a policy will have in the availability and cost of foreign capital at a time when direct and portfolio investment will be scarce, and over a third of the expanding current account deficit is to be financed through net foreign borrowing (compared with a tenth in 1998).

38. THE URGENT NEED TO PROTECT THE ENVIRONMENT. Estimates indicate that the annual cost of Mexico's environmental degradation is equivalent to over a tenth of the country's GDP. That degradation affects the full array of natural assets. Chief among those is water, which is likely to represent the main environmental challenge to Mexico in the medium-term. It is imperative to develop and implement a coherent strategy of water management and use (over 100 of Mexico's 258 aquifers are overdrawn), an area where politically sensitive pricing policies may be conveying perverse signals to consumers (especially in the arid and semiarid northern region) and where institutional reforms are needed. Also, only a small proportion of hazardous and solid waste, and less than a tenth of the wastewater, receives adequate treatment; the concentration of atmospheric contaminants in urban centers regularly exceeds acceptable levels; the deforestation rate ranks among the highest in Latin America; and growing losses of mega-diversity are just some of the environmental problems the Mexican government is attempting to address.

39. The authorities have articulated an initial response to their environmental challenge, and they are gradually implementing it. This accelerated the formal establishment in 1994 of a Ministry of Environment, Natural Resources and Fisheries, the issuance of a consistent legal and policy framework (the 1996 *Ley General de Equilibrio Ecologico y Proteccion del Ambiente* and

the 1995–2000 Environmental Development Plan), the reinforcement of the "polluter pays" principle, the initiation of an effort to decentralize environmental management to states and municipalities, the establishment of the basis for broader public consultation and awareness, and a stronger focus on biodiversity through the new Program for Natural Protected Areas.

40. On the basis of these achievements, five items are now top priorities in the environmental agenda. The first is more efficient pricing where, in the absence of appropriate mechanisms to reflect their scarcity, natural resources are often treated as free goods, leading to unsustainable practices. This applies particularly to water and water service provision, but also to other currently distorted markets (energy, timber, land). The second is institutional development. This will be a necessary condition if Mexico is to reap the benefits of the decentralization of environmental management, because it will drive necessary improvements in the enforcement capacity and accountability of state and municipal authorities. The third is more effective management of natural resources (water, forests) and pollution control (air, waste management). The fourth is the mainstreaming of global issues in order to comply with international agreements (such as OCDE, NAFTA, Climate Change and Biodiversity Convention, GEF, and the Montreal Protocol). Finally, Mexico is working to improve its disaster management capacity and be better prepared to prevent or mitigate the heavy recurrent losses it suffers (forest fires, earthquakes, floods, hurricanes, and so on).

c) More Effective Public Governance

41. The policy agenda described so far will tax the government's implementation capacity over the next three years and beyond. It is thus critical to strengthen the public administration function as much as feasible, given the timing and political context of the country. Three areas for strengthening stand out—decentralization, the judicial and tax administration systems, and governance mechanisms.

42. OFFERING A SOUND, DECENTRALIZED PUBLIC ADMINISTRATION. Much of the fiscal discipline that will anchor Mexico's macroeconomic framework, and much of the long-term growth that is expected to be led by the private sector, depends on, and to a large extent is impaired by, the quality of the country's public administration. First and foremost, the speed and scope of the ongoing decentralization (a process deeply rooted in and driven by Mexico's political democratization) is taxing the institutional capacity of both federal and state governments. While presenting a unique opportunity to enhance the quality of public services through closer proximity of policymakers and final beneficiaries, the transfer of expenditure responsibility has not been accompanied by a matching transfer of accountability or an efficient incentive structure. This is affecting policy design and implementation in virtually all sectors of the development spectrum (social protection, education, health, infrastructure, and so forth). In response, the federal government is rightly seeking, as a matter of urgent priority, to create legal, regulatory, and institutional frameworks conducive to decentralization. This effort will entail, among other steps, the (re)definition of revenue sharing arrangements; incentives for local taxation; common budgeting, accounting, auditing, and disclosure standards; sector-specific expenditure performance agreements; borrowing rules; and triggers for federal intervention. Once in place, these parameters are likely to feed a growing demand for training and institutional infrastructure by the subnational governments.

43. TOWARD BETTER JUDICIAL AND TAX ADMINISTRATION SYSTEMS. While decentralization

is bound to dominate Mexico's public administration agenda in the medium term, two other areas of reform are equally critical—judicial systems and tax administration. Constitutional amendments introduced in 1994 significantly altered the appointment, tenure, and governance of the federal judiciary, giving the system a much-needed step toward independence. Similar reforms are now being contemplated in a number of state-level judicial systems. These initial efforts now need to be followed by a more comprehensive strategy for reform. In spite of recent improvements, the Mexican judicial system, at both the state and federal levels, continues to require strengthening in the areas of efficiency, effectiveness, and accessibility (especially for the poor). More fundamentally, its performance is a key element in the development of the financial sector in general, and in the resolution of pending banking distress in particular.[10] Similar performance problems affect Mexico's tax administration system. Although the country effectively collects very little in the form of taxes (just over 10 percent of GDP in 1998), with a consequent macroeconomic dependency on oil prices, that system is seen as a major obstacle to business by the private sector. The authorities are aware of the need for reform of the tax administration function, and they are taking some targeted actions (notably, in customs administration). Up to now, however, they have not enjoyed sufficient political consensus to articulate a major reform in the tax and tax administration systems (for example, when suspending plans to overhaul the value added tax).

44. GOVERNANCE MECHANISMS. Finally, economic deregulation, political democratization, and an increasingly independent media have brought about enhanced awareness of the need for better public governance. While rent-seeking may no longer be a systematic problem (and less of a systemic one), improvements are still needed in the legal, administrative, and enforcement frameworks within which Mexican civil servants operate. In addition, Mexico's federal employees remain under a powerful internal comptroller (SECODAM) and an external auditor controlled by Congress (*Contaduria Mayor de Hacienda*). Similar problems affect state governments, especially in their newly decentralized functions.

45. The government is conscious of the need for strengthened public governance, both at the federal and state levels. It has recently taken important steps toward enhanced transparency in public procurement. In March 1996, Mexico subscribed to the Inter-American Convention Against Corruption in Caracas, Venezuela; every bid is now published electronically in the "Diario Oficial." SECODAM created a web page, "COMPRANET," where every government acquisition is published, as well as any complaints from suppliers, constructors, or consultants (the resolution of the complaints is also made public). Several anti-corruption seminars at the national and state levels were carried out in 1998. Bidding documents that include anti-corruption clauses have been standardized; the legislation that regulates SECODAM and the internal audit departments of the public agencies has been overhauled. A strong anti-corruption training program for public employees was put in place. *Convenios* (agreements) among SECODAM and several states to audit the use of federal monies were signed. Furthermore, SECODAM recently published a path-breaking book (*Corrupción y Cambio,* Fondo de Cultura Economica, February 1999) where specific corruption cases were analyzed and remedial actions presented. Additional work on the design of comparative corruption incidence indexes across states is planned to promote transparency at the subnational level. Despite these specific achievements, consensus for broader reform in the governance area is uncertain in the run-up to the coming presidential elections. Rather than coming about through specific actions, better

10. As an illustration of that performance, 500 ordinary court federal judges oversee some 350,000 cases annually, while lower-level courts maintain a backlog of about one-third of their caseload.

governance will primarily be pursued through more general initiatives, such as professionalization and political isolation of public servants, strengthening of enforcement bodies (judicial, police), and an increasingly assertive Congress.

46. Finally, the Mexican government has established an aggressive strategy for dealing with the Y2K problem both in the public and private sectors. A Presidential Commission has been created under the chairmanship of the President of the National Institute of Statistics, and the implementation of the strategy is well under way. Because of the progress in implementing the strategy, Mexico has been requested to provide support and assistance to countries in Central America on this issue.

## IV. THE WORLD BANK GROUP'S ASSISTANCE STRATEGY

a) The Lessons of the Recent CAS

47. The 1995 CAS sought to help Mexico deal with the short-term imperatives of that year's banking crisis. The 1996 CAS and its 1998 Progress Report served the WBG in supporting the Mexican government's effort to put the economy back on a positive growth path. Several lessons have been learned while implementing those CASs, lessons that carry significant value in the design of their 1999 successor, as the latter will focus on a socially sustainable adjustment to worsened external and domestic conditions. (Specific project examples of the lessons discussed below are presented in box 3).

48. Understanding of the client's political reality and capacity for reform pays off in the long term. By keeping its assistance program sensitive to that reality, the WBG was able to continue providing advice in areas where the government was willing and able to undertake reform (for example, in the rural economy), and to maintain a monitoring stance in areas where opportunities for reform were more limited (for example, in energy).

49. Program flexibility is essential. Mexico has experienced sudden, unexpected changes, both domestically (for example, decentralization of *Ramo 33*) and externally (such as the fall in oil prices), that have altered its policy priorities, especially in the short term. The WBG lending, nonlending, and investment instruments should thus be seen more as a framework menu, both in financial amounts and analytical focus, than as an irreversible commitment to a specific task. This approach will allow rapid reallocation of resources when priorities shift (this will be particularly relevant for adjustment operations).[11]

50. In part because of the domestic and external volatility faced by the Mexican economy, the use of progress benchmarks (particularly quantitative measures) should not be overemphasized. The 1996 CAS, for example, envisaged a series of actions that would lead to growth recovery of only around 5 percent in 1999. Although few of the actions were actually implemented, the economy had already grown by 7 percent in 1997. In contrast, decentralization was seen in the 1996 CAS as a tool to improve the utilization of local property taxes. While decentralization did happen (at an increased speed), that improvement did not take place for a variety of related reasons. In other words, the large array of variables outside the control of the

11. In the IFC's case, financing priorities will also shift in relation to the Mexican private sector's demand for, and access to, international funding.

WBG (or, sometimes, of the government) seems to suggest that the success or failure of its assistance is better measured in the role it is able to play as a catalyst in the reform process (through advice and lending), rather than in the achievement of specific, time-bound benchmarks. This remains true even when there is sometimes a natural lag between WBG assistance and country-owned reform implementation.

**Box 3. What Went Well and Less Well During the 1996 CAS Cycle—Some Lessons of Experience**

Useful portfolio management lessons can be drawn from three Mexican projects, two reviewed by OED (one satisfactory, the other not), and one whose ICR was recently completed.

The outcome of the Contractual Savings Development Program (Ln. 4123-ME), which supported structural reform in the national pension system, was rated highly satisfactory by OED because "this Bank loan demonstrates how politically sensitive reform can be supported, by making sure there was agreement on a reform agenda, mounting a highly competent technical team, ensuring that key measures were taken before loan approval (thus deemphasizing conditionality) and taking a low profile." The success of this loan (and of its subsequent follow-on operation (CSDP II, Ln. 4343-ME)) spilt over other critical operations within the social sectors, notably in the health area (Health Sector Reform—IMSS, Ln. 4364-ME).

In contrast, the Financial Sector Restructuring Loan (Ln. 3911-ME), which provided emergency support to the government following the 1995 financial crisis, was found by OED to have produced an unsatisfactory outcome, according to WBG performance criteria. The main lesson from this project was clear—"emergency or relief programs are not good vehicles for pursuing institutional or legislative reforms. This is especially true when, as in this case, the Bank's financial contribution is a relatively small part of a large package. Unless there is a single reform package on which all the partners have agreed, concerns of major partners will dominate. The pressure for disbursement in emergency situations also weakens the Bank's leverage in enforcing policy conditions."

Lessons from another operation resulting from the 1995 peso devaluation are also extremely relevant. The Program of Essential Social Services (Ln. 3912-ME) helped the government protect its social sector budget (education, health, worker training) in the years immediately following the 1995 crisis, and provides valuable insights should a similar, if contingent, program prove necessary as a result of the recent turmoil in international financial markets. First, the technical design needs to include disbursement items amenable to procurement that is both acceptable to the WBG and regularly used by the government. Second, given the fluid nature of emergency operations, it is essential to base the initial design on solid principles that closely tie the strategic objectives of the program with operational procedures. And, third, if possible, a sector loan consisting of tranches released upon fulfillment of critical policy conditions and clear, verifiable targets may be more efficient.

51. Finally, government-supported partnerships with other donors and stakeholders work well. The WBG has been effective in exploiting the synergies (monetary and intellectual) implicit in coordinating its activities with other national and international organizations (for example, with the IDB).

b) The Lessons of IBRD Portfolio Management

52. The IBRD's portfolio performance had steadily recovered from the 1994 crisis, but there are signs that the portfolio may be encountering difficulties again. Currently, 3 of 30 (10 percent) projects are rated as unsatisfactory according to WBG performance criteria, with the number of projects in the portfolio set to increase to approximately 36 by the end of FY99, corresponding to an anticipated increase in total commitments of approximately US$1.6 billion

for the fiscal year. In FY98, disbursements under investment projects recovered significantly from the previous year (19.5 percent versus 13.1 percent, respectively), but, in FY99, are starting to slow down again because of the fall in the exchange rate and successive cuts in the federal budget. Currently, disbursements under investment projects stand at 8.7 percent for the six-month period ending December 31, 1998, and are projected to reach 15 percent by the end of the fiscal year. With little prospect for dramatic improvements in the macroeconomic situation, the portfolio will need to be monitored carefully, and adjustments, if necessary, carried out promptly. Some loans may be partially canceled due to the lack of counterpart funds and to the depreciation of the peso. One of the three unsatisfactory projects, Federal Roads Modernization, has very recently been canceled as the government plans to continue the project utilizing its own funds. One category of projects to watch with particular vigilance is the group that relies on onlending arrangements, where high local borrowing costs are choking off investment at the subnational level. In adjustment lending, the Bank disbursed US$400 million in FY98 and, in the second quarter of FY99, another US$750 million. Detailed IBRD portfolio performance indicators are presented in Annex B2.

53. The increasing decentralization of federal resources has had both a positive and a negative impact on the IBRD's portfolio. In some cases, a more evenly spaced and predictable pattern of budget transfers to sector agencies and subnational entities has facilitated the process of planning and budgeting, as well as procurement. At the other end of the spectrum, the direct transfer to states and municipalities under the social infrastructure fund of *Ramo 33* essentially bypasses the federal monitoring and control system that had allowed the IBRD to disburse against municipal-level investments—hence, the unsatisfactory IP rating for the Second Decentralization and Regional Development (DRD II) project, which has stopped disbursement since January 1998. As the process of decentralization continues, the IBRD has been seeking ways to work directly with the states to install the necessary financial controls, not only to allow resumption of disbursement under a restructured DRD II, but also to facilitate other investments. Another important aspect in both implementation of existing projects and design of new ones is an ongoing discussion with the development banks—mainly BANOBRAS and NAFIN, who act as the exclusive financial agents for the channeling of IBRD funding—of their role and respective efficiency. In the case of BANOBRAS, which is currently the sole intermediary for credit-line operations, the structure, cost, and legal obligations underpinning onlending arrangements, in particular, need revisiting.

54. The creation of an Implementation Unit (led by a senior procurement specialist and a financial management specialist) in the Mexico CMU in late FY98 has started to pay off in faster processing time and improved client satisfaction. All procurement decisions are now being taken in the field, leading to turnaround times of approximately two weeks, compared with a previous average of six weeks. More importantly, additional mechanisms have been put in place to avoid corruption in WBG financed projects (for example, training executing agencies' staff in WBG procurement guidelines and procedures; agreement with the government on standard bidding documents and processes; enhanced *ex-post* reviews and verification of delivery; support to SECODAM's efforts to curb corruption). The presence of a financial management specialist has allowed the IBRD to improve its upstream preparation of projects through better design of financial management systems, and to start the process of converting (albeit slowly) existing projects to the new LACI system where applicable. As a further measure of rapprochement with the client, the functions of the country officer have also been moved to the field. The above actions, coupled with the increased operational experience of local staff in the office, will play a

significant part in helping the department to be prepared and to be more responsive to the client during this time of political and economic uncertainty.

c) The Lessons of the Decentralization of the IBRD Mexico Country Management Unit (CMU)

55. The previous CAS was presented to the Board precisely at the time when the decentralization of the IBRD Mexico CMU was being initiated; that is, in the second half of 1996. Two-and-a-half years into the process of decentralization, it is quite clear that most of the expected benefits of this decentralization are being obtained. Among them, the most noteworthy are: (a) a much closer dialogue with the clients, especially the sectoral government agencies; this has been manifested by a better strategic focus of IBRD interventions (with strong advances in strategic discussions in many sectors, such as agriculture, health, education, and the financial sector), an increase in the amount and impact of analytical and sector work, and improved portfolio performance; (b) greater coherence and effectiveness of the overall management of the IBRD program (lending, supervision, and NLS); and (c) a much improved understanding of the political and economic realities of the country, owing to a strong presence in the field (with an increasing contribution of locally recruited staff) and extensive contacts with representatives of Mexico's multifaceted civil society (private sector, academia, NGOs).

56. To be certain, the transition process has been a difficult one, and there is still much that needs to be done to ensure maximum effectiveness of the new system. A formal evaluation of the Mexico CMU's overall effectiveness since decentralization has not yet been carried out as it is still too early to assess fully its cost effectiveness component (although there are already encouraging indications). However, an important measure of the progress accomplished so far is the increasing manifestation of satisfaction expressed by government officials, from *Hacienda* and sectoral agencies, on the impact of the decentralization on the relationship between the IBRD and the government, particularly in traditional areas of friction (for example, procurement, disbursement, support to implementation, and availability and responsiveness of IBRD staff).

d) The Lessons from IFC's Implementation Experiences

57. Progress has been made in the implementation of most key areas of the last CAS for the IFC—in the financial sector and capital markets, private infrastructure, and regional development. An area that was not anticipated at the end of 1996, but has shown rapid progress, is the private health sector. In industry, demand for IFC support through the domestic banking sector has been greater than anticipated, while the IFC's direct financial support has been lower than envisaged. This is partially the result of dramatically improved access for large Mexican firms to international capital during 1996–97, and increased demand for long-term financing by middle-market companies and SMEs. In investment volume, the IFC's investment approvals during FY97–99 to date totaled US$601 million; US$379 million was for the IFC's own account. This was 38 percent of the anticipated FY97–99 total, net of syndications. Mexico's improved access to international capital markets and slow progress in privatization of infrastructure and petrochemicals during the period have been contributing factors (box 4).

