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President Wolfensohn - Briefings Books for Presidents Meetings - Meeting Materia
Discuss Mexico - Country Assistance Strategy [CAS] Review - November 4, 1996

~~Mexico: Joint Bank-IFC CAS Review~~

~~Monday, October 7, 1996~~
~~4:30 - 5:30 pm~~
~~E1227 Conference Room~~

Board date = Nov 5
canceled.

Meeting: Mexico CAS

Monday, November 4, 1996
4:30 - 6:30 p.m.
E1227 Conference Room

Archive Management for the President's Office

Document Log

Reference # : Archive-00912

IPS

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A. CLASSIFICATION

- [x] Meeting Material
- [ ] Trips
- [ ] Speeches
- [ ] Annual Meetings
- [ ] Corporate Management
- [ ] Communications with Staff
- [ ] Phone Logs
- [ ] Calendar
- [ ] Press Clippings/Photos
- [ ] JDW Transcripts
- [ ] Social Events
- [ ] Other

B. SUBJECT: Meeting to discuss Mexico: CAS Review
ATTENDEES: JDW, Koch-Weser, Kaji, Frank, Sandstrom, Lindbaek, Einhorn, Shihata, Squire, Burki, Zhang. Malloch Brown, Lafourcade, Dahlman (optional), Paul, Lastres, Adams, Swannack-Nunn, Soladay, Cracco, Salop, Qureshi, Assaad, Horiguchi
VENUE: E1227 Conference Room (4:30 - 6:30 p.m.)
Brief Included:
---Agenda (via Em) from Joanne Salop, November 1, 1996 (visiting Moscow)
---Board document: Mexico: Joint IBRD/IFC Country Assistance Strategy R96-207 / IFC/R96-204
---Memo from Messrs. Burki and Adams (09/30/96) - Mexico CAS: EXCOM Review

DATE: 11/04/96

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E. COMMENTS:

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A L L - I N - 1 N O T E

DATE: 01-Nov-1996 06:08am EST

TO: See Distribution Below

FROM: Joanne Salop - Moscow visitor, EXC (JOANNE SALOP@A1@MOSCOW)

EXT.:

SUBJECT: Mexico CAS: Meeting with Mr. Wolfensohn

Further to Ms. Horiguchi's EM on the above, a proposed agenda of issues for discussion at Monday's meeting is attached.

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Mexico CAS: November 4 Meeting with Mr. Wolfensohn

1. The October 7 meeting that Mr. Wolfensohn chaired on the Mexico CAS concentrated on the following issues:

* Poverty in Mexico, its causes and concentration and what the Bank Group is doing to address it -- including in the Southern States Initiative and other activities.

* The tight leash on which the Government has tried to keep the Bank, the Bank's recent attempts to broaden its dialogue to other actors in Mexico including civil society, and the Government's reactions to these attempts.

* The Government's more relaxed attitude toward IFC activities, and IFC's ability to work in a practical on-the-ground way with high-profile issues, such as privatization, and other issues that are proving important for the economic recovery, such as enterprise restructuring and financing for small- and medium-scale firms.

* Mexico's creditworthiness and the risks to the Bank of the Mexico program, including in the financial sector.

* The process of preparing the joint Bank/IFC CAS, including the interaction between Bank and IFC staff and management and with the Government.

Because time at that meeting was so short, these issues were generally not discussed in very much depth.

2. The CAS was subsequently distributed to Executive Directors on October 15 for discussion on November 5. On October 22, the Government registered concerns about the document, citing several presentational concerns and substantive concerns in three areas:

* Bank involvement in legal and judicial reform.

* Privatization in general, and in the energy sector in particular.

* Bank dialogue and working relations with NGOs, civil society, and stakeholders.

The CAS is currently being amended and Executive Directors will now discuss it on December 17, along with the proposed Contractual Savings Loan and DEC's paper on the Bank's Response to Crises. (The latter grew out of the review of the Mexico program that the Managing Directors, Operations had requested DEC to undertake.)

3. Against this background, the following agenda items are proposed for the November 4 meeting:

First, the Region may wish to update the meeting on the

Government's concerns and the current state of play on the CAS. Do the former reflect new developments that will circumscribe the Government's room to maneuver on the policy front? Or do they simply reflect concerns with managing public opinion, given the fact that the CAS may find its way into the hands of the press.

Second, participants may wish to consider the implications of the concerns raised for the Bank's activities in Mexico and for the visibility risks of the new office in Mexico City. How are these risks to be be managed? An important thrust of the CAS was to open up the dialogue with other parties -- both inside and outside Government. Is this now to be put on hold? How does this affect our work on the Southern States Initiative and other social development activities that involve civil society?

Third, participants may wish to discuss the implications (especially of the concerns voiced about privatization) for IFC activities -- in light of the fact that some 20 percent of IFC's FY97 investments are programmed for the energy sector. Or is this an example of the phenomenon discussed on October 7, in which the policy issues of interest to the Bank may stall even as transactions embodying the policy may proceed with IFC's on-the-ground support?

Fourth, participants may want to follow-up on the discussion of the downside risks in the Mexico program and the links to the financial sector that was initated at the October 7 meeting. What are the risks of another financial crisis? What would such a crisis look like and what would be the implications for the financial sector? How would the Bank Group respond?