**Box 4. Linkages in IBRD-IFC Assistance to Mexico**

The approaches and activities of the IBRD and IFC have increasingly been complementary and mutually reinforcing in helping Mexico address its private sector development objectives, as the following examples indicate:

- The financial sector. The IBRD's assistance in enhancing the legal and regulatory environment and the strengthening of the banking sector would help set the stage for the IFC's increased involvement in direct and indirect assistance to viable Mexican financial intermediaries. In nonlending assistance, the IBRD and IFC are also collaborating to study the Mexican capital markets and nonbank financial institutions.
- Infrastructure. A number of subsectors where the IBRD's assistance has helped improve the regulatory framework have provided increasing opportunities for the IFC's sequential involvement in helping structure and mobilize a financial package for pioneering private infrastructure projects (for example, ports, power, and telecommunications).
- SMEs. The IBRD is considering possible SME development pilots through business development services, which would draw on the IFC's experience with impediments to private sector development generally, with SMEs, and with business development services. This would also support the IFC's increasing focus on providing financial assistance for SMEs and middle-market companies.
- The consultation process in preparation of this CAS (as mentioned below) has been conducted jointly with IBRD and IFC staff in the field.

e) The Overarching Objective, Selectivity, and Prioritization Principles Applied in this CAS

58. Poverty reduction is the ultimate objective of the proposed CAS. Because of the current domestic and external circumstances, that poverty reduction objective will, over the next three years, translate into three imperatives. First, the poor (especially the most vulnerable among them) must be protected from the main structural consequences of the ongoing macroeconomic adjustment, and from eventual conjunctural circumstances (for example, natural disasters and external shocks). Second, the poor themselves and various segments of Mexico's society (with its very rich diversity) must be called upon to participate in the poverty reduction effort. And third, intensified support is needed for policy advice and projects that can effectively foster sustainable growth.

59. At the same time, the list of sectoral issues described in Section II amounts to a formidable development challenge, both for Mexico's policymakers and for the WBG's ability to support them, especially in light of the limited nature (and high opportunity cost) of the latter's resources. It is hence imperative to establish clear criteria for the selection of WBG assistance tools (both in each sector and in the aggregate), as well as for prioritization among those tools.

60. This CAS is thus driven by three main selectivity criteria. The first is *marginal impact on poverty reduction*. This underlines, for example, the primary importance of avoiding the adverse macroeconomic shocks that would likely hurt the poor—first and most severely. The second is *the client's expressed needs*. The WBG support agenda will be sensitive and proactive toward the authorities' sweeping reforms and pressing needs, such as the decentralization process or the degree of environmental degradation, and at the same time will be careful not to give the government grounds for disappointment in the face of unachievable requests. The final criterion is *comparative advantage*. The WBG is equipped to undertake support in a wide array

of areas, perhaps better equipped than any other donor (see Section VI). Yet it also needs to focus its resources where its capabilities can produce the largest return for Mexico. For example, this CAS envisages a decisive deployment of WBG environmental expertise. In contrast, there are areas where the WBG has neither the expertise nor the mandate to intervene (for example, the political process).

61. The above-mentioned criteria will guide the overall choice of WBG assistance tools. These, in turn, will be prioritized according to both their impact on poverty reduction and on growth (direct, indirect) *and* the likelihood of achieving, in the political time leading to the next presidential administration, country consensus around the necessary policy frameworks for the WBG assistance tools to be effective (already existing consensus, likely, less likely). The WBG will focus its support primarily on activities that have an impact on both poverty and/or growth, especially a direct impact, and for which suitable policy frameworks already exist or are likely to enjoy country consensus. In areas where country consensus is less likely, the WBG will follow a flexible, stand-by approach, seeking opportunities to foster reforms within the limits of feasibility, while "preparing the ground" for the next presidential administration.

f) The Programming Scenario of this CAS

62. Within those objectives, selection, and prioritization criteria, and given the constraining nature of the political economy factors converging through the year 2000, the *base case* agenda of WBG assistance has been drafted under the assumption that the current, market-oriented overall reform stance is maintained, along with ongoing sectoral initiatives, and that access to private external financing remains limited and/or expensive. Major fiscal slippages in the run-up to the 2000 presidential election are avoided and, partly as a consequence, no further turbulence in the domestic financial sector occurs. An IMF program that would permit the effective rollover of some US$5 billion in IMF credits that fall due during 1999 (a rollover that could be accompanied by a WBG fiscal adjustment loan) is in place, allowing for further WBG adjustment operations. Along with the previous CAS, and following recent agreements in Congress, this base scenario assumes that the banking restructuring plan is effectively implemented. In other words, this CAS, in line with realistic expectations for the next two to three years, assumes that external conditions will not substantially improve and that a major new reform impetus will not materialize.

63. This allows for a moderate growth rate of 3 percent in 1999 and a gradual resumption of growth up to 5 percent in 2000 (largely driven by strong private investment hovering around 24 percent of GDP and a continued expansion of exports); for inflation rates of about 13 and 10 percent, respectively, in those two years; and, more crucially, for an important reduction from current levels in the balance of payments' current account deficit to US$9.4 and 13.1 billion (or 2.2 and 2.8 percent of GDP) respectively, amounts to be financed primarily through foreign direct investment. Projections of the main macroeconomic aggregates, external exposure indicators, and projection comparisons with the last CAS under this scenario are shown in Annexes A1, B6, and B7.

64. A substantially less likely *downside scenario* could also be considered, in which fiscal discipline is weakened by the presidential election process. This would lead to substantial macroeconomic imbalances, paired with a loss of confidence in the stability of the financial sector. This loss of confidence translates into reduced access to foreign financing, as well as

reduced private investment (the latter may reach only 18 percent of GDP), which would produce slower growth (about 1 percent p.a.) and higher inflation (perhaps as high as 25 percent). No IMF program (and hence no rollover of IMF obligations or WBG adjustment lending) is in place, vastly curtailing the country's capacity to finance its current account deficit (albeit, with lower growth, that deficit would be smaller than in the base case). A reexamination of, and a contraction in, the WBG assistance program (in relation to the one described below) will be required if the downside scenario materializes, and virtually all emphasis would be placed on operations related to social sustainability. Similarly, even if the downside scenario does not materialize in full, the WBG will refrain from adjustment lending in the financial and fiscal sectors if sufficient reform progress in these areas is deemed lacking.

g) Sectoral Support Strategies and Tools to Deliver this CAS

65. Under the base case scenario, the WBG will align its assistance to the government's own policy priorities and tools. Both financial and nonfinancial instruments will be delivered across sectors, with special emphasis on their impact on poverty and growth (direct, indirect) and taking into account the likelihood that country consensus around the necessary policy frameworks materialize during an increasingly constraining political period (already existing, likely, less likely). The specific list of instruments and of the objectives and government actions that they attempt to support is presented in table 1.

66. As mentioned earlier, operational focus will be placed on activities for which country consensus either already exists or is likely. Where that consensus appears less likely, the WBG will seek to act as a catalyst for change, to accumulate knowledge, to foster and await reform opportunities, and to prepare a policy agenda that the next administration may adopt (separate sectoral strategy notes will be prepared for that administration). In all cases, a specific set of benchmarks will be used to monitor, on a continuing basis, progress in achieving the development objectives supported by this CAS (see table 1).

67. Following the lessons of the 1996 CAS, a degree of flexibility is essential and will be maintained in all sectors. This will help accommodate unexpected improvements or deterioration in either the underlying policy or the external environment. The goal of this CAS is less to commit the WBG to a predetermined program of operations than to maintain and develop an *evolving* partnership with the government in its quest to eradicate poverty. That flexibility is also necessary in the IFC's case, as its strategic priorities must be adjusted to rapidly developing market conditions and changes in the pace of reform.

68. Table 2 distills the flow of lending, equity, and other investments implicit in the proposed strategy. Altogether, US$5.2 billion in new IBRD commitments are envisaged through FY01; some US$1.9 billion would take the form of adjustment lending. While yearly commitment envelopes are provided, the individual project loan amounts are deliberately kept open to allow for the continuing flexibility that proved vital during the execution of the 1996 CAS. IFC activities are dependent on market conditions, the extent of the private sector's access to private financing, and the pace of reform; therefore, the implementation of IFC instruments listed in tables 1 and 2 (and their timing) is of an indicative nature.

69. The proposed CAS and its associated instruments are based on specific sectoral support strategies. In the implementation of these strategies, the WBG will pay increasing attention to the reality of large concentration of poverty in urban areas, while maintaining its strong focus in

rural areas where the incidence of extreme poverty is at its worst. The essence of these strategies is described below.

70. SOCIAL PROTECTION. The search for quality and participation in the delivery of social assistance programs will guide the WBG's support in this area. As a starting point, a LIL operation will be put in place to support the decentralization of DIF, a key institution in the government's social assistance strategy. An increased role for civil society in determining local DIF-sponsored policies will be sought, and an effort will be launched to professionalize the agency and build capacity in selected states and municipalities that deliver social programs under their recently decentralized responsibilities. This should place the WBG in a position to support a related nationwide institutional development program later on. In parallel, analytical work (and, eventually, financing) will be provided in social assistance for poor urban (male and female) youth, initially focused on the Federal District and other large cities. More generally, the WBG will continue and deepen its involvement in the monitoring of poverty and inequality trends, in the technical analysis of their determinants (educational, cyclical, labor-market-related, gender-related, and the like), and in the impact assessment of programs meant to reduce them. That involvement will take the form of issue-specific policy notes. These could eventually provide the conceptual underpinnings for emergency social assistance operations, should the need arise (for example, because of further deterioration in external conditions). In addition, and with an overall participation objective in mind, the WBG will support and contribute to the government's efforts in the formulation and communication of its national strategy on social assistance and social safety nets, something that would assist in the preparation of a longer-term policy agenda beyond the year 2000.

71. EDUCATION. Development of basic education, and increased access to these programs for the poor, will continue to be the central element of the WBG's sectoral strategy for the next three years. The objective is to achieve major improvements in equity, service quality, and institutional capacity for efficient delivery. Special attention will be given to assisting the states, under their newly decentralized educational responsibilities, in providing compulsory universal education through the twelfth grade (that assistance could eventually be provided to the schools themselves if decentralization eventually empowers that level of decision). Support for secondary education will focus on increased educational attainment, to gradually bring Mexico to the level of other OECD countries. In particular, Mexico has committed itself, in the Summit of the Americas, to reach a 75 percent enrollment in lower secondary education. In higher education, the WBG will continue to implement a market-based program of student loans to improve access to higher education, particularly for academically qualified but financially needy students, and to develop more effective, financially viable student loan institutions. Finally, WBG assistance will seek to improve worker's opportunities in the labor market, primarily through the development of a more demand-driven, financially sustainable vocational training system with stronger links to industry and increased private sector participation, within the framework of a national system of labor competency norms and certification.

72. HEALTH. The WBG will continue to offer a range of lending and nonlending services to assist Mexico with the execution of systemic health sector reforms, with two main objectives in mind—facilitating access for the poor and furthering private sector involvement. Five lines of assistance will be pursued: (i) ensuring the efficient implementation of the existing portfolio, which includes loans for a first-phase reform of IMSS, as well as support for decentralization of public health services to the states; (ii) providing analytical support in the areas of private health care (de)regulation, fiscal cost of health care services, and impact monitoring of ongoing health reforms, all of which should set the stage for the next round of reforms; (iii) providing new

## Table 1. Mexico—CAS Matrix FY1999—2001

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments: Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial: Country Consensus on Necessary Policy Frameworks During CAS Period: Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
|---|---|---|---|---|---|---|---|
| Social Sustainability | i) Protecting the most vulnerable | • Strengthened system of social protection and improve the effectiveness of federal anti-poverty programs in the poorest municipalities<br>• Widened coverage of vulnerable population as a result of decentralization of financing and introduction of demand-driven approach.<br>**For WBG performance**<br>• Effectiveness of Social Decentralization LIL and Poverty Reduction Loan both by FY00 | Direct[1] | Poverty Reduction—FY00 | Nat'l. Prog. on Social Asst. Decentralization Loan—FY01 | | Poverty Assessment—FY99<br>National Forum on Social Assistance and Social Safety Nets—FY00<br>Urban Youth Assistance Study—FY00<br>Follow-up Policy Notes on Poverty and Inequality—FY99–01<br>Follow-up Policy Notes on Self-Employment & Labor Markets —FY99–01<br>Economic Implications of Gender—FY99<br>Economic Policy for Micro Enterprises—FY00<br>Gender and Pension Reform—FY99<br>Gender Capacity-Building TA Grant—FY01 |
| | | | Indirect[1] | Social Assistance (DIF)<br>Decentralization LIL—FY99 | | | |
| | ii) Giving the poor better access to better education | • Improved quality of teachers & retention of teachers in isolated rural areas<br>• Improved acad. achievement of target population, reduced student repetition & dropout rates<br>• Increased fed. & state-level man. & strategic capacity & increased comm. part. in school management.<br>**For WBG performance**<br>• Delivery of WBG technical assistance leads, within this CAS period, to the removal of policy constraints, such as inefficiencies in the allocation of resources across states, and to substantial increases in the coverage and effectivness of educational programs | Direct[1] | Basic Education Development APL Phase II—FY01 | | | Education and Income Dist.—FY99<br>Education Decentralization Study—FY99–00<br>Options for Education Expenditure and Financing—Policy Note FY00<br>Training Mechanisms Reform—Policy Note FY00<br>Strategy for Upper-Secondary Education Reform—FY01 |
| | | | Indirect[1] | | IFC (possible) Education Loan Program–FY01 | | |
| | iii) Making basic health accessible to all | • Increased access to basic health care to the poor, espec. in urban areas<br>• Strengthen the fin. structure of public health care institutions & improve the qual. of their services.<br>**For WBG performance**<br>• Successful assistance for the delivery of a basic health care package for 11 million uncovered and underserved rural and peri-urban poor by FY01 | Direct[1] | Basic Health Care (PAC) Loan II—FY01 | | | Health Care Regulation—Policy Note FY99<br>Fiscal Impact of Health Insurance Reform—Policy Note FY00 |
| | | | Indirect[1] | | Health Care Reform Loan—FY00<br>IFC's Health Sector Financing—FY99–01 | | |

*continued*

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments | | | | |
|---|---|---|---|---|---|---|---|
| | | | Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial — Country Consensus on Necessary Policy Frameworks During CAS Period | | | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
| | | | | Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | |
| Social Sustain-ability (continued) | iv) Attending to the needs of the rural poor | • Expansion and dev. of Geografic Inform. System on indigenous peoples<br>• Expanded marginal areas project from 6 regional to nat'l program<br>• Developm. of local rural fin. structures in marginal areas.<br><br>**For WBG performance**<br>• Enhanced understanding of, and more effective efforts toward addressing, the needs of the rural poor (especially in health, education, productive and key rural services), with particular attention to indigenous populations | Direct[1] | Rural Dev. in Marginal Areas APL Phase II—FY00 (associated with GEF Oaxaca Hillside Management) | | | Indigenous Populations Profile (Phase II)—FY00<br>Cultural Heritage Assessment—FY00 |
| Removing Obstacles to Sustainable Growth and Main-taining Macro-economic Stability in the Context of Globaliza. | i) Assuring a viable macroeconomic framework | • Continued sound fiscal and monetary policies including reduced dependency on oil-related revenues, coupled with structural fiscal reform<br>• Achieve and maintain arrangement with IMF<br>• Sustainable balance of payments current account deficits.<br><br>**For WBG performance**<br>• Enhanced country awareness and debate around key macro vulnerabilities, notably the need for comprehensive fiscal reform as evidenced by relevant reform proposals by core interest groups | Direct[1, 2] | | | Fiscal Adjustment Loan–FY00<br>Fiscal Reform SAL II–FY01 | Fiscal Sustainability Study—FY99<br>Follow-up Policy Notes on Macro Sustainability—FY99-00<br>Enhanced Tech. Supp. on Macro Monitoring & Forecasting—FY99–01<br>Management & Prevention of External Shocks—Policy Note—FY00<br>Efficiency & Effectiveness of the Tax Regime—Policy Note—FY00<br>State-Level Public Expenditure Reviews—FY00–01 |
| | ii) Improving the efficiency and transparency of the financial sector | • Present new secured lending and bankruptcy laws to Congress<br>• Establishment of policies and incentive frameworks to encourage safe and sound operation of banks<br>• Develop strategy to extend pension system reform to public sector.<br><br>**For WBG performance**<br>• WBG technical assistance as a catalyst for reform in the overall incentive structure for the operation of the financial sector, especially in the area of legal framework for banking operations (secured lending, bankrupctcy, etc.) | Direct[2] | Financial Sector Technical Assistance Loan II—FY00 | IFC's Credit Lines for Middle-market companies/SMEs—FY99-01 | | The Mexican Banking System: An Update—FY99<br>Capital Markets Study—FY00<br>Non-Bank Financial Institutions Study—FY00<br>Development Banks Report—FY01 |
| | | | Indirect[2] | | Fin Sector Inf. Loan I (Secured Lending)—FY99<br>Registry Modernization Loan—FY01<br>Fin Sector Inf. Loan II—FY01<br>Contractual Savings Development Loan III—FY01 | | |