Fifth, participants may wish to discuss whether the CAS adequately reflects the lessons learned from the DEC review -- both in terms of emergency preparedness (per the above question) and in terms of pulling together the staff firepower to deliver sufficiently high-quality lending and non-lending services to satisfy our Mexican clients' needs.

① p26 –

② p13 – Myonarv. par 31

③ p14. 15 – Petrochemicals + Power

④ Civil society must be replaced by community participation
Marcel + Bonhoeffer – Thiago

[redacted] = list of attendees

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: October 30, 1996 04:19pm

TO: See Distribution Below

FROM: Lai Foong Goh, EXC (LAI FOONG GOH@A1@WBHQB)

EXT.: 80388

SUBJECT: MEXICO CAS MEETING WITH MR. WOLFENSOHN
SCHEDULED FOR: MONDAY, NOVEMBER 4 @ 4:30 P.M.

Your attendance is requested at the meeting with Mr. Wolfensohn to discuss issues regarding the MEXICO CAS, which is scheduled for Monday, November 4 from 4:30 to 6:30 p.m., in conference room E1227. Please advise only if you are unable to attend.

Questions regarding this meeting and/or related briefing materials should be directed to Ms. Atsuko Horiguchi at ext. 84256.

Many thanks.

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= list of attendees

A L L - I N - 1 N O T E

DATE: 18-Sep-1996 04:12pm

TO: See Distribution Below

FROM: Atsuko Horiguchi, EXC (ATSUKO HORIGUCHI)

EXT.: 84256

SUBJECT: MEXICO: Joint Bank-IFC CAS Review with Mr. Wolfensohn
Monday, October 7, 4:30-5:30 pm (NEW DATE, TIME & INVITEES)

Your attendance is requested at a meeting to review the first Bank-IFC joint CAS for Mexico (N.B. new Board date: Tuesday, November 5). This meeting will be chaired by Mr. Wolfensohn and take place on Monday, October 7, 4:30-5:30 pm, in conference room E12-27.

* The CAS package will be distributed jointly by Messrs Adams and Burki to invitees to this meeting by Friday, September 27.

* Ms. Salop will be sending the agenda for this meeting via EM to invitees to this meeting by Wednesday, October 2.

* Ms. Salop will also provide the briefing package for the President (2 copies -- E12-29) by c.o.b. Wednesday October 2.

not ready (Fri 19/4) - will be faxed to NY Sat or Sun.

Please feel free to call me (x84256) with any questions regarding this meeting.

Atsuko

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JDW

This EM came from Olivier in response to the question you fielded at the press conference on Thursday from the Mexican reporter (about the Bank's office being "more than an embassy"). The reporter implied that Olivier was setting up the Bank office in Mexico to interfere with the government.

You set the record straight and said that Olivier must have been misquoted. Olivier's response confirms this.

Josie
10/4

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: October 4, 1996 11:20am EST

TO: Caio Koch-Weser (CAIO KOCH-WESER)

FROM: Olivier Lafourcade, LAMXC (OLIVIER LAFOURCADE)

EXT.: 34880

SUBJECT: Mr. Wolfensohn's Press Conference

Caio,

I found out yesterday afternoon about the incident at Mr. Wolfensohn's Press Conference regarding Mexico and my alledged comments in the context of my own recent dealings with the Mexican Press.

The Mexican journalist who asked the question to Mr. Wolfensohn is Mr. Esquivel who, I discovered later on, does have a history of being difficult and somewhat mischievous in his reporting. His treatment of the issue and his angle on the story is more than dis-ingenuous.

In his question to Mr. Wolfensohn, the journalist made a quote from me to the effect that our Office in Mexico would be "more than an embassy".

The transcript of my press conference (at a luncheon on monday) clearly indicates that I did say these words.

What I was refering to was the functioning of our new Office in Mexico, in comparison with the previous Resident Mission Office of a more traditional nature, and in the context of our overall relationship with Government. So, to the observation of one of the participants ("it is an embassy, then") I did respond: "it's more than an embassy".

I believe it was clear to everyone in the room what I was talking about, and I am literally flabbergasted that someone could imply from it that I would claim our office would be more than a regular embassy (as a matter of fact, later on I also said that we were only one of the many partners of Mexico, and one with a relatively small weight compared to our place in other part of the world, e.g. in Africa).

I am particularly upset with the information that the journalist had posed the same dis-ingenuous question to Minister Ortiz in a previous interview. Ortiz was reportedly upset too, and with good reasons.

This incident is unfortunate, and will teach me to be doubly

careful in dealing with the press in Mexico. As you know, I have been dealing with the media for more than 10 years (countless interviews on radio, television, press conferences etc. as Director of the Paris Office and as Director of Africa I and IV -- from the trivial to the tricky and sometimes very sensitive issues such as the CFA devaluation saga). At times, I have been mis-interpreted, sometimes mis-quoted. This is the first time however that I find someone who deliberately fully distorts the sense and nature of what I said.

I was truly delighted and grateful for Mr. Wolfensohn's response to the journalist, of course. His comments on the role of our office in Mexico have already been reported in the Mexican press (e.g. in today's "Reforma"). Mr. Wolfensohn would probably be interested in what was behind the question and may be interested in this short note of explanation. Please advise if there is anything else you wish me to do.

Thanks

Olivier

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For consideration on
Tuesday, November 5, 1996

R96-207
IFC/R96-204

FROM: The Deputy Secretary

October 15, 1996

MEXICO: Joint IBRD/IFC Country Assistance Strategy

Attached is a Joint IBRD/IFC document entitled "Country Assistance Strategy of the World Bank Group for the United Mexican States" (Report No. 16056-ME).

A paper entitled "Note on the Lessons for the World Bank of the Mexican Crisis" is being distributed separately (SecM96-1053).

Questions on this document should be referred to Mr. Zia Qureshi (Bank, x85285) or Mr. John Soladay (IFC, x39713).

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President's Executive Committee
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Report No. 16056-ME

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

OCTOBER 15, 1996

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CURRENCY EQUIVALENT

Currency Unit	=	Mexico New Peso (MexN$)
US$1.00	=	MexN$7.615 (October 10, 1996)

ABBREVIATIONS AND ACRONYMS

ABS	Asset Backed Securities
AFORES	Administradoras de Fondos para el Retiro (Pension Fund Administrators)
ARCS	Audit Reports Compliance System
ABS	Asset Backed Securities
BIS	Bank for International Settlements
CEM	Country Economic Memorandum
CFE	Comisión Federal de Electricidad (Federal Electricity Commission)
CIMO	Programa de Calidad Integral y Modernización (Productivity Enhancement Program)
CNBV	Comisión Nacional Bancaria (National Banking Commission)
EDI	Economic Development Institute
EFF	Extended Fund Facility
ESW	Economic and Sector Work
FIAS	Foreign Investment Advisory Service
FIRA	Fideicomisos Instituidos en Relación con la Agricultura (Trust Fund for Agriculture)
FOBAPROA	Fondo Bancario de Protección al Ahorro (Bank Fund for Savings Protection)
FOVI	Fondo De Operación Y Financiamiento Bancario a la Vivienda (Bank Housing Finance Fund)
FOVISSSTE	Fondo para la Vivienda de los Trabajadores del ISSSTE (Government Workers' Housing Fund)
FSRL	Financial Sector Restructuring Loan
FTAL	Financial Technical Assistance Loan
GAB	General Arrangements to Borrow
GAAP	Generally Accepted Accounting Principles
IDB	Inter-American Development Bank
IDF	Institutional Development Fund
INFONAVIT	Instituto del Fondo Nacional de la Vivienda de los Trabajadores (National Workers' Housing Fund Institute)
MBS	Mortgage Backed Securities
NAFIN	Nacional Financiera, S.N.C.
NAFTA	North American Free Trade Agreement
NGO	Non-Governmental Organization
O&M	Operations and Maintenance
PARE	Programa para Abatir el Rezago Educativo (Bank's first Primary Education Project)
PEMEX	Petróleos Mexicanos
PESE	Programa Especial de Empleo (Special Employment Program)
PROBECAT	Programa de Becas de Capacitación para Trabajadores (Labor Retraining Program)
PROCEDE	Programa de Certificación de Derechos Ejidales y Titilación de Solares Urbanos (Program for Certification of Ejido Rights)
PROCAMPO	Programa de Apoyos Directos al Campo (Farm Support Payments Program)
PRODUCE	Agricultural Services Program
PROFORESTAL	Forestry Program
PRONASOL	Programa Nacional de Solidaridad (National Solidarity Program)
PROSSE	Programa de Servicios Sociales Esenciales (Program of Essential Social Services)
PTAL	Privatization Technical Assistance Loan
SAGAR	Secretaria de Agricultura Ganadera y Desarrollo Rural (Ministry of Agriculture and Rural Development)
SAR	Sistema de Ahorro para el Retiro (Retirement Saving System)
SME	Small and Medium Enterprises
SOFOL	Sociedad Financiera de Objeto Limitado (Limited Purpose Bank)
SSI	Southern States Initiative
UCABE	Unidad Coordinadora para el Acuerdo Bancario Empresarial (Bank Enterprise Workout Coordinating Unit)

Mexico
Country Assistance Strategy

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Table of Contents

I. Introduction 1

II. Economic and Social Context 2

III. Mexico's Development Agenda 4

IV. Economic Outlook and Risks 7

V. Mexico-Bank Group Development Partnership 10

- Growth with Stability 10
- Social Development 16
- Modernization of the State 18
- Portfolio Management 19

VI. Instruments of Partnership 20

VII. Size of Bank Group Program, Country Risk and Creditworthiness 22

VIII. Collaboration with Other Organizations 25

IX. CAS Priorities, Success Criteria and Risks 26

X. Agenda for Board Consideration 27

Annexes

1. Bank Portfolio Matrix
2. Bank Program of Lending and Non-Lending Services
3. Bank Fact Sheet
4. IFC Portfolio and Investment Program
5. Economic and Exposure Indicators
6. Mexico at a Glance

Attachment

Private Sector Strategy Paper

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LIST OF TEXT TABLES, CHARTS, AND BOXES

Table 1: Summary of Economic Indicators
Table 2: Summary Indicators of External Exposure
Table 3: Mexico Country Assistance Strategy Matrix, 1997-99
Table 4: Alternative Bank Lending Scenarios

Chart 1: Incidence of Poverty
Chart 2: Bank Exposure Ratios

Box 1: Bank Group's Crisis Response in Mexico: An Update

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 STATES OF MEXICO

I. INTRODUCTION

1. The FY97 Mexico CAS is the first to be prepared under the new CAS procedures being piloted Bankwide, and is also the first joint Bank-IFC CAS. It contains several innovations and new emphases:

- This CAS has been prepared with a view to making this document the main driver of the Bank Group[1] country program, the central tool for our partnership with the client and for managing our resources in the service of client needs and priorities.