*continued*

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments | | | | |
|---|---|---|---|---|---|---|---|
| | | | Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial: Country Consensus on Necessary Policy Frameworks During CAS Period | | | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
| | | | | Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | |
| Removing Obstacles to Sustainable Growth and Maintaining Macroeconomic Stability in the Context of Globaliza. (continued) | iii) Removing impediments to private sector growth and competitiveness | • Facilitate autonomy of CONSAR and revise investment regime for the AFORES<br>• Introduce new SIEFORES<br>• Rationalize and streamline government agency support to SMEs<br>• Select pilot PSD programs at state level with adequate availability of counterpart funds.<br><br>**For WBG performance**<br>• Delivery through FY01 of lending and non-lending services focused on the removal of barriers to efficient linkages between export-oriented, large firms and domestic, small and medium enterprises | Direct[1, 2] | | IFC's Eq. Funds for SMEs, Mortg. Fin., & Fact. & Educ.–FY00-01 | | Fundacion Mexico IDF—FY99<br>Decentralization of PSD Seminar—FY99<br>Industrial Promotion Decentralization Study—FY99<br>Export Competitiveness Report—FY00<br>State-level Private Sector Assessments—FY00-01<br>Regulatory Constraints to PSD—FY00<br>Corporate Governance of Conglomerates Study—FY00<br>Tech. Support for Business Partnerships in Southern States—FY01 |
| | | | Indirect[2] | | IFC Financial Asst. to Corporate Sector (Ind. & Ser.)—FY99–01<br>State-level Competitiveness LILs—FY00<br>Regional-level Competitiveness APLs—FY01 | | |
| | iv) Ensuring the provision of quality infrastructure | • Complete "white paper" on energy reform<br>• Continue progress on regulatory framework for energy<br>• Develop renewable energy policy<br>• Develop sound, market-based tools to assist municipalities in accessing funding<br>• Establish community investment trusts for slum upgrading<br>• Implement FOVI's efficiency enhancement program<br>• Continue reforms in other public and quasi-public housing agencies<br>• Implement low-income housing strategy<br>• Develop new financing mechanisms for transport<br>• Improved legal, regulatory, and financing framework for water and solid waste.<br><br>**For WBG Performance**<br>• Enhanced catalyst role in progress toward structural reform in key infrastructure subsectors, notably electricity, as evidenced by the production of a collection of subsectoral strategies through FY01 | Direct[1] | | Very-Low-Income Housing Loan—FY01 | | Tech. Support for Energy Regulation & Housing Finance—FY99–01<br>Macro Implications of Energy Reform—FY00<br>Very-Low-Income Housing Strategy—FY00<br>City Assistance Strategy—FY00<br>Alternative Energy Sources Assessment (GEF)—FY01<br>Urban Development Strategy—FY00<br>Transport Sector Strategy—FY01<br>Infrastructure Policy Notes Collection—Beyond 2000—FY01 |
| | | | Indirect[2] | FOVI Restructuring—FY99<br>Federal Roads—FY99<br>Solar Combined Cycle (GEF)—FY00<br>Wind Energy (GEF)—FY01 | IFC's Priv. Sec. Inv. in Infrastructure, Gas & Petrochemical—FY00–01<br>Renewable Energy (LIL)—FY00<br>City Develop. Strategy (LIL)—FY00<br>Highway Finance—FY00 | Border Infrastructure LILs—FY00<br>Energy Sector Loan—FY00<br>State Roads Investment Loan—FY01<br>Water & Sanitation Loan III—FY01 | |

*continued*

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments | | | | |
|---|---|---|---|---|---|---|---|
| | | | Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial: Country Consensus on Necessary Policy Frameworks During CAS Period | | | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
| | | | | Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | |
| Removing Obstacles to Sustainable Growth and Maintaining Macro-economic Stability in the Context of Globaliza. (continued) | v) Fostering agricultural productivity and efficiency in the rural sector | • Improved performance of factor markets (marketing channels, warehousing, water, land)<br>• Improved access of small farmers to productive investments, support services, tech., and information.<br>• Implement a decentralized strategy promoting better inst. coordination and strengthening, and establish a direct dialogue with states for rural and social infrastructure financing.<br>• Complete and consolidate the transfer of irrigation districts to water users and promote irrigation district modernization.<br><br>**For WBG Performance**<br>• Contribution, through timely delivery of programmed sectoral studies and loans, to the completion of the reform agenda in the agriculture sector, to the decentralization of key rural public services, and to necessary local capacity building | Direct[1,2] | Agricultural Productivity Loan (associated with GEF Alternative Rural Energy)—FY99<br>Rural Micro-Finance (LIL)—FY00<br>Rural Social Infrastructure APL—FY01 | IFC Financing in agribusiness | | Information Systems for the Rural Sector—FY99<br>Ejido Sector Study—FY99<br>Support for Institutional Coordination in Regional Dev.—FY99<br>Rural Micro-Finance Study—FY00<br>Food Marketing Policy Note—FY00<br>Land Markets Policy Note—FY00<br>Rural Economy Policy Notes Collection—Beyond 2000—FY01<br>State-level Inst. Strength. IDF–FY01 |
| | | | Indirect[2] | Irrigation Sector Loan—FY01 | | | |

*continued*

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments | | | | |
|---|---|---|---|---|---|---|---|
| | | | Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial: Country Consensus on Necessary Policy Frameworks During CAS Period | | | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
| | | | | Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | |
| Removing Obstacles to Sustainable Growth and Main-taining Macro-economic Stability in the Context of Globaliza. (continued) | vi) Protecting the environment | • Design and implement decentralized env. mgmt. schemes and establish Env. Mgmt. Funds in pilot states<br>• Build consensus on required reforms in groundwater sector<br>• Expanded forestry develop. Initiatives to new states and integrate with PRODEFOR<br>• Expanded protected areas system to new reserves and establish Mesoamerican biological corridor<br>• Improved air quality in DF by addressing ozone and particles pollution (through the promotion of natural gas conversion in transport and power sectors)<br>• Establish better disaster prevention and mgmt. mechanisms.<br><br>**For WBG Performance**<br>• Contribution to the efficient decentralization of environmental management systems, to improved cost recovery of environmental services, and to effective management of natural resources, with special monitoring emphasis on water, air, forests, soil and biodiversity | Direct[1, 2] | | Disaster Prevention (Loan)—FY00 | | Groundwater Management Study—FY99<br>Disaster Prevention Case Study—FY99<br>Env. Mgmt. Systems for Industrial Pollution—FY99<br>Energy-Environment Review—FY00<br>Env. Policy Notes Collection–Beyond 2000—FY01<br>Inst. Strength. on Climate Change (IDF)—FY99<br>Inst. Coordination for Reg. Dev. (IDF)—FY99 |
| | | | Indirect[2] | Oaxaca Community Forestry Reserves (GEF)—FY99<br>El Triunfo Reserve (GEF)—FY99<br>Air Quality II (Loan) & Greenhouse Gases (GEF)—FY00<br>Meso-American Corridor (GEF)—FY00<br>Protected Areas II (GEF)—FY00 | Env. Management & Decentralization APL I—FY99 | | |

| Dev. Objective | Government Strategy/ Action | Progress Benchmarks | World Bank Group Instruments | | | | |
|---|---|---|---|---|---|---|---|
| | | | Effect on Poverty Reduction[1] and on Elimination of Growth Obstacles[2] | Financial — Country Consensus on Necessary Policy Frameworks During CAS Period | | | Nonfinancial (Knowledge accumulation, public debate and awareness, problem-solving) |
| | | | | Existing (Seek to Continue Support) | Likely (Seek to Support Actual Reforms) | Less Likely (Seek to "Prepare Ground" for next Admin.) | |
| Effective Public Governance | i) Offering a sound, decentralized public administration | • Continue progress in the decentralization process with matching institutional development capacity at the state level and adequate accountability mechanisms.<br>**For WBG Performance**<br>• Continue playing a catalyst role in the implementation of efficient decentralization, as evidenced by the *dissemination of a* comprehensive policy agenda for decentralization and ensuing policy based operation | Direct[2]<br>Indirect[2] | | Decentralization SAL—FY00 | States Decentralization APL—FY00<br>State-level Public Admin. (LIL)—FY00 | Decentralization Policy Agenda—FY99<br>State-level Inst. Dev. & Human Resource Mgmt. Strategies—FY00–01 |
| | ii) Improving the Commercial Dispute Resolution Mechanisms and Tax Administration Systems | • Launch comprehensive and participatory reform of commercial dispute resolution mechanisms<br>• Implement suitable fiscal reform program.<br>**For WBG Performance**<br>• Triggering, through policy advice, initial steps (such as the production of sector reform strategies by FY01) toward the reform of commercial dispute resolution mechanisms and more comprehensive reform of tax administration | Direct[2] | | Tech. Assistance Loan for Tax Administration Reform—FY00 | Commercial Dispute Resolution Mechanism Reform (LIL)—FY01 | Tax Administration Policy Note—FY00<br>Technical Support for Partnerships in Commercial Dispute Resolution Mechanism Reform—FY00<br>Commercial Dispute Resolution Mechanism Reform Strategy—FY00 |
| | iii) Enhancing Governance Mechanisms | • Implement pilot governance reform initiatives in key, selected public institutions.<br>**For WBG Performance**<br>• Building country consensus around specific initial steps toward reform in public governance tools, especially through country-sponsored seminars and publications on the causes and costs of weak governance | Direct[2] | | | Selected Public Governance Institutions (LIL)—FY01 | Country Procurement Assessment—FY00<br>Governance Policy Workshop—FY00<br>Public Governance Policy Note—FY01 |

*Note*: The matrix includes both formal and nonformal ESW tasks. It does not include all non-ESW, nonfinancial activities such as seminar and conference support and participation (whose role is likely to expand), or substantial analytical work that may be carried out as part of technical assistance and investment projects.

1. Direct or indirect effects on poverty reduction.
2. Direct or indirect effects on the elimination of obstacles to growth.

**Table 2. Mexico—World Bank Group Financial Instruments—FY1999–2001**

| FY99 | FY00 | FY01 |
|---|---|---|
| **Policy-Based** | | |
| Fiscal Adjustment Loan<br>Fin Sector Inf. Loan I (Secured Lending) | Decentralization SAL<br>Energy Sector Loan | Fiscal Reform SAL II<br>Contractual Savings Development Loan III<br>Fin Sector Inf. Loan II |
| **Standard Investment Projects/New APLs** | | |
| Agricultural Productivity Loan (associated to GEF Alternative Rural Energy)<br>FOVI Restructuring<br>Federal Roads | Health Care Reform Loan<br>Financial Sector Technical Assistance Loan II<br>Disaster Prevention (Loan)<br>State Decentralization APL<br>Tech. Assistance Loan for Tax Administration Reform<br>Poverty Reduction<br>Highway Finance<br>Air Quality II (Loan) & Greenhouse Gases (GEF)<br>Env. Management & Decentralization APL | Nat'l/. Program on Social Asst. Decentralization Loan<br>FC (possible) Education Loan Progam<br>Basic Health Care (PAC) Loan II<br>Registry Modernization Loan<br>Very-Low-Income Housing Loan<br>Irrigation Sector Loan<br>State Roads Investment Loan<br>Water & Sanitation Loan III<br>Rural Social Infrastructure Loan<br>Forestry Development Loan |
| **APL Follow-up Phases** | | |
| | Rural Dev. in Marginal Areas APL Phase II—FY00 (associated with GEF Oaxaca Hillside Management) | Basic Education Development APL Phase II |
| **LIL** | | |
| Social Assistance (DIF) Decentralization LIL | State-level Competitiveness LILs—FY00<br>Renewable Energy (LIL)<br>City Develop. Strategy (LIL)<br>Rural Microfinance (LIL)<br>State-level Public Admin. (LIL)<br>Border Infrastructure (LILs) | Commercial Dispute Resolution Mechanism Reform (LIL)<br>Selected Public Governance Institutions (LIL)<br>Regional-level Competitiveness LILs |

*continued*

**Table 2. Mexico—World Bank Group Financial Instruments—FY1999–2001 (continued)**

| FY99 | FY00 | FY01 |
|---|---|---|
| **GEF/MP** | | |
| Oaxaca Community Forestry Reserves (GEF)<br>El Triunfo Reserve (GEF) | Solar Combined Cycle (GEF)<br>Meso-American Corridor (GEF)<br>Protected Areas II (GEF) | Wind Energy (GEF) |
| **IDF/Grants** | | |
| Fundacion Mexico IDF | | Gender Capacity-Building TA Grant |
| **IFC[a]** | | |
| Credit Lines for Middle-market companies/SMEs<br>Eq. Funds for SMEs, Mortg. Fin., & Fact. & Educ.<br>Private Infrastructure, Gas & Petrochemical<br>Health /Education Sector Investment<br>Direct financial support for corporate sector in industry & services (incl. tourism) | Credit Lines for Middle-market companies/ SMEs<br>Eq.. Funds for SMEs, Mortg. Fin., & Fact. & Educ.<br>Health /Education Sector Investment<br>Direct financial support for corporate sector in industry & services (incl. Tourism).<br>Priv. Sec. Inv. in Infrastructure, Gas & Petrochemical | Credit Lines for Middle-market companies/SMEs<br>Eq. Funds for SMEs, Mortg. Fin., & Fact. & Educ.<br>Health /Education Sector Investment<br>Direct financial support for corporate sector in industry & services (incl. tourism).<br>Priv. Sec. Inv. in Infrastructure, Gas & Petrochemical |
| *Note:*<br>IBRD overall projected lending commitment $1.6 billion, of which $500 million in adjustment lending | IBRD overall projected lending commitment $1.7 billion, of which $700 million in adjustment lending | IBRD overall projected lending commitment $1.9 billion, of which $700 million in adjustment lending |

a. All IFC instruments are indicative, and subject to the Mexican private sector's demand for IFC assistance.

investment lending in the form of follow-up operations for expanded access to basic services for the poor (IMSS) and for the strengthening of the remaining public health care institutions; (iv) expanding financing of the private health market through IFC-led involvement; and (v) preparing a broad-based adjustment loan that could support a further round of reforms across the array of public health institutions, and could also become a part of an emergency social protection operation, should there be a sharp deterioration in the macroeconomic environment.

73. THE RURAL ECONOMY AND THE RURAL POOR. In line with the fundamental structural reforms that have taken place in the sector over the past decade and the challenges still facing the rural agenda, the WBG will base its sectoral strategy on four main elements. First, support is needed for the current policy orientation and its ensuing second generation initiatives to (i) improve the efficiency of agricultural marketing channels and the management of inventories following CONASUPO's closure, together with a renewed effort to promote farmers organization and rural micro-enterprise development; (ii) develop financial services in rural areas, in particular, savings and loan schemes at the community level and (iii) foster a better understanding of the functioning of land markets. Second, the living standards of the rural poor, especially indigenous populations and small-holders, need to be improved through increased policy attention to the development of marginal areas and through the enhancement of agricultural productivity (primarily through the promotion of investments and support services for small farmers). Third, completing and consolidating the transfer of irrigation districts to water users' associations is in order, along with developing co-financing mechanisms for their modernization. And, finally, it is necessary to develop a direct dialogue with the states to support the strengthening of local institutional capacity in the provision of basic infrastructure in rural areas, and to promote more effective institutional coordination of Government programs for local regional development. The WBG will continue to deepen its knowledge of the social and cultural factors that affect the economic well-being of indigenous populations and their heritage and to mainstream its findings in the design and implementation of sectoral operations. An IFC-sponsored equity fund for the southern states will be maintained. In addition, in an effort to contribute to the preparation of a longer-term rural policy agenda for the new administration in the year 2000, the WBG would expand and consolidate existing analytical knowledge into a body of sector work that would attempt, among other things, to study the opportunities available to, and growth impediments faced by, the smallholder subsector.

74. FINANCIAL SECTOR. The WBG's assistance to Mexico's financial sector has been affected by the process of banking sector restructuring, an issue that will shape Mexico's banking industry and determine the effectiveness of donor interventions. There is, however, a critical role for the WBG in continued support for reforms in the legal, regulatory, and institutional framework that will shape post-FOBAPROA banking activity and, more generally, financial intermediation. Both formal and informal advisories to related policymakers will be maintained, together with possible additional technical assistance operations to address issues pertaining to secure transactions, bankruptcy, and asset-backed securities, among others. The WBG will also be ready to provide an operation focused on the modernization of legal and regulatory frameworks (Financial Infrastructure Loan); a loan to assist in bank-by-bank resolutions (possibly in the form of a "bank capitalization trust fund"); direct budgetary support in absorbing the fiscal cost of banking sector restructuring (if an adequate incentive framework is simultaneously put in place); and IFC-sponsored operations to provide long-term credit lines for middle-market firms and SMEs and support to nonbank financial institutions in leasing, factoring, housing, and education. (A detailed WBG strategy for PSD, the financial sector, and

infrastructure is presented in Annex B10.)

75. REMOVING IMPEDIMENTS TO PRIVATE SECTOR GROWTH AND COMPETITIVENESS. Three main objectives will guide the WBG's strategy in the PSD area—reforming industrial promotion, removing remaining policy impediments in the business environment (including improving access to long-term investment capital), and fostering PSD in less-developed regions with IBRD taking the lead in policy advice, framework setting, and institution building, and IFC in catalyzing long-term investment capital with its financial assistance to the private sector. The WBG will thus provide analytical support for the efforts of SECOFI (formally the lead agency in this area) to rationalize and further decentralize federal industrial promotion programs and will explore the possibility of related pilot lending operations with BANCOMEXT, NAFIN, and CONALEP. The WBG will also continue to play the critical role of knowledge broker between private sector beneficiaries and public agencies through private-public seminars focusing on PSD decentralization and regional "shared visions." A series of state-level private sector assessments will assist in the formation of those visions by identifying, and providing policy recommendations for, PSD constraints that can be addressed by local governments. In collaboration with the WBG's Business Partners for Development Initiative and the Inter-American Foundation, best practices in partnership building between large corporations and local governments will be disseminated. The bulk of these initiatives will be concentrated on the poorer southeastern states, as will a number of competitiveness-focused state-level lending operations of the LIL type. In parallel, a flow of direct and credit line lending, as well as targeted equity funds, is expected to be delivered by the IFC to middle-market companies, SMEs, and nonbank financial institutions (particularly in mortgage financing, leasing, and factoring).

76. INFRASTRUCTURE. The WBG's infrastructure sector strategy generally follows the government's own PRONAFIDE program. It pursues four objectives. The first is greater private participation and competition in the provision of infrastructure services, primarily in electricity, but also in other urban services. Given adequate policy commitment, this could be supported by a broad-based SECAL operation; the challenge will be to design a range of public-private partnerships that take into account subsidy requirements and political constraints. The second is exploiting the synergy of capital market development in financing these services. As a first step, and as a priority, the WBG is to provide analysis and funding toward the design and implementation of a very-low-income housing initiative. The third objective is the establishment of conducive legal and regulatory frameworks. Much has been done in this regard and needs to be sustained, particularly in support of the energy and telecommunications agencies with whom the WBG has an ongoing, informal advisory role. The next round of legal and constitutional reform pertains to electricity. Finally, publicly funded provision of infrastructure services must be supported where externalities clearly warrant it. Federal highways and state roads, an area in which the WBG plans both strategy-design work and project lending, are examples. Subject to adequate progress in deregulation and privatization, IFC investments in infrastructure, gas, and petrochemicals, respectively, are also envisaged.