- The new CAS emphasizes a shift of focus from inputs—projects, reports—to outputs—results on the ground. It does this by: defining development objectives and strategies in key areas of Bank Group support with greater clarity and specificity; and establishing benchmarks against which to measure progress. The specific instruments of support the Bank Group will deploy—lending, investments, guarantees, advice, portfolio management—and the related allocation of our budget are articulated within this more strategic and results-oriented framework.

- Bank and IFC programs are integrated within a unified strategic framework. A jointly prepared Private Sector Strategy paper (Attachment 1) spells out in more detail key elements of the agenda for private sector development and Bank-IFC collaboration.

- The CAS has been formulated through a more participatory process involving the client. It will be a 'living" document, with the strategy, performance benchmarks, and our instruments of support evaluated, together with the client, against actual results and adapted as necessary.

- The development agenda and the Bank Group assistance strategy are defined in a more thematic framework, focused on three core themes of growth with stability, social development, and modernization of the state, all linked together by the overarching objective of this CAS—raising human welfare and reducing Mexico's high poverty.

[1] "Bank Group" in this document refers to both IBRD and IFC while "Bank" refers only to the former.

- Improving portfolio quality is an emphasis that cuts across the proposed strategy, and will be supported by another important innovative dimension of the CAS—the decentralization of the Bank's Mexico Department to the field. This change will help improve project implementation; allow a closer, more proactive policy dialogue; and facilitate stakeholder participation. IFC also is strengthening its field office.

2. The previous (FY95) CAS focused on the causes of the 1994 financial crisis and the Bank Group's response in the short term. This CAS has a longer horizon, addressing the challenges Mexico faces over the next several years in its transition from crisis to healthy growth. It spans the remainder of the term of the Zedillo Administration, which ends in the year 2000. Lessons learned from the crisis underpin the strategy for the future.

II. ECONOMIC AND SOCIAL CONTEXT

3. Mexico has responded to the financial crisis that erupted in 1994 with a strong adjustment program. The Government's program has comprised: a substantial tightening of monetary and fiscal policies; a large exchange rate adjustment through moving to a floating exchange rate regime; steps to deal with the severe distress in the banking system; initiation of further structural reforms (in social security, deregulation and privatization); and measures to strengthen the social safety net to cushion the impact on the poor. The Government program has been supported by a large international financial package.

4. Thanks to this adjustment effort, Mexico has made substantial progress in a relatively short period of time in restoring financial stability and creating conditions for a resumption of growth. Fueled by improved competitiveness resulting from the exchange rate adjustment, resurgent exports have drastically cut the current account deficit, correcting a fundamental imbalance underlying the 1994 financial crisis (Table 1). Inflation is on a downward course, dropping from a monthly peak rate of 8 percent in April 1995 to an average of 1.5 percent in recent months. The reduction of inflation has allowed the *peso* to stabilize and interest rates to decline, with the annual rate on the benchmark 28-day *cetes* falling from a peak of around 80 percent during the crisis to around 25 percent in the past two months. Improved investor confidence is reflected in progress in restoring Mexico's access to international capital markets, which has permitted Mexico to refinance some of its external obligations on more favorable terms and, together with the international assistance package, rebuild foreign reserves.

5. The crisis and the adjustment it necessitated led to a sharp contraction in economic activity in 1995, with GDP falling by as much as 6.9 percent, domestic fixed investment plunging by 30 percent, and formal sector unemployment doubling. But a recovery is now under way, led by exports that continue to grow strongly and supported by an incipient revival in domestic demand as adjustment policies succeed in restoring financial stability. On present trends, GDP growth of around 3 percent is expected for 1996.

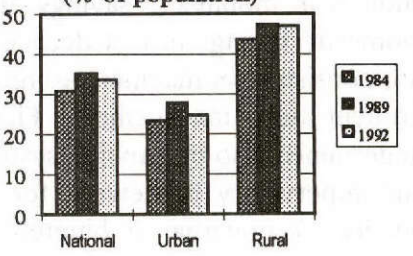
Table 1: Summary Economic Indicators

	Actuals		Est.	Projected				
	91-93	94	95	96	97	98	99	2000
Average Real Growth Rates %):								
GDP	2.4	3.5	-6.9	3.0	3.5	4.0	5.0	5.0
Exports (GNFS)	3.3	7.3	28.4	16.5	8.4	8.2	8.0	7.0
Shares of GDP (%):								
Gross domestic investment	23.7	23.5	19.4	19.2	20.6	21.9	23.7	24.2
Gross national savings	17.4	16.0	18.7	17.9	19.0	20.0	21.6	22.1
Non-financial public sector balance	0.4	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3
Current account balance	-6.3	-7.8	-0.3	-1.2	-1.6	-1.9	-2.1	-2.1
External debt	35.9	36.1	64.4	54.9	52.3	49.5	46.2	42.5
Other:								
Annual inflation (CPI, end of year) (%)	12.9	7.0	51.3	27.0	12.5	9.0	7.0	5.0
Real exchange rate (annual change, depreciation +) (%)	-7.6	3.8	45.2	-11.7	--	--	--	--
Gross intl. reserves/imports (mos.)	5.5	1.3	4.4	3.2	3.1	2.7	2.4	2.5
Debt service/ GNFS exports plus current transfers (%)	41.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4

6. This improving outlook is contingent upon continued firm implementation of the Government's adjustment program. While investor confidence has recovered, it remains fragile and vulnerable to policy slippages and shocks. Also, the banking system problems remain a major concern. With the decline in interest rates and the upturn in economic activity, bank portfolios, afflicted by large non-performing loans, are beginning to stabilize. Government efforts in support of bank restructuring have helped strengthen bank capital positions and improve accounting practices and prudential controls. Nonetheless, the banking system remains fragile. Fiscal costs associated with the various Government bank support programs are currently estimated at around 9 percent of GDP in present value terms, and will be a source of pressure on an already tight fiscal position.

7. The recession in 1995 in all probability increased the incidence of poverty, from levels that were already high. High poverty rates have persisted nationally, but they are especially high in rural areas (Chart 1). The poverty picture is reflected in a highly unequal distribution of income; in 1992, the bottom 20 percent of the population received only 3.8 percent of income compared with 55.6 percent by the top 20 percent. Reducing these high levels of poverty and inequality is essential, not only on grounds of human welfare and equity but also to preserve social stability without which sustained economic progress cannot be achieved. The growth process needs to involve, and draw on the productive potential of, a broader mass of population and the lagging regions. Poverty is highly concentrated in the southern states, and it was rebellion in one of these states—

Chart 1: Incidence of Poverty
(% of population)



Source: World Bank, *Mexico Poverty Assessment, 1996*

Chiapas—that contributed to the economic instability in 1994. The recent rash of rebel activity originated in another poor southern state—Guerrero. Whatever may be the specific political factors associated with such unrest inimical to national stability, poverty provides a fertile ground for it. The rise in unemployment and the erosion of living standards caused by the recession are reflected also in a general increase in crime. Social discontent could mount if the still fragile economic recovery falters, raising the stakes for Mexico to consolidate and build on the recent economic gains.

8. Political reforms—democratization, decentralization, rule of law—are a major element of the Zedillo Administration's agenda. These reforms will strengthen public institutions and are necessary for stronger, stable growth and more effective poverty reduction programs in the long run, but inevitably add to uncertainties in the short run. President Zedillo faces strong resistance from entrenched interests, including from within the ruling party, to these reforms. Against this background, an important recent achievement is the enactment of a major electoral reform that supports the transition toward a more pluralistic political system. This reform will provide a more level playing field to political parties in the congressional elections scheduled for July 1997. Opposition parties are expected to strengthen their position in Congress in these elections. Mounting political pressures in the run-up to the elections will test the Government's determination to persevere with monetary and fiscal discipline. Creating a more democratic, open political system is important to another major thrust of the present Administration's institutional reform agenda—devolving more responsibilities to states and municipalities. Unaccompanied by effective democratization, decentralization runs the risk of decentralized authority being captured by powerful local elites.

III. MEXICO'S DEVELOPMENT AGENDA

9. The reforms of the mid- to late 1980s and early 1990s reoriented the economy toward market-led growth and international integration, and redefined private and public sector roles. Yet they did not deliver the expected rapid growth, poverty reduction and improvements in social welfare. Lasting macroeconomic stability also was not achieved, as the 1994 crisis makes clear. Why? Structural reforms, though significant, did not go far enough in mobilizing savings and increasing productivity, the fundamentals of growth. Domestic savings in fact declined. Macroeconomic management, though improving, was not consistent in maintaining monetary and fiscal discipline, external competitiveness, and prudent debt management. Financial stability and efficient resource allocation were undermined also by banking system weaknesses, reflecting a deficient incentive, regulatory and supervisory framework for banks. Public institutional weaknesses undermining the quality of governance blunted the edge of expenditure programs aimed at poverty reduction. How can Mexico do better? Analysis suggests the need to:

- pursue sound macroeconomic policies in a consistent and sustained manner, reducing Mexico's vulnerability to periodic financial crises;

- extend and deepen the structural reforms that Mexico has been implementing—opening up markets to true competition, increasing private sector participation in the economy, mobilizing domestic resources, reforming the financial system; and

- initiate new, second-generation reforms, with a focus on strengthening the institutional foundation for growth and development.

10. The central, overarching development objective is a broad-based improvement in the level of human welfare and reduction of Mexico's high poverty. This implies a development agenda with three core, interrelated themes: growth with stability; social development; and modernization of the state. Mexico's development strategy, articulated most recently in the National Development Plan 1995-2000 (the *sexenio* of the Zedillo Administration), captures this agenda well, emphasizing the same core themes. The Bank Group agrees with the thrust of the Government strategy and the CAS outlines the development agenda, in common with the Plan document, within a framework defined by these three themes. The Country Strategy Matrix (Table 3) identifies the main performance issues in each of these thematic areas and outlines how the proposed development strategy would address the identified issues.

11. ***Growth with Stability***. Moving Mexico onto a higher and sustainable growth path is indispensable if serious inroads are to be made into Mexico's persistent and widespread poverty. A first priority is to consolidate the still fragile economic recovery. At the same time, reforms must continue that will support stronger growth in the medium term. Key elements of the agenda are:

- Maintaining fiscal and monetary discipline to underpin *macroeconomic stability*, together with an exchange rate policy that supports competitiveness.