77. MACROECONOMIC SUSTAINABILITY. A strong emphasis on analytical support has characterized WBG assistance in the macroeconomic area. This assistance will be maintained and upgraded during the implementation of this CAS. It will focus primarily on the structural, medium-, and long-term pillars of macroeconomic stability (for example, tax regimes and contingent liability management, debt structure), the minimization of the effects of external

volatility (for example, through oil price fluctuations), and monitoring and forecasting capacity. The program will, however, be kept flexible to allow for quick responses to the unexpected needs of policymakers, particularly through the production of rapid-turnover, *ad hoc* policy notes. The WBG will also attempt to articulate adjustment operations with strong macro content (especially in support of the government's efforts to make macroeconomic management socially sustainable), in coordination with, and in support of, Mexico's prospective arrangement with the IMF. In particular, if country consensus so warrants, the WBG will be prepared to articulate adjustment and investment operations in support of comprehensive fiscal reforms, both in the tax code and in tax administration.

78. THE ENVIRONMENT. The WBG's support in this area will follow four main strategic thrusts: (i) pursue an effective dialogue on the strategic priorities for the sector and assist in the design of policies (better pricing of resources, energy-environment assessments, regulatory framework, enhanced public awareness); (ii) institutional development and decentralization of environmental management, including the development of mechanisms to improve the financing base of the environment through more effective decentralized cost-recovery of environmental services and pollution charges; (iii) better management of natural resources, especially water, forests, air, and biodiversity (through an array of lending and nonlending services); and (iv) support for a more systematic effort in the design and implementation of effective disaster prevention policies, to be underpinned by suitable lending operations. In accessing the possibilities offered under the GEF, priority will be given to identifying "win-win" investment opportunities, where global environmental benefits *and* national economic benefits can be generated through an integrated and mainstreamed approach to development priorities (for example, methane gas capture within solid waste management programs, renewable energy technologies within agricultural productivity programs, biodiversity conservation within sustainable forestry management programs, greenhouse gas control within air quality programs, and so on). In pursuing the above objectives, the WBG will need to be particularly selective, because overall fiscal tightness is likely to limit government's capacity to undertake new programs (or expand existing ones). The WBG will assist the government in setting priorities for the environmental sector beyond the year 2000, through the production of a policy note collection.

79. PUBLIC GOVERNANCE. The WBG is already playing, and will continue to play, a critical support role in the government's decentralization efforts. This will entail both analytical work (such as the drafting of an overall decentralization-focused policy agenda for the federal authorities and human resource management strategies for selected states) and lending to the states (through APL-type operations) and to the federation (through traditional adjustment lending). In addition, because of the multisectoral nature of the decentralization process itself, many of the WBG interventions (such as DRD II in the environmental area) will carry sector-specific decentralization components, especially in state-level institutional development. The WBG will also be ready to provide assistance in the reform of the commercial dispute resolution mechanisms, tax administration, and public governance systems, both through advice and through lending, at all levels of government. To be effective, however, this assistance will first focus on creating broad consensus among the stakeholders (for example, through partnerships programs in the commercial dispute resolution area); on producing initial analytical assessments (such as the incentive framework in tax administration); and, later, on possible funding of technical assistance (for example, through LIL operations for selected public governance institutions and for the design of state-level transparency indexes in procurement). In addition, a

Country Procurement Assessment will be carried out early in this CAS cycle.

## V. RISKS IN THE PROPOSED CAS

80. The possibility that the period leading to the change in presidential administration may slow down the pace of existing and planned reforms is undoubtedly the single most important cross-sectoral risk faced by the proposed CAS. While the WBG has no direct instruments to influence the process, it will keep its work program flexible and refrain from new initiatives that lack broad consensus across political boundaries. Under the government's guidance, the WBG will also seek to disseminate its economic and sectoral technical analysis as broadly as possible in order to create awareness, ownership, and consensus around needed reform agendas.

81. A second source of generalized risk is the stability of the domestic financial system, particularly the effective restructuring of the banking industry. The availability of a suitable program for that restructuring has been a triggering condition for the WBG to make adjustment lending available to Mexico's financial sector. Although a technically solid plan to resolve the FOBAPROA issue has recently been passed by Congress, it may face fiscal limitations (especially in necessary funding for the successor deposit-protection agency). While the WBG will continue to closely monitor the actual implementation of that plan (the *stock* problem), it will focus on advice and lending in support of the legal and regulatory framework within which the financial sector operates (the *flow* problem). Progress in this latter area has so far been very encouraging, albeit gradual.

82. Third, the stability of Mexico's macroeconomic framework remains subject to external and domestic pressures. Renewed turbulence in the international financial markets and/or further depression in oil prices could deliver another shock to the Mexican economy. Similarly, important domestic sources of fiscal instability remain (contingent liabilities, state finances, quasi-fiscal debt, potential infrastructure gaps, and so forth). Furthermore, while the country's balance of payments' current account deficit is still within sustainable levels, it has recently widened (3.5 percent of GDP), possibly indicating the kind of saving imbalance problem that has preceded Mexico's past crises (particularly between 1992 and 1994). It is reassuring that the authorities' recent macroeconomic management record is sound, and it is likely to remain so. The WBG is supporting them with a body of analytical work on fiscal sustainability and macro modeling and monitoring that it plans to expand further during this CAS period. In addition, the WBG will be prepared to articulate emergency adjustment lending in support of social protection reforms (for example, in the health sector), should an unexpected macroeconomic shock warrant such action.

83. Fourth, an unexpected deterioration in current, poor social conditions, especially in the southern states, could conceivably lead to a loss of investor confidence. The government, however, is well aware of this risk, and is committed to delivering both short-term assistance and long-term solutions. The WBG is supporting, and will continue to support, that work, especially efforts on behalf of rural indigenous populations and economically less-competitive states.

84. Finally, an array of programmatic risks will also need careful monitoring. Among them is the possibility that budget tightening at the federal level (or large unexpected expenditures, such as those caused by natural disasters) could force the government to reduce counterpart funding of sector-focused projects (for example, in the rural, health, PSD, and education sectors).

## VI. COORDINATION WITH OTHER ORGANIZATIONS AND PARTICIPATION IN THIS CAS

85. The WBG has so far maintained a fluid and productive relationship with the donor community in Mexico. In some areas (agriculture, environment, health, education), the WBG is the most prominent donor in both policy dialogue and lending, and acts as a catalyst partner for the interventions of others (for example, the WBG works very closely with UNEP and UNDP in GEF operations). In other areas, it has developed a very close and participatory working relationship with multilateral institutions (for example, IDB and FAO in fiscal decentralization and water management; the IMF in macroeconomic monitoring and, more recently, in the structural underpinnings of a prospective Stand-by operation). In some cases, these relationships have led to joint programs and parallel-financing operations (for example, the IDB's parallel financing of DRD II; analytical work with the OECD on deregulation), and in others the government has guided donors toward specialization (for example, in water and sanitation, where the IDB supports projects in the Valley of Mexico, while the WBG has focused its work elsewhere in the country). (Box 5).

**Box 5. Role and Activities of the Inter-American Development Bank (IDB)**

The WBG and the IDB maintain a very close, complementary relationship in Mexico, both through regular consultations and mutual mission participation. IDB's Mexico office was established in 1965, much before the WBG's, in a fully decentralized way in regards to project execution, project supervision and country dialogue.

Over the years, IDB operations have provided support in a number of areas—basic infrastructure (transport), production activities (agriculture, industry, tourism and mining), and social sectors (education, health, poverty, municipal development, water and waste water). More recently, operational emphasis both through adjustment and investment lending has been placed on the social sectors (where a third of IDB's Mexico's loan portfolio is located), modernization of the state, and the agriculture, transport and financial sectors.

Budget constraints within the Mexican Government have led to fluctuations in IDB's yearly disbursement path, with annual lending volumes ranging from about US$200 million up to US$1.6 billion between 1994 and 1998. The total loan commitment of IDB toward Mexico amounts to some US$5 billion, of which US$3 billion have already been disbursed. In addition, IDB offers in Mexico an array of technical cooperation programs on highly concessional or grant terms (for poverty alleviation, micro-enterprise support and institutional development), as well as a financing window for private-sector-led infrastructure projects without sovereign guarantee.

In general, the government has been very attentive to minimize the risks of duplication and/or competition in its requests for assistance from IDB and the WBG. As part of its current strategy, IDB is focussing its assistance primarily on decentralization and private sector development, especially through the strengthening of sustainable financing mechanisms.

86. Partnerships have also been developed with bilateral donors (notably, Germany and Japan in environmental matters; Germany and France in decentralization), and others are in the making (for example, with the OECF and EXIM-J in solid waste). This fruitful relationship with the donor community will be continued and expanded during the implementation of this CAS. Partnerships with the private sector and NGOs have also proved effective—prime examples are the collaboration achieved with the maquila industries, the *Caja Popular Mexicana*, and other parts of civil society to address the housing and services problems of slum areas in boarder cities

under the Border Infrastructure Project; the GEF-supported innovative partnerships with NGOs as grant recipients and executing agencies (especially for "medium-size projects"); and the WBG–private sector partnerships to phase out ozone-depleting substances under the Montreal Protocol.

87. This CAS was drafted after extensive dialogue with and participation by the government and selective consultations with representatives of NGOs, the business community, unions, the banking industry, politicians, religious groups, academia, independent think-tanks, and the media (a special Consultative Country Meeting—*Reunión de Consulta*—was convened on April 15, 1999 to receive comments from those representatives).

## VII. CONCLUDING REMARKS

88. The consolidation of Mexico's democratic process will make the period leading to the next presidential election increasingly uncertain on the political front, with natural implications for the economic and social life of the country. The objective of the proposed WBG assistance strategy during that period is to support the government's efforts to ensure social sustainability, to remove obstacles to sustainable growth and maintain macroeconomic stability, and to deliver more effective public governance. That strategy is the result of extensive analytical work, lessons of operational experience, and country consultation.

James D. Wolfensohn
President

By:

Sven Sandstrom

Peter L. Woicke

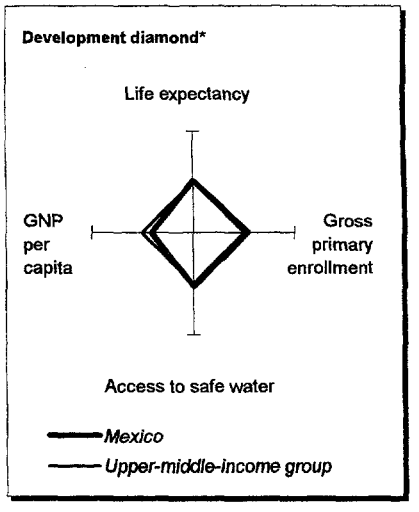
Washington, D.C., May 13, 1999

Attachments

# Mexico at a glance

2/26/99

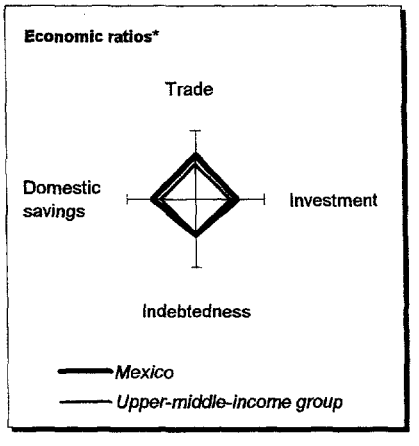
| POVERTY and SOCIAL | Mexico | Latin America & Carib. | Upper-middle-income |
|---|---|---|---|
| **1997** | | | |
| Population, mid-year (millions) | 94.8 | 494 | 571 |
| GNP per capita (Atlas method, US$) | 3,680 | 3,880 | 4,520 |
| GNP (Atlas method, US$ billions) | 348.9 | 1,917 | 2,584 |
| **Average annual growth, 1991-97** | | | |
| Population (%) | 1.8 | 1.7 | 1.5 |
| Labor force (%) | 2.8 | 2.3 | 1.9 |
| **Most recent estimate (latest year available, 1991-97)** | | | |
| Poverty (% of population below national poverty line) | .. | .. | .. |
| Urban population (% of total population) | 74 | 74 | 73 |
| Life expectancy at birth (years) | 72 | 70 | 70 |
| Infant mortality (per 1,000 live births) | 30 | 32 | 30 |
| Child malnutrition (% of children under 5) | 14 | .. | .. |
| Access to safe water (% of population) | 83 | 73 | 79 |
| Illiteracy (% of population age 15+) | 10 | 13 | 15 |
| Gross primary enrollment (% of school-age population) | 115 | 111 | 107 |
| Male | 116 | .. | .. |
| Female | 113 | .. | .. |




**KEY ECONOMIC RATIOS and LONG-TERM TRENDS**

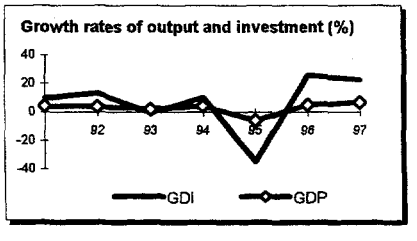
| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| GDP (US$ billions) | 95.3 | 128.8 | 332.9 | 401.9 |
| Gross domestic investment/GDP | 21.0 | 18.1 | 23.0 | 26.5 |
| Exports of goods and services/GDP | 7.0 | 17.4 | 32.1 | 30.3 |
| Gross domestic savings/GDP | 18.8 | 22.0 | 26.2 | 26.2 |
| Gross national savings/GDP | 16.5 | 17.4 | 23.3 | 24.3 |
| Current account balance/GDP | -3.7 | -1.1 | -0.7 | -1.9 |
| Interest payments/GDP | 1.4 | 6.0 | 2.5 | 2.1 |
| Total debt/GDP | 25.1 | 78.3 | 47.4 | 37.2 |
| Total debt service/exports | 46.4 | 53.5 | 35.4 | 32.4 |
| Present value of debt/GDP | .. | .. | 44.6 | 36.0 |
| Present value of debt/exports | .. | .. | 128.9 | 110.3 |

| | 1976-86 | 1987-97 | 1996 | 1997 | 1998-02 |
|---|---|---|---|---|---|
| *(average annual growth)* | | | | | |
| GDP | 3.3 | 2.9 | 5.1 | 6.8 | 3.5 |
| GNP per capita | 0.9 | 0.6 | 3.8 | 6.1 | 1.7 |
| Exports of goods and services | 10.3 | 11.1 | 18.2 | 13.0 | 5.5 |

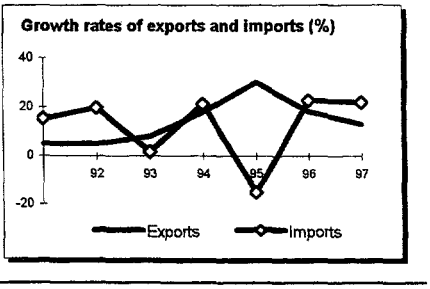



**STRUCTURE of the ECONOMY**

| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| *(% of GDP)* | | | | |
| Agriculture | 10.2 | 9.0 | 6.3 | 5.7 |
| Industry | 29.8 | 33.9 | 28.4 | 28.5 |
| Manufacturing | 21.6 | 24.7 | 21.5 | 21.4 |
| Services | 60.0 | 57.1 | 65.4 | 65.8 |
| Private consumption | 71.3 | 68.8 | 64.2 | 65.4 |
| General government consumption | 9.9 | 9.1 | 9.6 | 8.4 |
| Imports of goods and services | 9.2 | 13.5 | 30.0 | 30.3 |




| | 1976-86 | 1987-97 | 1996 | 1997 |
|---|---|---|---|---|
| *(average annual growth)* | | | | |
| Agriculture | 2.7 | 1.5 | 3.3 | 0.2 |
| Industry | 3.6 | 3.3 | 10.1 | 9.3 |
| Manufacturing | 3.2 | 3.7 | 10.8 | 10.0 |
| Services | .. | .. | .. | .. |
| Private consumption | 3.0 | 2.7 | 2.2 | 6.3 |
| General government consumption | 5.8 | 2.0 | -0.7 | 1.8 |
| Gross domestic investment | -2.5 | 4.8 | 25.7 | 22.8 |
| Imports of goods and services | 0.1 | 13.3 | 22.8 | 22.0 |
| Gross national product | 3.4 | 2.5 | 5.6 | 7.9 |

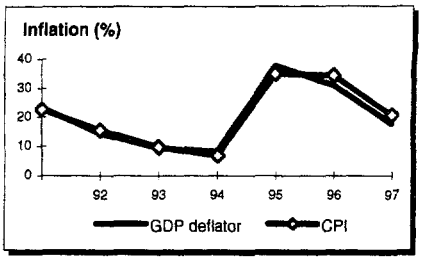



*Note: 1997 data are preliminary estimates.*

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

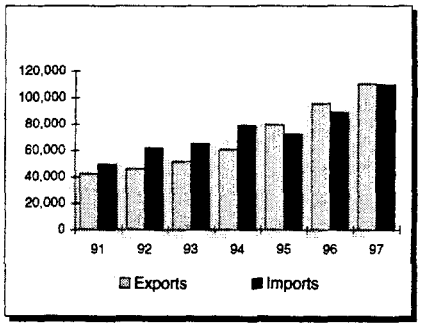
## PRICES and GOVERNMENT FINANCE

| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| ***Domestic prices*** | | | | |
| *(% change)* | | | | |
| Consumer prices | .. | 86.2 | 34.4 | 20.6 |
| Implicit GDP deflator | 21.3 | 79.2 | 31.0 | 17.7 |
| ***Government finance*** | | | | |
| *(% of GDP, includes current grants)* | | | | |
| Current revenue | .. | 31.8 | 22.9 | 23.0 |
| Current budget balance | .. | -10.1 | 3.7 | 3.2 |
| Overall surplus/deficit | .. | -15.0 | 0.0 | -0.7 |