- Strengthening the fundamentals of growth—*saving and productivity*. Key to mobilizing domestic savings to support higher investment will be: raising public savings, including through tax reform; and boosting private savings through successful completion of the pension system reform the Government has initiated, and sound development of financial/capital markets (especially rapid restoration of confidence in the banking system). Areas of emphasis in raising productivity will be: removing regulatory (trade, domestic and foreign investment) barriers to efficient private sector development, at federal and lower levels; fostering a competitive environment for small and medium-scale enterprises; strengthening infrastructure, especially through increased private investment; making labor markets more flexible and upgrading education and training; and improving the functioning of agricultural markets.

- Fostering longer-term sustainability of growth through improved *environmental management*, moving beyond the introduction of regulations to the promotion of necessary investments in environmental infrastructure and the development of institutions (national and local) and markets for sustainable development.

12. ***Social Development.*** Stronger growth is essential to reducing poverty and inequality, but programs targeted to the poor also are necessary. Poverty in Mexico has remained persistently high, especially in rural areas where the incidence of poverty is almost twice as high as in urban areas, indicating that the programs adopted so far have not been very successful. A two-pronged effort is needed for greater effectiveness:

- Better targeting and improving the quality of *basic social services*—education, health, nutrition, safety nets. At about 55% of federal programmable expenditure, social sector spending in Mexico is large. The main challenge is increasing its effectiveness and efficiency. Recent initiatives by the Government to better target food subsidy schemes, improve social safety nets for the rural poor, and restructure the *Solidaridad* program that supports basic economic and social infrastructure development (including a major decentralization of the program, recently renamed *Programa de Bienestar*, to the municipal level) are important steps in that direction.

- Promoting in an effective and sustainable way *the productive sector in the poor areas*, especially the southern states, to expand income-earning opportunities for the poor and thereby break the vicious circle of poverty—through agrarian reforms, development of rural financial markets, stronger private sector and community (including women, indigenous people) participation in the development of productive activities (agriculture, forestry, rural industry), and provision of basic infrastructure.

13. ***Modernization of the State.*** The agenda for reform in the coming years will be increasingly institutional in nature. An example is the financial sector. Past reforms focused on liberalization of controls. The next set of reforms must focus on strengthening prudential regulation and supervision, accounting and reporting standards, and bank management. Similarly, deregulation of controls on private investment and commerce—domestic and foreign—must be supported by legal and judicial reforms to provide a level playing field, ensure enforceability of contracts, and establish the rule of law. Such institutional reforms are essential to consolidate and make effective earlier reforms. In many countries, including Mexico, liberalization unaccompanied by timely institution-building contributed importantly to the banking system crises that developed. There are similar issues with respect to the machinery of government itself: the main problems with many public expenditure programs are not due to a lack of funding but institutional deficiencies. Compared to earlier reforms, institutional reforms would be more complex and painstaking: for example, it is easy to tear up interest and credit controls but a lot harder to develop good regulatory and supervisory systems and train management and staff. The institutional agenda, accordingly, will have two main thrusts:

- Strengthening the *institutional underpinnings of markets* to ensure they function efficiently and equitably—institution-building in the financial sector; accounting, auditing, and reporting standards; commercial laws (property rights, bankruptcy, securitization); judicial reform.

- Modernizing *public administration* to improve the quality of governance and increase the effectiveness of public programs, e.g., improving the efficiency and transparency of the budget system, upgrading the civil service, and decentralizing responsibilities to state and municipal levels where that would improve service delivery—basic social services, local infrastructure—backed by steps to strengthen fiscal and institutional capacities and accountability at these levels.

IV. ECONOMIC OUTLOOK AND RISKS

14. ***Base Case***. The next few years represent a crucial transition for Mexico—from crisis to sustainable growth. Given steady progress on the above agenda, Mexico can build on its recent gains in stabilizing the economy and restoring growth. Growth in the next 2-3 years will likely be moderate, averaging around 3.5 percent, with economic fragility diminishing but continuing for much of this period. Provided Mexico successfully completes this transition, growth could rise to a higher plateau of about 5 percent in later years (projections are summarized in Table 1 and detailed in Annex 5). The projected gradual rise in growth assumes that it will take time for gains in macroeconomic stability and market confidence to solidify and private investment to rebound, the banking system to return to health, and the structural and (especially) institutional reforms to bear fruit.

15. As imports recover with economic growth, the current account deficit will widen again. But if Mexico maintains the new dynamism of its exports by not allowing the competitive advantage conferred by the *peso* depreciation to be eroded, the deficit can be contained to below 2 percent of GDP, consistent with an improvement in Mexico's external debt indicators in the medium term. Besides containing the rise in external debt, Mexico is taking steps to improve its maturity profile. Debt service, nevertheless, will remain high in the next three years, especially in 1998-99 when the bulk of the crisis-related financing Mexico received is to be repaid, keeping the reserve position tight. To support faster growth, domestic investment will need to increase, but is projected to be financed mainly from higher domestic savings. The base case assumes that three fundamental lessons of the recent crisis—the need to maintain a competitive exchange rate, raise domestic savings, and prudently manage public debt—are well understood.

16. The base case economic outlook depends crucially on an orderly resolution of the banking system problems. The Government will need to move vigorously on the next phase of system reform (para. 30). A related challenge will be in fiscal management. Budgetary costs of bank support programs, together with the transitional fiscal costs of social security reform, could add up to 2.5-3 percent of GDP in each of the next several years. These additional expenditures will need to be absorbed without relaxing the fiscal discipline Mexico must maintain as part of its stabilization program.

17. ***High Case***. The growth outcome will depend fundamentally on the pace and comprehensiveness with which Mexico pursues the development agenda outlined in Section III. A real opportunity exists for achieving higher growth than forecast in the base case: the country's development potential is immense; major new growth opportunities are

offered by NAFTA; and substantial structural reforms have been implemented since the late 1980s which have yet to yield their full growth dividend. An aggressive reform effort, that removes constraints to higher and more efficient private investment, can tap this potential, permitting growth to exceed 5 percent toward the end of the decade and allowing a faster reduction of poverty. Such an upside scenario has a parallel in Chile's experience, where the reform momentum triggered by a crisis similar to Mexico's helped put the country on a markedly higher growth path following the initial adjustment phase.

18. ***Low Case.*** The base case economic outlook is subject to two main risks: strains in the banking system; and the vulnerability of the Government's reform program to social and political disruption. A collapse of the banking system has been averted, but the crisis has left behind a highly fragile system. Improved macroeconomic conditions should contribute to a strengthening of bank portfolios, but a renewed deterioration is possible if the economic recovery falters or if the Government fails to press ahead with financial sector reform. On the political front, the Government's adherence to a tight stabilization program in the face of a steep recession provides a reassuring demonstration of its commitment to adjustment. Nonetheless, political pressures will continue to test the Government's resolve, especially in the run-up to the 1997 elections.

19. A downside scenario was developed to examine the implications of an interplay of these risks. It assumes that a lack of political will keeps the Government from aggressively pursuing the agenda for restructuring the banking system and weaning it from public support. Fiscal costs of bank and debtor support continue to mount, reaching 15 percent of GDP in present value terms (they are assumed to be contained to about 10 percent in the base case). These higher costs show up as a rise in the fiscal deficit as political difficulties render the Government unable to absorb them without relaxing fiscal discipline. This sets off a vicious cycle of a renewed rise in inflation and interest rates, declining investor confidence, and a narrowing of access to foreign capital. With the rise in inflation, the *peso* initially appreciates in real terms but becomes increasingly vulnerable to volatility as investor confidence dips. The recovery from the crisis is protracted, with growth stagnating around 2 percent in the next 2-3 years. Mexico is able to continue to meet its external debt service obligations, but at lower income and import levels. An additional risk in this scenario is that the economy remains vulnerable to shocks over an extended period.

20. ***External Environment.*** Mexico's integration into international trade and capital markets has increased appreciably since the late 1980s. This brings important benefits—wider markets for trade, increased access to foreign capital and technology. But it also confronts policymakers with new challenges, as Mexico's experience vividly demonstrates. Especially important is the need for stricter discipline in macroeconomic management, including sound financial sector management, given the increased mobility and potential volatility of capital. For Mexico, with increased international integration, the payoffs to sound policies are larger, but so are the penalties for policy errors.

21. Mexico's exposure to external shocks—developments in export markets, foreign interest rates, capital flows—is sizable, but the country has taken steps since the 1994

crisis to reduce its exposure and vulnerability to such shocks. First, the surge in exports fueled by the restoration of a competitive exchange rate has substantially expanded the export base. Oil, whose price is particularly subject to volatility, remains a major source of exports and fiscal revenues, but its contribution has now dropped to 15-20 percent from around 30 percent in the mid- to late 1980s. Second, the large reduction in the current account deficit has reduced Mexico's dependence on capital inflows. Third, Mexico has been able to improve the maturity structure of its external debt, reducing its reliance on the more volatile short-term portfolio flows. The accumulated stock of nearly $30 billion in dollar-indexed short-term domestic securities (*tesobonos*), which played an important role in the financial crisis, has all been retired, mostly replaced with longer-maturity external debt. Fourth, the financial cushion available to absorb shocks, virtually depleted after the 1994 crisis, has been strengthened, through replenishment of reserves and restoration of access to international capital markets. A decline in external risk is also indicated by some summary exposure indicators shown in Table 2. Despite these improvements, however, Mexico remains vulnerable to external shocks, especially over the next three years when the debt service will stay high and international reserves relatively low, requiring strict adherence to prudent macroeconomic policies.

22. New trade opportunities created by NAFTA are a key element in Mexico's export prospects. But NAFTA also brings challenges: firms must become more flexible and efficient to stand the test of increased competition, in domestic as well as export markets. With closer integration, the sensitivity to the U.S. economy rises. About three-quarters of Mexican exports now go to the U.S. A strong resurgence of protectionist sentiment or a marked slowdown in growth in the U.S. market would have important implications for Mexico, though both appear unlikely at this time. U.S. electoral politics may temporarily slow the implementation of some aspects of NAFTA in 1996, but a serious backtracking on the agreement is considered unlikely. The medium-term growth outlook for the U.S. economy remains positive. At present levels, a 1 percent decline in U.S. GDP is estimated to lower Mexico's total exports by around $1 billion. As Table 2 indicates, another source of sensitivity to developments in the U.S. economy is interest rates. Some rise in U.S. rates in the period ahead is likely, but current forecasts do not point to a sharp surge.