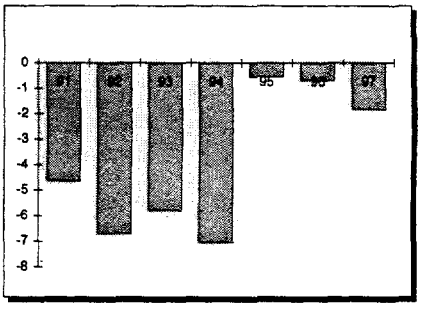

## TRADE

| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| *(US$ millions)* | | | | |
| Total exports (fob) | .. | 17,452 | 96,000 | 110,431 |
| Oil | .. | 6,307 | 11,654 | 11,323 |
| Agriculture | .. | 2,098 | 3,592 | 3,828 |
| Manufactures | .. | 8,537 | 80,305 | 94,802 |
| Total imports (cif) | .. | 12,432 | 89,469 | 109,808 |
| Consumer goods | .. | 846 | 6,657 | 9,326 |
| Intermediate goods | .. | 8,632 | 71,890 | 85,366 |
| Capital goods | .. | 2,954 | 10,922 | 15,116 |
| Export price index (1995=100) | .. | 84 | 102 | 101 |
| Import price index (1995=100) | .. | 76 | 101 | 101 |
| Terms of trade (1995=100) | .. | 112 | 101 | 100 |



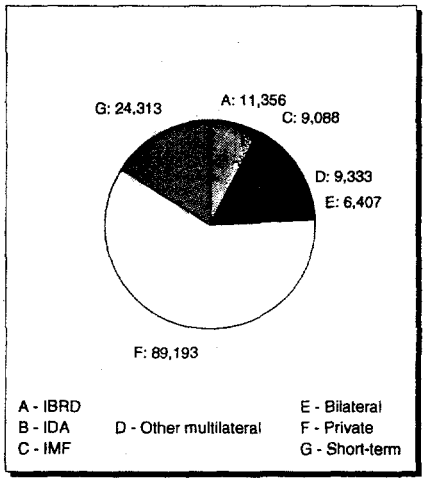

## BALANCE of PAYMENTS

| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| *(US$ millions)* | | | | |
| Exports of goods and services | 6,840 | 22,024 | 106,779 | 121,701 |
| Imports of goods and services | 8,289 | 17,454 | 99,700 | 121,608 |
| Resource balance | -1,449 | 4,571 | 7,079 | 94 |
| Net income | -2,115 | -7,519 | -13,940 | -12,790 |
| Net current transfers | 73 | 1,575 | 4,531 | 5,247 |
| Current account balance | -3,492 | -1,374 | -2,330 | -7,448 |
| Financing items (net) | 2,632 | 1,976 | 4,098 | 17,942 |
| Changes in net reserves | 860 | -603 | -1,768 | -10,494 |
| ***Memo:*** | | | | |
| Reserves including gold (US$ millions) | .. | 5,780 | 19,456 | 28,815 |
| Conversion rate (DEC, local/US$) | 0.02 | 0.61 | 7.60 | 7.91 |




## EXTERNAL DEBT and RESOURCE FLOWS

| | 1976 | 1986 | 1996 | 1997 |
|---|---|---|---|---|
| *(US$ millions)* | | | | |
| Total debt outstanding and disbursed | 23,960 | 100,878 | 157,848 | 149,690 |
| IBRD | 1,222 | 5,566 | 12,568 | 11,356 |
| IDA | 0 | 0 | 0 | 0 |
| Total debt service | 3,344 | 12,939 | 40,792 | 42,453 |
| IBRD | 132 | 819 | 2,372 | 2,102 |
| IDA | 0 | 0 | 0 | 0 |
| Composition of net resource flows | | | | |
| Official grants | 6 | 77 | 30 | .. |
| Official creditors | 300 | 1,458 | -7,681 | -4,563 |
| Private creditors | 4,203 | -911 | 12,123 | 6,003 |
| Foreign direct investment | 628 | 1,523 | 9,186 | 12,478 |
| Portfolio equity | 0 | 0 | 2,801 | 3,215 |
| World Bank program | | | | |
| Commitments | 410 | 1,272 | 617 | 485 |
| Disbursements | 142 | 1,016 | 1,051 | 995 |
| Principal repayments | 42 | 424 | 1,409 | 1,311 |
| Net flows | 99 | 592 | -359 | -316 |
| Interest payments | 89 | 395 | 962 | 791 |
| Net transfers | 10 | 197 | -1,321 | -1,107 |




2/26/99

## Annex B2. Mexico—Selected Portfolio Performance Indicators

| Indicator | 1996 | 1997 | 1998 | 1999[a] |
|---|---|---|---|---|
| *Portfolio Assessment* | | | | |
| Number of projects under implementation[b] | 35 | 35 | 36 | 29 |
| Average implementation period (years)[c] | 3.80 | 3.70 | 3.44 | 3.30 |
| Percent of problem projects[b, d] | | | | |
| By number | 22.86 | 14.29 | 8.33 | 10.34 |
| By amount | 16.09 | 11.25 | 15.40 | 15.69 |
| Percent of projects at risk[b, e] | | | | |
| By number | 30.00 | 17.24 | 7.14 | 11.11 |
| By amount | 23.60 | 18.89 | 16.18 | 17.11 |
| Disbursement ratio (%)[f] | 21.73 | 13.07 | 19.46 | 8.74 |
| *Portfolio Management* | | | | |
| CPPR during the year (yes/no) | No | Yes | No | No |
| Supervision resources (total US$000, direct costs only) | 2,097.88 | 1,639.10 | 1,621.54 | 798.59 |
| Average supervision (US$000/project) | 59.94 | 46.83 | 45.04 | 27.54 |

| Memorandum item | Since FY80 | Last five FYs |
|---|---|---|
| Projects evaluated by OED | | |
| By number | 101 | 45 |
| By amount (US$ millions) | 19,129.49 | 9,805.80 |
| Percent rated U or HU | | |
| By number | 31.68 | 22.22 |
| By amount | 25.76 | 21.42 |

a. As of December 1998.
b. As shown in the *Annual Report on Portfolio Performance* (except for current FY).
c. Average age of projects in the Bank's country portfolio.
d. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
e. As defined under the Portfolio Improvement Program.
f. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: investment projects only.

## Annex B3. Mexico—Bank Group Program Summary, FY 1999-2001

### Proposed IBRD/IDA Base-Case Lending Program, FY 1999-2001[a]

| FY | Project | Strategic Rewards | Impl. Risks |
|---|---|---|---|
| 1999 | Agricultural Productivity | M | M |
| | Env. Mgmt. & Decentralization (PROMAD) APL | H | M |
| | Federal Roads | M | M |
| | Financial Sector Infrastructure (Secured Lending) | H | L |
| | Fiscal Adjustment Loan | H | M |
| | FOVI Restructuring | H | M |
| | Social Assistance Decentralization LIL | M | L |
| 2000 | Air Quality II (& Greenhouse Gases/GEF) | M | L |
| | Border Infrastructure LIL—Juarez | M | L |
| | Border Infrastructure LIL—Tijuana | M | L |
| | City Development Strategy LIL | M | L |
| | Decentralization SAL | H | H |
| | Disaster Prevention | H | M |
| | Energy Sector Loan | H | H |
| | Financial Sector TAL II | M | L |
| | Health Care Reform | H | M |
| | Highway Finance | H | H |
| | Poverty Reduction (PROSSE II) | H | M |
| | Renewable Energy LIL | M | L |
| | Rural Dev. Marginal Areas APL II | H | L |
| | Rural Micro-Finance LIL | M | L |
| | State-level Competitiveness LIL | M | L |
| | State-level Public Administration LIL | M | M |
| | States Decentralization APL | H | M |
| | TAL for Tax Administration | H | M |
| 20001 | | | |
| | Basic Education Dev. APL II | M | L |
| | Basic Health Care PAC II | H | L |
| | Commercial Dispute Resolution Mechanism Reform LIL | H | M |
| | Contractual Savings Development III | M | M |
| | Financial Sector Infrastructure II | H | M |
| | Fiscal Reform SAL II | H | M |
| | Irrigation Sector Loan | M | L |
| | Nat'l. Program on Social Assistance Decentralization | H | M |
| | Regional-level Competitiveness LIL | M | M |
| | Registry Modernization Loan | M | L |
| | Rural Social Infrastructure (DRD II) APL | H | M |
| | Selected Public Governance Institutions LIL | H | H |
| | State Roads | M | M |
| | Very-Low-Income Housing Loan | H | M |
| | Water & Sanitation III | H | M |

a. This table presents the proposed program for the next three fiscal years.

b. For each project, indicate whether the strategic rewards and implementation risks are expected to be high (H), moderate (M), or low (L).

## Annex B3. Mexico—IFC and MIGA Program, FY96–99

| Category | Past 1996 | Past 1997 | Past 1998 | Dec. 1999 |
|---|---|---|---|---|
| IFC approvals (US$m) [a] | 243.12 | 219.02 | 142.19 | 18.20 |
| Sector (%) | | | | |
| Financial services | 42.00 | 63.00 | 23.00 | 0.00 |
| Food & agro-business | 14.00 | 14.00 | 14.00 | 88.00 |
| Hotels & tourism | 12.00 | 0.00 | 0.00 | 0.00 |
| Infrastructure | 0.00 | 14.00 | 25.00 | 8.00 |
| Manufacturing | 0.00 | 10.00 | 13.00 | 0.00 |
| Mining & metals | 2.00 | 0.00 | 0.00 | 0.00 |
| Motor vehicles & parts | 13.00 | 0.00 | 12.00 | 4.00 |
| Oil refining | 16.00 | 0.00 | 0.00 | 0.00 |
| Social services | 0.00 | 0.00 | 13.00 | 0.00 |
| Total | 100.00 | 100.00 | 100.00 | 100.00 |
| Investment instrument (%) | | | | |
| Loans | 84.00 | 66.00 | 65.00 | 0.00 |
| Equity | 3.00 | 15.00 | 34.00 | 68.00 |
| Quasi-equity [b] | 9.00 | 19.00 | 0.00 | 32.00 |
| Other | 5.00 | 0.00 | 1.00 | 0.00 |
| Total | 100.00 | 100.00 | 100.00 | 100.00 |
| MIGA guarantees (US$m) | 0.00 | 0.00 | 0.00 | 0.00 |
| MIGA commitments (US$m) | 0.00 | 0.00 | 0.00 | 0.00 |

a. Excludes AEF projects.
b. Includes quasi-equity types of both loan and equity instruments.

## Annex B4. Summary of Nonlending Services

### Social Sustainability

Poverty Assessment—FY99
Economic Implications of Gender—FY99
Gender and Pension Reform—FY99
Education and Income Distribution—FY99
Education Decentralization Study—FY99
Health Care Regulation—Policy Note FY99
Follow-up Policy Notes on Poverty and Inequality—FY99–01
Follow-up Policy Notes on Self-Employment & Labor Markets —FY99–01

Options for Education Expenditure and Financing—Policy Note FY00
Training Mechanisms Reform—Policy Note FY00
National Forum on Social Assistance and Social Safety Nets—FY00
Urban Youth Assistance Study—FY00
Economic Policy for Macro Enterprises—FY00
Fiscal Impact of Health Insurance Reform—Policy Note FY00
Indigenous Populations Profile (Phase II)—FY00
Cultural Heritage Assessment—FY00

Gender Capacity-Building TA Grant—FY01
Strategy for Upper-Secondary Education Reform—FY01

### Removing Obstacles to Sustainable Growth and Maintaining Macroeconomic Stability in the Context of Globalization

Fiscal Sustainability Study—FY99
The Mexican Banking System: An Update—FY99
*Fundacion* Mexico IDF—FY99
Decentralization of PSD Seminar—FY99
Industrial Promotion Decentralization Study—FY99
Information Systems for the Rural Sector—FY99
*Ejido* Sector Study—FY99
Support for Institutional Coordination in Regional Development—FY99
Groundwater Management Study—FY99
Disaster Prevention Case Study—FY99
Environmental. Management Systems for Industrial Pollution—FY99
Institutional Strengthening on Climate Change (IDF)—FY99
Institutional Coordination for Regional Development (IDF)—FY99

Decentralization Policy Agenda—FY99
Follow-up Policy Notes on Macro Sustainability—FY99–00
Enhanced Tech. Supp. on Macro Monitoring & Forecasting—FY99–01
Tech. Support for Energy Regulation & Housing Finance—FY99–01

Management & Prevention of External Shocks—Policy Note—FY00
Efficiency & Effectiveness of the Tax Regime—Policy Note—FY00
Capital Markets Study—FY00
Nonbank Financial Institutions Study—FY00
Export Competitiveness Report—FY00
Regulatory Constraints to PSD—FY00
Corporate Governance of Conglomerates Study—FY00
Macro Implications of Energy Reform—FY00
Very-Low-Income Housing Strategy—FY00
City Assistance Strategy—FY00
Urban Development Strategy—FY00
Rural Microfinance Study—FY00
Food Marketing Policy Note—FY00
Land Markets Policy Note—FY00
Energy-Environment Review—FY00
State-Level Private Sector Assessments—FY00–01
State-Level Public Expenditure Reviews—FY00–01

Development Banks Report—FY01
Technical Support for Business Partnerships in Southern States—FY01
Alternative Energy Sources Assessment (GEF)—FY01
Transport Sector Strategy—FY01
Infrastructure Policy Notes Collection—Beyond 2000—FY01
Rural Economy Policy Notes Collection—Beyond 2000—FY01
Environmental Policy Notes Collection—Beyond 2000—FY01

### Efficient Public Governance

Tax Administration Policy Note—FY00
Technical Support for Partnerships in Judicial Reform—FY00
Commercial Dispute Resolution Mechanism Reform Strategy—FY00
Country Procurement Assessment—FY00
State-Level Institutional Development & Human Resource Management Strategies—FY00–01
Public Governance Policy Note—FY01

## Annex B5. Mexico—Poverty and Social Development Indicators

| | 1996 (latest single year) | Latin America & Caribbean | Lower-middle Income |
|---|---|---|---|
| **POPULATION** | | | |
| Total population, mid-year (millions) | 93.2 | 485.8 | 1,125.4 |
| Growth rate (percent, annual average) | 1.8 | 1.7 | 1.4 |
| Urban population (percent of population) | 73.8 | 73.7 | 58.2 |
| Total fertility rate (births per woman) | 2.9 | 2.7 | 2.6 |
| **POVERTY** (unadjusted figure—all poor) | | | |
| National headcount index (percent of total population) | 61.88 | — | — |
| Urban headcount index (percent of total population) | 53.25 | — | — |
| Rural headcount index (percent of total population) | 84.84 | — | — |
| **INCOME** | | | |
| GNP per capita (US$) | 3,670 | 3,710 | 1,740 |
| Consumer price index (1994 = 100) | 181 | 631 | 341 |
| **INCOME DISTRIBUTION** (percent of current income) | | | |
| Highest decile | 41.25 | — | — |
| Lowest decile | 1.4 | — | — |
| **SOCIAL INDICATORS** | | | |
| **Public expenditure** | | | |
| Education (percent of GDP) | 3.70 | 3 | 2.4 |
| Health (percent of GDP) | 2.08 | 3.9 | 5.2 |
| Social Security (percent of GDP) | 1.34 | | |
| Labor (percent of GDP) | 0.07 | | |
| **Net primary school enrollment rate** | | | |
| Total | 94.9 | 91 | 94 |
| Urban | 95.4 | | |
| Rural | 93.9 | | |
| **Access to safe water** (percent of population) | | | |
| Total | 77.59 | 73 | 75 |
| Urban | | 84 | |
| Rural | | 43 | |
| **Immunization rate** (percent under 12 months) | | | |
| Sabin | 83.5 | | |
| DPT | 82.8 | 85 | 88 |
| BCG | 96.9 | | |
| **Child malnutrition** (percent under 5 years) | | | |
| Total | 14 | — | — |
| Urban | — | — | — |
| Rural | — | — | — |
| **Life expectancy at birth** (years) | | | |
| Total | 72 | 70 | 67 |
| Male | 69 | 65 | |
| Female | 75 | 73 | 70 |
| **Mortality** | | | |
| Infant (per thousand live births) | 32 | 33 | 40 |
| Under 5 (per thousand live births) | 36 | 41 | 49 |
| Adult (ages 15–59) | | | |
| Male (per 1,000 population) | 162 | 182 | 260 |
| Female (per 1,000 population) | 89 | 114 | 155 |
| Maternal (per 100,000 live births) | 110 | | |

*Source*: Statistical Annex of the President (1998), ENIGH and World Development Indicators, 1998.

# Annex B6. Mexico—Key Economic Indicators

| Indicator | Actual 1994 | Actual 1995 | Actual 1996 | Estimate 1997 | Estimate 1998 | Projected 1999 | Projected 2000 | Projected 2001 |
|---|---|---|---|---|---|---|---|---|
| **National accounts (as % GDP at current market prices)** | | | | | | | | |
| Gross domestic product | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Agriculture[a] | 5.7 | 5.5 | 6.3 | 5.7 | 5.4 | 5.2 | 5.0 | 4.9 |
| Industry[a] | 26.9 | 27.9 | 28.4 | 28.5 | 29.1 | 28.7 | 28.6 | 28.7 |
| Services[a] | 67.4 | 66.6 | 65.4 | 65.8 | 65.5 | 66.1 | 66.4 | 66.4 |
| Total consumption | 83.1 | 77.5 | 74.7 | 74.0 | 77.6 | 73.2 | 73.6 | 73.2 |
| Gross domestic fixed investment | 19.4 | 16.2 | 17.8 | 19.5 | 21.8 | 22.8 | 23.3 | 24.0 |
| Government investment | 3.8 | 3.3 | 3.0 | 3.1 | 3.0 | 2.9 | 3.0 | 3.0 |
| Private investment (includes increase in stocks) | 18.0 | 16.5 | 20.2 | 23.0 | 21.9 | 24.2 | 24.3 | 24.8 |
| Exports (GNFS)[b] | 16.8 | 30.4 | 32.1 | 30.3 | 31.2 | 34.3 | 34.7 | 34.8 |
| Imports (GNFS) | 21.7 | 27.8 | 30.0 | 30.3 | 33.2 | 34.6 | 35.6 | 35.8 |
| Gross domestic savings | 16.9 | 22.5 | 25.3 | 26.0 | 22.4 | 26.8 | 26.4 | 26.8 |
| Gross national savings[c] | 14.7 | 19.2 | 22.5 | 24.1 | 20.6 | 24.8 | 24.4 | 24.6 |
| *Memorandum items* | | | | | | | | |
| Gross domestic product (US$ million at current prices) | 420,776 | 286,167 | 332,909 | 401,682 | 410,302 | 414,399 | 446,432 | 481,409 |
| Gross national product per capita (US$, Atlas method) | 4,590 | 3,800 | 3,650 | 3,700 | 3,970 | 4,070 | 4,310 | 4,560 |
| Real annual growth rates (% calculated from 1993 prices) | | | | | | | | |
| Gross domestic product at market prices | 4.4% | -6.2% | 5.1% | 6.8% | 4.8% | 3.0% | 5.0% | 5.0% |
| Gross domestic income | 4.5% | -7.9% | 5.3% | 7.7% | 4.2% | 2.8% | 5.1% | 5.0% |
| Real annual per capita growth rates (%, calculated from 1993 prices) | | | | | | | | |
| Gross domestic product at market prices | 2.5% | -7.8% | 3.3% | 4.9% | 3.0% | 1.2% | 3.1% | 3.1% |
| Total consumption | 2.5% | -10.0% | 0.1% | 4.1% | 3.5% | -0.3% | 3.7% | 2.7% |
| Private consumption | 2.7% | -11.1% | 0.5% | 4.5% | 4.5% | 0.0% | 3.3% | 2.6% |

*(Continued)*

# Annex B6. Mexico— Key Economic Indicators (continued)

| Indicator | Actual 1994 | 1995 | 1996 | Estimate 1997 | 1998 | 1999 | Projected 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|
| **Balance of Payments (US$m)** | | | | | | | | |
| Exports (GNFS)[b] | 71,184 | 89,207 | 106,779 | 121,701 | 129,427 | 142,325 | 154,851 | 167,683 |
| Merchandise FOB | 60,882 | 79,542 | 96,000 | 110,431 | 117,500 | 129,417 | 140,986 | 152,761 |
| Imports (GNFS)[b] | 91,616 | 81,454 | 99,700 | 121,608 | 137,729 | 143,532 | 158,942 | 172,471 |
| Merchandise FOB | 79,346 | 72,453 | 89,469 | 109,808 | 125,243 | 130,280 | 144,708 | 157,151 |
| Resource balance | -20,432 | 7,753 | 7,079 | 94 | -8,302 | -1,207 | -4,092 | -4,788 |
| Net current transfers (including official current transfers) | 3,782 | 3,960 | 4,531 | 5,247 | 6,012 | 5,887 | 6,183 | 6,493 |
| Current account balance (after official capital grants) | -29,662 | -1,577 | -2,330 | -7,448 | -15,786 | -9,427 | -13,162 | -15,605 |
| Net private foreign direct investment | 10,973 | 9,526 | 9,186 | 12,830 | 10,238 | 8,500 | 10,000 | 11,000 |
| Net private portfolio investment | 8,182 | -9,715 | 13,419 | 5,037 | 1,293 | 2,000 | 2,000 | 2,000 |
| Long-term loans (net) | 4,630 | 16,344 | 4,441 | 1,440 | 4,071 | 2,831 | 6,342 | 10,922 |
| Official | -585 | 10,352 | -7,681 | -4,563 | 129 | 407 | 1,213 | 1,305 |
| Private | 5,214 | 5,992 | 12,122 | 6,003 | 3,942 | 2,423 | 5,129 | 9,617 |
| Other capital (net, including errors and omissions) | -12,514 | -4,986 | -22,947 | -1,365 | 2,322 | -3,195 | -4,198 | -3,890 |
| Change in reserves[d] | 18,391 | -9,593 | -1,768 | -10,494 | -2,137 | -709 | -983 | -4,426 |
| *Memorandum items* | | | | | | | | |
| Resource balance (% of GDP at current market prices) | -4.9% | 2.7% | 2.1% | 0.0% | -2.0% | -0.3% | -0.9% | -1.0% |
| Current Account Balance (% of GDP at current market prices) | -7.0% | -0.6% | -0.7% | -1.9% | -3.8% | -2.2% | -2.8% | -3.2% |

*(Continued)*

# Annex B6. Mexico—Key Economic Indicators (continued)

| Indicator | Actual 1994 | 1995 | 1996 | Estimate 1997 | 1998 | Projected 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|
| **Public finance** | | | | | | | | |
| **'(as % of GDP at current market prices)[e]** | | | | | | | | |
| Current revenues | 22.8 | 22.8 | 22.9 | 23.0 | 20.6 | 20.7 | 20.8 | 20.4 |
| Current expenditures | 19.2 | 19.6 | 19.2 | 20.3 | 18.7 | 19.1 | 18.7 | 18.6 |
| Current account surplus (+) or deficit (-) | 3.5 | 3.2 | 3.7 | 2.7 | 1.8 | 1.6 | 2.0 | 1.8 |
| Capital expenditure | 3.7 | 3.2 | 3.7 | 3.4 | 3.1 | 2.9 | 3.0 | 3.0 |
| Overall balance | -0.1 | 0.0 | 0.0 | -0.7 | -1.3 | -1.3 | -1.0 | -1.3 |
| **Monetary indicators** | | | | | | | | |
| M2/GDP (at current market prices) | 31.3 | 33.6 | 31.7 | 30.0 | 31.1 | --- | --- | --- |
| Growth of M2 (%) | 28.4 | 38.7 | 30.1 | 19.1 | 23.3 | --- | --- | --- |
| **Price indices(1993 =100)** | | | | | | | | |
| Real exchange rate (LCU/US$)[f] | 105.3 | 152.9 | 134.5 | 113.9 | 112.5 | 116.0 | 116.0 | 116.0 |
| Real interest rates | 7.2% | 5.6% | 6.6% | 5.1% | 7.5% | 8.0% | 7.0% | 6.0% |
| Consumer price index (period average % growth rate) | 7.0% | 35.0% | 34.4% | 20.6% | 15.9% | 15.8% | 11.5% | 10.0% |
| Consumer price index (end of period % growth rate) | 7.1% | 52.0% | 27.7% | 15.7% | 18.6% | 13.0% | 10.0% | 10.0% |
| GDP deflator (% growth rate) | 8.3% | 37.9% | 31.0% | 17.7% | 13.8% | 13.0% | 10.0% | 10.0% |

a. GDP components are estimated at factor cost.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers, excluding official capital grants.
d. Includes use of IMF resources.
e. Non Financial Public Sector.
f. "LCU" denotes "local currency units." An increase in LCU/US$ denotes depreciation.

# Annex B7. Mexico—Key Exposure Indicators

| Indicator | Actual 1994 | Actual 1995 | Actual 1996 | Estimate 1997 | Estimate 1998 | Estimate 1999 | Projected 2000 | Projected 2001 |
|---|---|---|---|---|---|---|---|---|
| Total debt outstanding and disbursed (TDO) (US$m)[a] | 140,002 | 166,780 | 157,848 | 149,690 | 154,656 | 150,763 | 155,610 | 161,963 |
| Net disbursements (US$m)[a] | 6,491 | 26,466 | (4,843) | (3,560) | 4,565 | (3,893) | 4,847 | 6,354 |
| Total debt service (TDS) (US$m)[a] | 21,941 | 26,886 | 40,792 | 42,453 | 35,328 | 32,093 | 33,588 | 34,782 |
| Debt and debt service indicators (%) | | | | | | | | |
| TDO/XGS[b] | 179.4 | 172.5 | 137.1 | 114.2 | 110.3 | 99.3 | 94.5 | 91.0 |
| TDO/GDP | 33.3 | 58.3 | 47.4 | 37.3 | 37.7 | 36.4 | 34.9 | 33.6 |
| TDS/XGS | 28.1 | 27.8 | 35.4 | 32.4 | 25.4 | 21.1 | 20.4 | 19.5 |
| Concessional/TDO | 1.2 | 0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| IBRD exposure indicators (%) | | | | | | | | |
| IBRD DS/public DS | 15.0 | 13.8 | 8.1 | 6.6 | 10.5 | 10.6 | 11.4 | 12.1 |
| Preferred creditor DS/public DS (%)[c] | 30.9 | 27.4 | 19.5 | 20.9 | 22.9 | 39.5 | 36.3 | 33.1 |
| IBRD DS/XGS | 2.5 | 2.5 | 2.1 | 1.6 | 1.4 | 1.5 | 1.4 | 1.3 |
| IBRD TDO (US$m)[d] | 13,475 | 14,295 | 13,078 | 11,906 | 12,108 | 12,762 | 13,216 | 13,365 |
| present value of guarantees (US$m) | 437 | 472 | 510 | 550 | 595 | 642 | 693 | 481 |
| Share of IBRD portfolio (%) | 11.7 | 13.1 | 12.1 | 9.7 | 9.6 | 9.4 | 9.3 | 9.2 |
| IFC (US$m) | | | | | | | | |
| Loans | 534 | 550 | 528 | 495 | 338 | | | |
| Equity and quasi-equity /c | 51 | 57 | 65 | 76 | 78 | | | |
| MIGA | | | | | | | | |
| MIGA guarantees (US$m) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. "XGS" denotes exports of goods and services, including workers' remittances.

c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

d. Includes present value of guarantees.

e. Includes equity and quasi-equity types of both loan and equity instruments.

# Annex B8. Status of Bank Group Operations in Mexico Operations Portfolio

| Project ID | Fiscal Year | Borrower | Purpose | Original amount (US$ millions) IBRD | IDA | Cancel. | Undisb. | Difference between expected and actual disbursements[a] Orig | Frm Rev'd | Last PSR Supervision rating[b] Dev Obj | Imp Prog |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Number of Closed Projects: 141 | | | | | | | | | | | |
| Active Projects | | | | | | | | | | | |
| MX-PE-7667 | 1992 | NAFIN | IRRIG SCTR | 400.00 | 0.00 | 50.00 | 56.31 | 106.27 | -19.53 | S | S |
| MX-PE-7723 | 1993 | BANOBRAS | HWY RHB & SAFETY | 480.00 | 0.00 | 0.00 | 160.06 | 40.05 | 0.00 | S | HS |
| MX-PE-7648 | 1993 | BANOBRAS | MEDIUM CITIES TRANSP | 200.00 | 0.00 | 23.00 | 120.56 | 117.49 | .59 | S | S |
| MX-PE-7694 | 1993 | NAFIN | TRNSPRT AIR POLL CON | 220.00 | 0.00 | 43.12 | 79.96 | 123.08 | 70.00 | S | S |
| MX-PE-7725 | 1994 | NAFIN | PRIM.EDUC.II | 412.00 | 0.00 | 40.00 | 172.95 | 202.99 | 39.71 | S | S |
| MX-PE-7710 | 1994 | BANOBRAS | N. BORDER I ENVIRONM | 368.00 | 0.00 | 273.40 | 65.36 | 290.16 | 31.86 | S | S |
| MX-PE-7701 | 1994 | NAFIN | ON-FARM & MINOR IRRI | 200.00 | 0.00 | 30.00 | 81.06 | 81.05 | 1.05 | S | S |
| MX-PE-7612 | 1994 | BANOBRAS | SOLID WASTE II | 200.00 | 0.00 | 193.06 | 1.48 | -4.46 | .76 | S | S |
| MX-PE-7707 | 1994 | BANOBRAS | WATER/SANIT II | 350.00 | 0.00 | 0.00 | 173.30 | 173.27 | 0.00 | S | S |
| MX-PE-34490 | 1995 | NAFIN | TECH EDU/TRAING | 265.00 | 0.00 | 30.00 | 158.41 | 138.45 | -3.61 | S | S |
| MX-PE-7702 | 1995 | SEDESOL | SECOND DECENTRALZTN | 500.00 | 0.00 | 0.00 | 144.08 | 124.12 | 26.70 | S | U |
| MX-PE-7607 | 1995 | GOVERNMENT | RAINFED AREAS DEVELO | 85.00 | 0.00 | 0.00 | 4.25 | -1.76 | -9.04 | S | S |
| MX-PE-34161 | 1995 | NAFIN | FINANCIAL SEC T.A. | 37.40 | 0.00 | 0.00 | 10.78 | -3.01 | 10.79 | S | S |
| MX-PE-40685 | 1996 | NACIONAL FINANCIERA (NAFI | INFRA. PRIVATZTN TA | 30.00 | 0.00 | 0.00 | 19.83 | 19.83 | 0.00 | S | S |
| MX-PE-7689 | 1996 | NAFIN | BASIC HLTH II | 310.00 | 0.00 | 0.00 | 204.46 | 45.46 | 33.06 | HS | HS |
| MX-PE-7713 | 1996 | GOM | WATER RESOURCES MANA | 186.50 | 0.00 | 0.00 | 172.06 | 28.12 | 0.00 | S | S |
| MX-PE-43163 | 1997 | BANOBRAS | FEDERAL ROADS MODZTN | 475.00 | 0.00 | 0.00 | 475.00 | 80.00 | 0.00 | U | U |
| MX-PE-7732 | 1997 | GOVERNMENT | RURAL FIN. MKTS T.A. | 30.00 | 0.00 | 0.00 | 28.44 | 20.79 | 5.24 | S | S |
| MX-PE-7700 | 1997 | GOVT OF MEXICO | COMMUNITY FORESTRY | 15.00 | 0.00 | 0.00 | 14.44 | 3.94 | 0.00 | S | S |
| MX-PE-7726 | 1997 | GOVERNMENT | AQUACULTURE | 40.00 | 0.00 | 0.00 | 39.85 | 5.35 | 0.00 | S | U |
| MX-PE-55061 | 1998 | BANOBRAS | HLTH.SYSTEM REF. TA | 25.00 | 0.00 | 0.00 | 25.00 | 0.00 | 0.00 | S | S |
| MX-PE-49895 | 1998 | MINISTRY OF FINANCE | HIGHER ED. FINANCING | 180.20 | 0.00 | 0.00 | 180.20 | 5.26 | 0.00 | S | S |
| MX-PE-40199 | 1998 | MEXICAN GOVERNMENT | BASIC EDC. DEV. | 115.00 | 0.00 | 0.00 | 115.00 | 6.66 | 0.00 | S | S |
| MX-PE-7711 | 1998 | NAFIN | RURAL DEV. MARG.AREA | 47.00 | 0.00 | 0.00 | 47.00 | 11.00 | 0.00 | S | S |
| MX-PE-7720 | 1998 | BANOBRAS | HEALTH SYSTEM REFORM | 700.00 | 0.00 | 0.00 | 350.00 | 0.00 | 0.00 | S | S |
| MX-PE-44531 | 1998 | GOM | KNOWLEDGE & INNOV. | 300.00 | 0.00 | 0.00 | 300.00 | 0.00 | 0.00 | S | S |
| MX-PE-48505 | 1999 | NAFIN | AGRICULTURAL PRODUCT | 444.45 | 0.00 | 0.00 | 444.45 | 0.00 | 0.00 | | |
| Total | | | | 6,615.55 | 0.00 | 682.58 | 3,644.29 | 1,614.11 | 187.58 | | |

| | Active projects | Closed projects | Total |
|---|---|---|---|
| Total disbursed (IBRD and IDA) | 2,288.67 | 21,199.75 | 23,488.42 |
| repaid | 72.33 | 11,752.60 | 11,824.93 |
| Total now held by IBRD and IDA | 5,860.63 | 9,484.39 | 15,345.02 |
| Amount sold | 0.00 | 92.34 | 92.34 |
| repaid | 0.00 | 92.34 | 92.34 |
| Total Undisbursed | 3,644.29 | 37.22 | 3,681.51 |

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter-based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

*Note*: Disbursement data is updated at the end of the first week of the month.

# MEXICO: PRIVATE SECTOR STRATEGY

## I. Introduction

1. Reducing poverty through support for private-sector-led growth, and helping to improve international competitiveness of the Mexican private sector[1] remain key thrusts of the World Bank Group (WBG)[2] assistance for Mexico. The last Country Assistance Strategy (CAS) for Mexico of November 25, 1996 (Report No. 16135-ME), included an extensive Private Sector Strategy (PSS), which addressed selected issues in Mexico's private sector development and the WBG assistance strategy. Broad categories of PSD priorities of the last PSS remain substantially intact: strengthening the financial sector (in particular, the banking sector), enhancing the competitiveness of Mexican corporations, improving infrastructure, and improving regional equity in development. Private sector development remains a key element in the WBG's current CAS objectives. This PSS expands on the summary discussion of this area presented in the main text of this CAS.

## II. Private Sector Development Priorities

a) Developments since the last PSS

2. Having managed to come through the *peso* and the Asian crises, the Mexican private sector has, in aggregate, shown its resilience to external shocks. The economy grew at a rate of 5.2 percent and 7 percent in 1996 and 1997, respectively, albeit from a post-*peso* crisis low base, and has generally regained its pre-crisis level of activity. Industry showed the strongest sectoral growth (9.3 percent in 1997), followed by service (6.6 percent in 1997), particularly transport and telecommunications. However, the current turbulence in international financial markets will further challenge this resilience.

3. This recovery has not been uniform across the private sector. The series of external shocks have underlined the split nature of the Mexican private sector: on one hand, there are large Mexican and foreign firms, many of which are conglomerates or "maquiladoras" oriented toward exports, with access to foreign financing, and on the other hand, there are smaller Mexican firms and the informal sector, mainly oriented to domestic markets, which use outdated technology, are uncompetitive internationally, and have restricted access even to domestic sources of financing for modernization and expansion. The gap between the two groups appears to have widened during the past economic crises, especially in their differing access to private capital. The small number of firms that had adjusted to globalization have been able to access capital to modernize and expand (see below), but the larger number of small firms that have been left behind have little capital, and have fallen further back. An indicator of this issue is that, in spite of significant export growth since trade liberalization, exports are still highly concentrated among a limited number of large firms, and the import content of exports is quite high. Export

1. The Mexican private sector presently accounts for about 70 percent of GDP and about 86 percent of total employment.
2. WBG, in this context, refers to the IBRD (the International Bank for Reconstruction and Development), the IFC (the International Finance Corporation), and FIAS (the Foreign Investment Advisory Service).

orientation, and its efficiency benefits, has not yet extended to the majority of Mexican firms, and the linkages between the domestic economy and the export sector continue to be weak.[3] As the CEM of August 1998 documented (Report No. 17392-ME), this structure has contributed to Mexico's persistently low productivity growth, despite ten years of trade liberalization, regional trade agreements, privatization, and deregulation.

4. Mexico has been one of the primary beneficiaries of private capital flows to emerging market economies, partly because of Mexico's proximity and attractiveness to the North American capital markets. Table 1 shows the magnitude, relative to other developing countries, of international capital flows prior to the Asian crisis. Average spreads between LIBOR and corporate borrowing rates in Mexico dropped 250 basis points (2.5 percent p.a.) from the beginning of 1996 to September 1997.[4] Even after the Asian crisis, until August 1998, top-tier Mexican firms maintained access to international financial markets (albeit with higher spreads).

**Table 1. Top Recipients of Private Capital Flows**

| | Net private capital flows (US$ billion, 1996) | Percent |
|---|---|---|
| China | 50.1 | 20.3 |
| Brazil | 28.4 | 11.5 |
| Mexico | 23.6 | 9.6 |
| Indonesia | 18.0 | 7.3 |
| Argentina | 14.6 | 5.9 |
| Malaysia | 12.1 | 4.9 |
| All developing countries | 246.9 | 100 |

5. These foreign capital flows (table 2) helped the internationally competitive segment of Mexico's private sector grow strongly in 1996 and 1997. With this has come strong export growth, with exports almost doubling as a percentage of GDP since 1994. The surge in capital flows was primarily led by a strong increase in private debt, followed by foreign direct investment, both of which contributed to modernization of Mexican firms.[5] The Mexican private sector has increasingly relied on external private debt financing for its long-term investment during this period. Carrying forward reforms that could help sustain such financing flows has become a key element in policy considerations, particularly under the current turbulence in international markets.

3. The linkage to the export sector has recently been developing in some areas—for example, some firms are increasingly becoming suppliers to the "maquila" sector.
4. Borrowing spreads for some top Mexican corporates were even lower. For example, one of the IFC's recent clients in Mexico obtained alternative long-term private financing at LIBOR plus 67.5 basis points.
5. As distinct from portfolio investments which primarily represent short-term capital flows for equity investments. The decline in long-term debt from 1996 to 1997 reflects the effect of the Asian crisis in the latter half of 1997.

**Table 2. Net Private Capital Flows to Mexico (US$ million)**

| | 1994 | 1995 | 1996 | 1997 | Percent GDP (1996) |
|---|---|---|---|---|---|
| FDI (net) | 10,973 | 9,526 | 9,186 | 12,478 | 2.8 |
| Portfolio equity | 8,182 | -9,715 | 13,419 | 5,037 | 4.1 |
| Long-term private debt | 5,214 | 5,992 | 12,122 | 6,003 | 3.7 |
| Total | 24,369 | 5,803 | 34,727 | 23,518 | 10.5 |

6. The role of external finance in this recovery has been critical, especially with the difficulty of Mexico's domestic financial sector to provide the capital needed by Mexican firms. The banking sector is still under adjustment, and monetary tightening continues. Credit is limited to the largest companies (at high interest rates) and long-term financing is unavailable for corporates, other than those with access to international finance. Mexico has experienced a significant contraction of credit to the private sector since 1995. While real bank deposits have recovered after some moderate decline in total bank funding, total bank loans and bank lending to the private sector continued to decrease until the first half of 1998, a time when Mexico was experiencing robust GDP growth (table 3). Lack of credit access is a crucial impediment to continued recovery of the economy.[6] Smaller firms that are oriented toward the domestic market—the majority of Mexican firms—face a shortage of domestic long-term financing, which is their only source of investment financing, while top corporates continue to access external financing. Addressing the shortage of financing, particularly for the non–blue chip corporate sector, represents a key priority in achieving broad-based and sustainable growth.

**Table 3. Mexico: Growth without Domestic Credit (percent)**

| Year | Real GDP growth | Changes in real credit to the private sector |
|---|---|---|
| 1995 | -6.2 | -16 |
| 1996 | 5.2 | -22 |
| 1997 | 7.0 | -8 |
| 1998 | | |
| I semester | 5.2 | -2 |
| II semester (e) | 4.5 | -5 |

7. The last PSS identified four priority areas—strengthening the financial sector, enhancing the competitiveness of Mexican corporations, improving infrastructure, and fostering regional development. The records are mixed across and within the sectors. In certain areas, implementation is more advanced. For example, in infrastructure, privatization has progressed in some subsectors (such as railways and airports), while the legal and regulatory framework has improved in others (for example, telecommunications). Progress has been uneven in other areas,

6. A Bank of Mexico survey (September 1997) of a large sample of enterprises shows that "the main factor limiting economic activity was access to financing (19 percent of responses), followed by the condition of the banks (16.9 percent), and a slow recovery of real wages (14.6 percent)."

such as the banking and energy sectors. Weakness in the domestic financial system, particularly the banking sector, continues to be an issue that must be addressed with urgency, although the Government has taken steps to allow greater participation of foreign banks in the sector and has made progress in reforming the pension system. Further improvement in regional development is needed to attend to regional social demand. Given these developments, and the current turbulence in the external environments, the WBG, in consultation with the government of Mexico, has refocused its priorities for private sector development under the present CAS.

b) Private Sector Development Priorities

8. Priority areas under the present PSS are broadly divided into three categories: the financial sector; infrastructure; and removing impediments to competitiveness and fostering its growth. These priorities are interrelated and mutually reinforcing with each other, as well as with other CAS objectives. The strengthening of the banking sector would serve to help prepare the ground for restoring investor confidence and external financing, as well as improving access of the non–blue chip and smaller Mexican firms to investment capital for growth. Improvements in legal and regulatory frameworks in areas such as company law and minority shareholders rights and secured transactions would help reinforce access to domestic financing. Improvements in infrastructure would enhance efficiency and international competitiveness of the Mexican firms—for example, through lower costs and higher-quality services in transportation. Taken together, these measures would help Mexico attain more equitable and sustainable growth through more broadly based and less segmented expansion in the private sector. The remaining paragraphs of this PSS detail these key priorities. Maintaining macro-stability, of course, is a prerequisite for these improvements in private investment, and is a keystone for any of the following private sector development priorities.

FINANCIAL SECTOR

9. Mexico's financial sector consists of commercial banks; national development banks; securities brokerage houses; development trust funds; insurance companies; bonded warehouses; foreign exchange houses; leasing, factoring, and bonding companies; and specialized financial institutions. Of these, commercial banks represent the majority of assets, and this is where most of the problems of "stock" and "flow" are found. It is noteworthy that while real domestic credit to the private sector shrunk over the past three and half years (see table 3, para. 6), gross domestic savings (as a percentage of GDP) grew from 16.9 percent in 1994 to 26.4 percent in 1997, one of the highest in the region. This shows Mexico is facing a growing problem with intermediation of domestic savings. Given this situation and the effects that its improvement could have in reducing the increasingly segmented Mexican private sector (through making available much-needed financing to middle market corporates and SMEs for modernization), addressing banking sector issues is a high priority. The WBG's strategy for assisting the government in the financial sector, therefore, places a primary focus on strengthening the banking sector and increasing the breadth and depth of financial intermediation, particularly in nonbank financial institutions and, initially, to a lesser extent, capital markets. These priorities need to be supported by continued strengthening of the legal and the regulatory framework, as discussed below.

10. (a) *Strengthening of banks' balance sheets.* One of the factors restraining credit to

middle market corporates and SMEs is that a significant portion of banks' assets are represented by noncash earning assets. This lack of liquidity has limited the banks' ability/willingness to extend new credit. Specifically, (i) a significant portion of banks' assets are represented by FOBRAPROA and other government loan restructuring program bonds that do not pay cash interest[7] and (ii) banks' currently have a high level of restructured and past-due loans, affecting income from lending operations (some banks are losing money on their lending operations). Hence the need for banks to access either capital to restructure their balance sheets or some mechanism to increase the liquidity of existing assets to facilitate increased credit to the private sector.

(b) *Nonbank financial institutions and capital markets.* While the immediate priority is the strengthening of the banking sector, nonbank financial institution development is needed to contribute to improved intermediation and resource allocation. Priorities include supporting institutions that usually compliment bank financing to middle-market corporates and SMEs, such as leasing and factoring institutions.

Medium-term priorities to facilitate growth through the broadening and deepening of capital markets include (i) developing an active asset-backed securities market (to facilitate liquidity), (ii) stimulating additional private equity financing institutions (to provide middle-market companies with capital for growth and to encourage good governance), and (iii) increasing the depth of the stock market (also to increase capital availability and promote good governance). In the social sector, the development of housing and education finance institutions needs to be encouraged.

However, more efficient creditor enforcement, better accounting standards, clearer regulations, standardized mortgage and consumer lending products, and increased shareholder rights are required to make significant improvements in this sector. Further developments in the investment regulations for the new private pension system would assist in capital market development by better allocating a significant source of longer-term savings.

(c) *Strengthening of the legal and regulatory framework.* This is critical in supporting the above priorities; specifically, the following legal and regulatory issues need to be addressed:

(i) There are continuing deficiencies in the legal framework underpinning the use of collateral in lending operations. This has put Mexican enterprises at a comparative disadvantage in financing their activities and discourages the development of specialized nonbank financial institutions (such as leasing, factoring, and housing finance), which can be useful in supporting the development of the middle-market and SME sector.

(ii) A weak legal framework for collateral recovery is a major obstacle in the

7. A new law dealing with FOBAPROA (and other financial matters) was passed in the Lower House on December 12, 1998. While the law permits the trading of FOBRAPROA bonds, regulations still need to be promulgated to clarify to what degree the banks will be able to use this asset to increase their liquidity.

resolution of nonperforming loans and a critical factor contributing to a poor repayment discipline, leading to the continued impairment of banks' portfolios.

(iii) While there has been a consolidation of regulatory authority in a single entity (CNBV), progress is still needed to clarify the roles and enhance independence of the regulatory functions.

(iv) CNBV's circular 13438 outlines new accounting rules that tightened, among other items, when past due interest should be recognized, as well as when, and how much of, past-due loans should be provisioned. This has increased transparency, but in some areas (inflation accounting, restructured and past-due mortgage loans, related party lending, and the like) there continues to be room for improvement.

INFRASTRUCTURE

11. Efficient infrastructure services, with higher quality and broader coverage, are critical if the Mexican private sector is to improve its competitiveness and attain equitable and sustainable growth. Mexico's remaining infrastructure deficiencies must continue to be addressed through improvements in regulation, competition, and private sector participation. There has been significant progress in privatization in railways, gas, and ports. The telecommunications market is also becoming increasingly open to private participation. But there have been difficulties in some areas. For example, in toll roads, the government and the companies involved are facing severe financing difficulties, which were later compounded by the *peso* crisis. Private participation in some areas of Mexican infrastructure (for example, power distribution and transmission, oil, and gas) is not as advanced as it is in other Latin American countries at a similar stage of private participation.

**Table 4. Introduction of Private Infrastructure[a]**

| | | Power | | | | | | | | Oil & Gas | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Telecom | Gen | Distr | Trans | Ports | Roads | Railways | Airports | Water | Prod | Distr |
| Mexico | √ | √ | | | √ | √ | √ | √ | √ | | √ |
| Argentina | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ | √ |
| Bolivia | √ | √ | √ | √ | √ | | √ | √ | √ | √ | √ |
| Brazil | √ | √ | √ | √ | √ | √ | √ | √ | √ | | √ |
| Colombia | √ | √ | | | √ | √ | | √ | √ | √ | √ |
| Peru | √ | √ | | √ | | | | | | √ | √ |
| Venezuela | √ | | | | | | | | | √ | |

a. While this table indicates which countries have introduced private capital/management in at least some enterprises in the sector indicated, it should not be interpreted to mean that the overall sector in the country has been privatized. Also, in Mexico, toll roads were once privatized, but are in the public domain at the moment

12. Improvements in infrastructure would address two critical issues for the development of the Mexican private sector: international competitiveness, particularly in the context of NAFTA, and urbanization. As NAFTA has brought liberalization and competition, the Mexican corporate

8. Issued in January 1997.

sector will face an increasing need to remain competitive in the international markets, and it will need higher-quality infrastructure services in electricity and transportation. Growing demands for services (such as water) in the urban areas and the present fiscal tightening will limit the public sector capacity to deliver such high-quality services to the corporate sector, as well as to the broader population. This would necessitate increasing the private sector participation in financing and management in the infrastructure sector to complement the government's effort.

13. Key priorities in this area include:

(a) *Moving forward to increased private participation in the power sector.* Private participation in the power-generation sector seems to have gained some momentum, as shown by the recent government announcement that it will tap the private sector for about $8.4 billion of the $14 billion investment planned for 1999, in addition to the 11 projects already announced or tendered, and the proposed private participation in the electricity sector. This trend is encouraging, and the momentum should be carried forward. Improving the regulatory framework and moving forward to introducing private participation in the areas previously closed to the private sector (generation and transmission) are priority steps.

(b) *Follow through in the subsectors where progress has been made.* In ports, railways, airports, and telecommunications, conditions for private participation have been improved through privatization and a more appropriate regulatory framework, providing a basis for further investment by the private sector. In this area, a priority is second-generation reform, such as further improvements in the regulatory framework, institutional strengthening, and helping the private sector proceed with follow-on investments for up-grading services.

(c) *Improving services and fostering private participation in other sectors.* This category covers a broad range of subsectors, such as urban services (e.g., water and sanitation, housing) and hydrocarbons. In these sectors, which have some manner of constitutional "protection," there has been limited progress in private participation. In water, privatization has fallen short of expectations, partially because of the varying commitments of state water authorities to relinquish control in favor of private operators within a regulated system. Where substantial externalities exist, public provision of infrastructure services plays an important role. To direct the public funds to where real needs are, private participation needs to play an increasing role in providing services where the private sector can replace public provision. To succeed in mobilizing adequate levels of financing in a sustainable manner in these areas, work is needed on a sustained political commitment at all levels of governments to promoting private participation, legal and regulatory frameworks, concession design, tariff and market structuring policies, and subsovereign risks.

REMOVING IMPEDIMENTS AND ENHANCING COMPETITIVENESS

14. The third and last category encompasses broad issues that affect private sector development in Mexico, particularly in helping achieve broad-based, sustainable productivity

growth. They are:

(a) *Removing regulatory, institutional, and administrative impediments.* Deregulation of controls on private investment and commerce must be supported by legal and judicial reforms to provide a level playing field and to ensure enforceability of contracts. Liberalization and decentralization efforts initiated in recent years should now be accompanied by institution building and a higher level of local accountability. At the policy level, this would involve improvements at various levels of government in a number of areas, including contract enforcement, commercial dispute resolution processes and collateral recovery, simplification of regulatory and administrative procedures for doing business, and corporate governance, among other concerns.

(b) *Helping Mexican firms modernize, expand, and improve competitiveness.* The current emerging market turbulence and NAFTA underline the Mexican private sector's strong need to improve its competitiveness through restructuring and modernization. As noted above, a large segment of the Mexican corporate sector suffers a shortage of long-term financing. This segment can be further divided into three subsets. (i) There are needs to help improve efficiency and increase capacity of middle-market companies, to enable them to access export markets or, alternatively, to become efficient suppliers of the "maquiladoras." (ii) The need for operational and financial restructuring is particularly relevant in the SME sector, since this sector lagged in modernization, and the banking system has thus far directed new credits toward larger corporations. (iii) Much needs to be done to improve the regulatory, legal, and financial environments for microenterprises in the rural/regional areas. And last, high costs of financing under the current market conditions are constraining the large corporates' ability to raise new financing for modernization and improvement in competitiveness. The need of these companies would also have to be addressed (particularly if financial market conditions worsen), given their significant impact on the growth of the corporate sector.

(c) *Introducing private participation in social services.* The continuing fiscal tightening has highlighted the importance of tapping private sector resources in the social program. The government is moving forward with a Bank-supported health system reform, which focuses on the introduction of market mechanisms in the Mexican Social Security Institute (IMSS) system; changes in health insurance schemes to allow consumers to opt in and opt out of IMSS insurance; and a change in the financing of the premium structure through modification. Promoting a greater role for the private sector under the reform program is a priority. In education, too, private participation, particularly at higher education levels (for example, university, student loans), would create a fiscal space for areas that require public funding.

## III. WORLD BANK GROUP ASSISTANCE STRATEGY

15. This section outlines the respective roles of various components of the World Bank Group (WBG) assistance in private sector development in Mexico. As noted in the main text of this CAS, a degree of flexibility in the WBG's strategy under the present PSS will be maintained in order to allow for unexpected changes in the external environment or the pace of reform. The different institutions of the World Bank Group have developed distinct but coordinated strategies to assist Mexico in addressing the priorities for private sector development. The WBG's overall private sector strategy is formulated to help Mexico attain socially sustainable adjustment and growth by helping foster broad-based, long-term growth in the productivity of the sector. At a strategic level, the ***IBRD's*** overall approach to supporting private sector development in Mexico is to assist the government in (a) assuring a viable macroeconomic framework; (b) improving efficiency and transparency of the financial sector; (c) ensuring the provision of quality infrastructure; and (d) removing impediments to broad-based private sector development.

16. The ***IFC's*** strategy complements that of the IBRD, and is centered on three themes: (a) helping the Mexican private sector regain access to external private financing; (b) helping improve the efficiency of domestic financial intermediation, as well as mobilizing additional domestic resources; and (c) helping private firms grow and improve international competitiveness. Relative emphasis across these themes, and the overall level of IFC activities, could vary considerably over the CAS period, depending on the extent of Mexico's access to international financial markets and the pace of regulatory reform. The IFC's main areas of concentration are expected to be: (a) financial support for the corporate sector, including middle-market companies and SMEs; (b) the financial sector; (c) private infrastructure; (d) agribusiness; and (e) support for sectors newly opened to further private participation, including the social, housing, health, and education sectors.

17. Taken together, the approaches and activities of the IBRD and IFC have increasingly been complementary and mutually reinforcing in helping Mexico address its private sector development objectives. For example, in the financial sector, the IBRD's assistance in enhancing the legal and regulatory environment and the strengthening of the banking sector would help set the stage for the IFC's increased involvement in direct and indirect assistance to viable Mexican financial intermediaries. In nonlending assistance, the IBRD and IFC are also collaborating to study the Mexican capital markets and nonbank financial institutions. In infrastructure, a number of subsectors where the IBRD's assistance has helped the government improve the regulatory framework have provided increasing opportunities for the IFC's sequential involvement in helping structure and mobilize a financial package for pioneering private infrastructure projects (for example, ports, power, telecommunications). For SMEs, the IBRD is considering possible SME development pilots through business development services, which would draw on the IFC's experience with impediments to private sector development generally, with SMEs, and with business development services. This would also support the IFC's increasing focus on providing financial assistance for SMEs and middle-market companies.

18. At a sectoral level, the following paragraphs summarize the role of the agencies of the WBG in the three priority areas of private sector development: (i) financial sector; (ii) infrastructure; and (iii) removing impediments to competitiveness and enhancing its growth.

a) Financial Sector

19. In the context of the current turbulence in the international market and lessons learned through the past crises, the WBG's strategy places a high priority on the strengthening of the Mexican financial sector, particularly the banking sector. A critical role of the WBG is to continue support for legal, regulatory, and institutional reform in the banking sector and, more generally, to improve financial intermediation.

20. The ***IBRD*** will attempt to strengthen banks' balance sheets through a multi-pronged lending program. It will examine the new deposit insurance fund (IPAB) regulations and the accompanying law to see if there is a basis for a structural adjustment loan in FY00. This loan would support IPAB's operations and assist in the orderly liquidation of distressed assets. Along this line, the IBRD can also help FOBAPROA (or IPAB, as the successor institution) finance fiscal losses as they become explicit when banks' assets are sold. This will (i) crystallize the amount of contingent liability that the banks will have to address, thereby removing some uncertainty in the market and encouraging new capital, and (ii) provide some liquidity to FOBAPROA/IPAB for the ongoing restructuring/liquidating of nonperforming loans. Finally, IBRD will explore with the relevant authorities the possibility of a "Bank Capitalization Trust Fund" to assist weaker banks in their merger and/or restructuring plans. This should help individual banks attract new capital and provide some liquidity from existing assets, eventually increasing credit to the private sector. While discussion of the above program is under way, the IBRD will continue to focus on the legal reform agenda (including secured lending and collateral recovery issues). As reforms are implemented, the IBRD is expected to support the required infrastructure through a loan. Once completed, it is expected that there will be faster resolution of non-performing loans and increased financing activity (especially by the nonbank financial institutions), which should benefit the middle-market and SME sectors.

21. The IBRD will, in some cases jointly with the IFC, undertake sector studies. The objective of these studies is to ensure that the WBG and the government of Mexico have a clear understanding of the status of these sectors and to provide a basis for discussion of how to implement improvements. Areas for updated or new studies are in the banking sector, nonbank financial institutions, and capital markets.

22. The ***IFC***'s main objectives in the financial sector are to (i) increase the banking sector's support for Mexican middle-market firms and SMEs, and (ii) help further develop capital markets and nonbank financial institutions. Support will continue to be achieved mainly through credit lines with the more creditworthy Mexican banks, as well as through private equity funds. These lines assist in the bank's development through the need for the institutions to properly evaluate sub-borrowers to ensure asset quality. These lines also help improve the use of strict financial discipline, both in the banking and corporate sectors. Recent credit line structures attempt to promote a transfer of good practice, with subloans having also to pass an IFC-supervised review.

23. In nonbank financial institutions, the IFC will continue to support viable leasing and factoring institutions as these types of specialized financial institutions promote credit to middle-market companies and SMEs. Investment funds that mainly target the needs of middle-market companies and SMEs will also be evaluated. However, this sector continue to be constrained by

the lack of an efficient creditor enforcement system, clear regulations, and minority shareholder rights.

24. In institutions supporting the social sectors, the IFC will continue to support housing finance and will explore opportunities in education finance (student loans). However, the lack of standardized mortgage and consumer lending products, as well as an efficient creditor enforcement system, constrains this subsector's development.

b) Infrastructure

25. The core strategic objective of the WBG in infrastructure is to ensure the provision of quality infrastructure that can provide a basis for sustainable growth and poverty reduction. Within this framework, the WBG's strategy includes four objectives that have direct linkage to private sector development:

(i) Establish greater private sector participation and competition in the provision of infrastructure services.

(ii) Establish and/or enhance legal and regulatory frameworks conducive to private participation and improved services, particularly in telecommunications, energy, and electricity.

(iii) Improve response to growing needs in urbanization, through developing financial and capital markets instruments for infrastructure financing, for example, subsovereign infrastructure (e.g., water) and housing.

(iv) Direct (IBRD) financing support to publicly funded infrastructure when adequate private investment is unlikely to be forthcoming.

26. In support of the government's efforts toward greater private participation in infrastructure, the ***IBRD*** will focus its assistance on the development of a framework for greater private participation, primarily in electricity, but also in other urban services. The IBRD's instruments could be a broad-based sector adjustment loan, given adequate policy commitment, and technical assistance for regulation in areas such as energy and housing. In electricity, an important area of focus would be to help design an overall balance of private participation in the electricity sector (that is, generation, transmission, and distribution), which could maximize the benefits of increased private participation, taking into account political constraints and social requirements. Private sector participation also needs to be supported through sustained legal and regulatory reform. The progress that has been achieved in various subsectors—such as ports, railways, gas, and telecommunications—needs to be sustained with an adequately functioning regulatory system. The IBRD has an ongoing informal advisory role in assisting the government, particularly in energy and telecommunications. Also, at the government's request, the IBRD will conduct a cross-sectoral assessment of the infrastructure regulatory framework and private participation under a country infrastructure framework study.

27. The use of the IBRD's lending instruments is envisaged in areas where the existence of externalities warrants its direct assistance. At one end of a continuum of possibilities, this would involve support for analysis (through technical assistance) and funding for design and implementation of a scheme to help housing finance for very-low-income segments of the

population, as well as assistance for municipal finance and credit enhancement. At the other end of the continuum, the IBRD's direct financial support would entail financing for federal highways and state roads. The IBRD's support in this regard is envisaged to include strategy-design work and project lending. The IBRD's assistance may be extended to other areas critical to urban infrastructure, such as water and sanitation, solid wastes, urban transport, and housing,[9] when private sector investment and financing are not likely to be attracted to projects in these areas.

28. Drawing on the synergy of the activities of the IBRD and the IFC, the ***IFC*** will place its focus in infrastructure on direct financing support (including mobilization) for private infrastructure projects. The IFC has invested in power generation, ports, wastewater treatment, and a toll road in Mexico, and will continue to support viable projects in sectors where privatization and regulatory reform are sufficiently advanced for private infrastructure. The IFC's main areas of activity include:

(i) continuing support for projects in deregulated sectors such as transport, and

(ii) subject to adequate progress in regulatory and concession frameworks, support for projects with demonstration effects in sectors opened to private participation, such as:

- Power distribution and transmission,
- telecommunications,
- railways,
- water and sanitation, waste treatment, and
- gas.

The IFC's involvement in hydrocarbons and petrochemicals will be subject to a clear and adequate definition of the private sector role, and progress in the legal and regulatory environment. In addition, the IFC is exploring ways to mitigate subsovereign risks in infrastructure financing (as in the water sector).

c) Removing Impediments and Fostering Competitiveness

29. In this category of private sector development priorities, as in the other categories, the activities of the IBRD and the IFC complement one another, and focus on their respective comparative advantages. The IBRD will focus primarily on helping the government remove legal and regulatory impediments and helping create frameworks more conducive to private sector investments. The IFC will concentrate on financial assistance, helping channel long-term financial flows to private firms that require investment funding, and helping to improve their access to external financing. In making assessments of the private sector and impediments to its development, both agencies will collaborate with each other in a number of areas (for example, the financial sector, SMEs).

[9] Such assistance will need to be accompanied with assistance in establishing an appropriate decentralization framework.

30. The ***IBRD's*** activities are guided by three common objectives of the government in this area: removing remaining policy impediments in the business environment, reforming industrial promotion, and fostering private sector development in regions lagging development. A particular emphasis will be put on helping the Mexican private sector attain broad-based, long-term productivity growth. In view of the ongoing decentralization, the IBRD's support will progressively move toward the state and provincial levels. A series of private sector assessments will assist local governments in identifying and formulating policy reform on constraints to balanced private sector development, which could be addressed at local levels. The IBRD also expects to fill a significant role as knowledge broker for private-public collaboration at a decentralized level through a number of means, such as private-public seminars and dissemination of best practices (in collaboration with the Business Partners for Development Initiative and the Inter-American Foundation). Rationalization and decentralization of the federal industrial promotion programs will be explored. Lending and sector work in the area of competitiveness will also increasingly shift their focus toward provincial and less-developed areas.

31. Also critical in the area of removing constraints to private sector development are issues of effective governance. In this context, IBRD envisages nonlending and lending support to provide assistance in commercial dispute resolution and public governance, subject to the government's strong interest in such a reform. Improvements in this area, such as expeditious dispute resolution, improved commercial contract enforcement, and improved governance, are critical in fostering private investment and efficiency in business (especially in the segments of smaller businesses), because they would reduce the financing costs associated with risks of prolonged and unpredictable legal processes and the hidden transaction costs arising from rent-seeking.

32. The last, but not the least, element of IBRD's strategy in this category is to further private sector involvement in the social sector, particularly health and pension reform. Assistance will be provided in the context of overall health sector strategy, which envisages a number of lending and nonlending operations. Particular support for private sector participation will be provided through assistance in analysis and design of private health care deregulation, in the introduction of market mechanisms in the IMSS system, and in changes in health insurance schemes.

33. In support of the WBG's objectives in this area, the ***IFC*** will focus on providing financial support for Mexican private firms, which require financing for investments for modernization and/or expansion and strengthening of their balance sheets. The IFC's assistance will take both a wholesale and a direct financing approach. In the wholesale approach, the IFC will work with local financial intermediaries or help establish specialized institutions (such as leasing and factoring companies) capable of providing financing for middle-market companies and SMEs. The IFC's direct financial assistance will be primarily targeted at larger corporations, including middle-market companies, where the IFC's direct involvement is more cost-effective and the IFC plays a significant role in catalyzing financing, improving corporate governance, and/or bringing about development impact. Pulling together the WBG's experience and expertise in helping the SME sector, the IFC also expects to collaborate with the IBRD in studying the possibility of SME development pilots.

34. Across industry and services, the IFC will focus particularly on middle-market companies and SMEs. The need for operational restructuring and access to longer-term financing is particularly relevant for middle-market companies and SMEs, since this sector has lagged considerably in modernization. In addition to credit lines, the IFC will seek to further develop financial instruments and markets critical to SME development, such as private equity and venture capital funds, and will also maintain its investment in a venture capital fund in Chiapas for regional development. Direct financing will also be used to encourage good corporate governance, better accounting standards, management professionalization, and eventual public offerings to diversify the companies' funding sources.

35. In sectoral focus, the IFC's areas of concentration include the financial sector, infrastructure, general industry (as noted above), agribusiness, services, and the social sector, including private health and education. In agribusiness, an emphasis will be placed on helping regional development through support for segments such as poultry, meat processing, and dairy products. In the social sector, the IFC will support the early initiatives by the private sector to create and rehabilitate the medical infrastructure, as well as the financing options to meet the expected growth in the private health care brought about by the social security reforms recently implemented. As noted earlier, the overall size of the IFC's activities will depend largely on the level of the Mexican private sector's access to international financial markets, and progress in reform.

**Mexico**
**STATEMENT OF IFC's**
**Committed and Disbursed Portfolio**
As of 31-Dec-98
(US$ millions)

| | | Committed | | | | Disbursed | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | IFC | | | | IFC | | | |
| FY Approval | Company | Loan | Equity | Quasi | Partic | Loan | Equity | Quasi | Partic |
| 1984/87/94/96 | Metalsa | 0.00 | 0.00 | 6.00 | 0.00 | 0.00 | 0.00 | 6.00 | 0.00 |
| 1988/91/92/93/95 | Apasco | 19.20 | 0.00 | 0.00 | 86.80 | 19.20 | 0.00 | 0.00 | 86.80 |
| 1988/94/95 | Sigma | 0.00 | 5.00 | 0.00 | 0.00 | 0.00 | 5.00 | 0.00 | 0.00 |
| 1989 | Cemex | .93 | 0.00 | 0.00 | .50 | .93 | 0.00 | 0.00 | .50 |
| 1989 | Grupo FEMSA | 0.00 | 9.43 | 0.00 | 0.00 | 0.00 | 9.43 | 0.00 | 0.00 |
| 1990 | Petrocel | 3.90 | 0.00 | 1.80 | 2.10 | 3.90 | 0.00 | 1.80 | 2.10 |
| 1990/91 | Condumex | 6.20 | 0.00 | 0.00 | 2.55 | 6.20 | 0.00 | 0.00 | 2.55 |
| 1990/92/96 | BANAMEX | 56.26 | 0.00 | 0.00 | 84.89 | 53.86 | 0.00 | 0.00 | 84.89 |
| 1991 | CEDETEL | 2.50 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 1991 | Vitro Flotado | 9.92 | 0.00 | 0.00 | 4.14 | 9.92 | 0.00 | 0.00 | 4.14 |
| 1991/96 | GIBSA | 27.05 | 0.00 | 10.00 | 90.95 | 27.05 | 0.00 | 10.00 | 90.95 |
| 1992 | Banorte-SABROZA | 3.00 | 0.00 | 0.00 | 0.00 | 3.00 | 0.00 | 0.00 | 0.00 |
| 1992 | Toluca Toll Road | 7.78 | 0.00 | 0.00 | 0.00 | 7.78 | 0.00 | 0.00 | 0.00 |
| 1992/91 | Vitro | 0.00 | 10.17 | 0.00 | 0.00 | 0.00 | 10.17 | 0.00 | 0.00 |
| 1992/93/95/96 | Grupo Posadas | 24.88 | 5.00 | 5.00 | 40.58 | 24.88 | 5.00 | 5.00 | 40.58 |
| 1992/96/97/98 | Grupo Probursa | 0.00 | 10.16 | .21 | 0.00 | 0.00 | 10.16 | .21 | 0.00 |
| 1993 | Derivados | 5.50 | 0.00 | 0.00 | 9.03 | 5.50 | 0.00 | 0.00 | 9.03 |
| 1993 | GIDESA | 10.00 | 8.00 | 0.00 | 17.00 | 10.00 | 8.00 | 0.00 | 17.00 |
| 1993 | GOTM | 1.29 | 0.00 | 0.00 | 1.10 | 1.29 | 0.00 | 0.00 | 1.10 |
| 1993 | Masterpak | 6.00 | 0.00 | 0.00 | 9.72 | 6.00 | 0.00 | 0.00 | 9.72 |
| 1994 | CTAPV | 4.34 | 0.00 | 2.53 | 0.00 | 4.34 | 0.00 | 2.53 | 0.00 |
| 1994 | Interceramic | 11.00 | 0.00 | 6.00 | 8.75 | 11.00 | 0.00 | 6.00 | 8.75 |
| 1994/96/98 | Aurum-Heller | 0.00 | 2.80 | 0.00 | 0.00 | 0.00 | 2.80 | 0.00 | 0.00 |
| 1995 | Baring Venture | 0.00 | 9.09 | 0.00 | 0.00 | 0.00 | 7.27 | 0.00 | 0.00 |
| 1995/96 | Baring Mex. FMC | 0.00 | .18 | 0.00 | 0.00 | 0.00 | .17 | 0.00 | 0.00 |
| 1995/99 | Mexplus Puertos | 0.00 | 4.45 | 0.00 | 0.00 | 0.00 | 3.28 | 0.00 | 0.00 |
| 1996 | GIRSA | 30.00 | 0.00 | 10.00 | 115.00 | 30.00 | 0.00 | 10.00 | 115.00 |
| 1996 | NEMAK | 0.00 | 0.00 | 6.00 | 0.00 | 0.00 | 0.00 | 6.00 | 0.00 |
| 1997 | Banco Bilbao MXC | 80.00 | 0.00 | 30.00 | 0.00 | 50.00 | 0.00 | 30.00 | 0.00 |
| 1997 | Comercializadora | 6.00 | 0.00 | 0.00 | 7.50 | 6.00 | 0.00 | 0.00 | 7.50 |
| 1997 | Fondo Chiapas | 0.00 | 5.00 | 0.00 | 0.00 | 0.00 | .19 | 0.00 | 0.00 |
| 1997 | Gen. Hipotecaria | 0.00 | 1.43 | 0.00 | 0.00 | 0.00 | 1.43 | 0.00 | 0.00 |
| 1997 | Grupo Minsa | 20.00 | 10.00 | 0.00 | 30.00 | 20.00 | 10.00 | 0.00 | 30.00 |
| 1997 | TMA | 5.10 | 0.00 | 0.00 | 10.40 | 5.10 | 0.00 | 0.00 | 10.40 |
| 1998 | CIMA Mexico | 0.00 | 4.80 | 0.00 | 0.00 | 0.00 | 4.80 | 0.00 | 0.00 |
| 1998 | Forja Monterrey | 13.00 | 3.00 | 0.00 | 13.00 | 11.00 | 3.00 | 0.00 | 11.00 |
| 1998 | Grupo Calidra | 12.00 | 6.00 | 0.00 | 10.00 | 3.82 | 6.00 | 0.00 | 3.18 |
| 1998 | Grupo Sanfandila | 10.00 | 0.00 | 0.00 | 5.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| 1998 | Merida III | 30.00 | 0.00 | 0.00 | 73.95 | 10.39 | 0.00 | 0.00 | 25.61 |
| 1998 | Punta Langosta | 4.00 | 1.00 | 0.00 | 7.00 | 2.76 | 1.00 | 0.00 | 4.84 |
| 1998 | ZN Mxc Eqty Fund | 0.00 | 25.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Total Portfolio: | | 409.85 | 120.51 | 77.54 | 629.96 | 333.92 | 87.70 | 77.54 | 565.64 |

| | | Approvals Pending Commitment | | | |
|---|---|---|---|---|---|
| | | **Loan** | **Equity** | **Quasi** | **Partic** |
| 1997 | ALTAMIRA | 17.80 | 0.00 | 1.00 | 38.00 |
| 1998 | AYVI | 10.00 | 0.00 | 0.00 | 0.00 |
| 1997 | CHIAPAS FMC | 0.00 | .02 | 0.00 | 0.00 |
| 1998 | CIMA HERMOSILLO | 7.00 | 0.00 | 0.00 | 0.00 |
| 1998 | CIMA PUEBLA | 7.00 | 0.00 | 0.00 | 0.00 |
| 1998 | HIPOTECARIA EQ | 0.00 | 1.20 | 0.00 | 0.00 |
| 1999 | NEMAK RI | 0.00 | 0.00 | .70 | 0.00 |
| Total pending commitment: | | 41.80 | 1.22 | 1.70 | 38.00 |

IBRD 23547


FEBRUARY 1992