Table 2: Summary Indicators of External Exposure

Source of Shock	Magnitude of Shock[1]	Annual Impact of Shock[2] (% of exports)	
		1994-96	1997-99
Terms of Trade	4.3% deterioration	6.2	6.5
International Interest Rates	290 basis points rise	3.6	2.4
Manuf. Export Volume	5.7% decline	2.7	3.1
Private Capital Inflows (excl. FDI)	$8.4 billion decline	11.9	8.0
Total[3]		24.4	20.0

[1]Measured as one standard deviation of three-year moving average of time series for past 10-15 years.

[2]Impact, in terms of exports of goods and services, of deterioration in the shock variable from the base case path over the three-year period by the indicated magnitude.

[3]These shocks are unlikely to occur simultaneously and so their impact is not additive; the total is shown merely to illustrate the change in overall exposure to these shocks over the two periods.

V. MEXICO-BANK GROUP DEVELOPMENT PARTNERSHIP

23. The Bank Group assistance strategy for the next three years has been designed, in consultation with the Government, to support key elements of Mexico's development agenda outlined in Section III. The CAS Matrix (Table 3) maps Bank Group assistance strategy into the three core themes of this agenda—growth with stability, social development, and modernization of the state, all linked together by the overarching objective of raising human welfare and reducing poverty. The matrix relates Bank and IFC instruments of support to the main elements of this strategic framework and defines benchmarks against which performance will be monitored. While details of the country assistance program are in the CAS Matrix, key features of, and issues in, the program are highlighted here. Four features cut across the program:

- As Mexico is likely to remain in a difficult state of transition from crisis to sustainable growth for much of the next three years, part of Bank Group operations will continue to focus on the short term and assist the Government in dealing with the crisis and its effects (Box 1 provides an update on the Bank Group's crisis response). Increasingly, however, the Bank Group will focus on operations that will help lay the basis for stronger growth and speedier reduction of poverty in the medium to long term.

- The agenda for private sector development will be pursued through more focused, concerted Bank and IFC efforts, utilizing the framework of a jointly prepared Private Sector Strategy (PSS, Attachment 1). While Bank-IFC collaboration will span a broad agenda for private sector development, key areas of collaboration over the next three years, as detailed in the PSS, will be: banking, capital market, small and medium-scale enterprise restructuring, infrastructure, and regional development.

- A major emphasis across the Bank portfolio will be to improve portfolio quality and results on the ground—through better quality at entry and improved implementation.

- IFC will focus more on small and medium-scale enterprise development and ensure that its operations catalyze and not displace private investment.

Growth with Stability

24. A large part of the Bank Group lending and non-lending program over the next three years will support the fundamentals of sustainable growth: sound macroeconomic management, higher savings and productivity, and improved environmental management.

25. ***Macroeconomic Management***. Supporting sound macroeconomic management and financial stability will remain a major focus for the Bank. The Bank has stepped up its macroeconomic monitoring. In combination with enhanced surveillance by the IMF and more timely provision of economic data by the Government, this should help institute an improved warning system for any emerging problems and assist in contingency planning and policy dialogue. While the IMF will lead the dialogue on the stabilization program and

exchange rate and liability management, the Bank Group will concentrate on issues relating to savings, investment and productivity; public expenditures; and financial sector management. Policy dialogue in these areas will be underpinned by analytical work carried out in the framework of both the ESW program and related lending operations, and supported by an enhancement of Bank analytical capacity.

Box 1: Bank Group's Crisis Response in Mexico: An Update

Financial Sector Restructuring. A Financial Sector Restructuring Loan ($1 billion) has supported a substantial sector adjustment program. Bank supervision has been close. Measures supported by the second tranche released in July included: implementation of revised accounting standards for banks and other financial institutions that will assist supervisors in better assessing the condition of banks and also strengthen market-based supervision by providing investors with more transparent information; and issuance of revised capital rules for brokerage firms and agreement on an implementation schedule for credit exposure limits for development bank lending to commercial banks. Through an operation approved in July, including up to $100 million of IFC's own resources and up to $200 million in syndicated financing, IFC is helping Banamex, the largest commercial bank, develop a loan restructuring facility for viable medium-size enterprises.

Essential Social Services Loan (PROSSE). Out of a loan of $500 million, disbursements totaled $302 million by July. Under the loan, the Government committed to two courses of action: protecting budgetary allocations for high priority social programs targeted to the poor; and initiating a system of monitoring and evaluating social expenditures to increase their efficiency. PROSSE-related budget allocations rose from 5.67 billion pesos in 1995 to 8.76 billion pesos in 1996; and the finance secretariat has established a monitoring and evaluation unit for social expenditures.

Privatization Technical Assistance Loan. Disbursements have so far been modest under this $30 million loan, largely due to delay in privatization in electricity (the largest component of the loan) and secondary petrochemicals. But other privatizations are broadly on track—in telecommunications, railways, ports and airports. As the divestiture process winds down, greater attention is being given to regulatory and cross-sectoral issues.

Portfolio Restructuring. Since the 1994 crisis the Bank has restructured a number of projects with partial cancellations of about $860 million. Projects involving on-lending, especially in environment, were affected due to the reluctance of states/municipalities and private enterprises to borrow at the high interest rates prevailing in Mexico. Social sectors also were affected, due to the reduced dollar amounts needed to support the same level of peso expenditures and revised priorities following the crisis.

Non-Lending Services. The Bank has stepped up macroeconomic monitoring, and both the Bank and IFC have increased non-lending activities, including analysis of financial sector and enterprise restructuring issues and new approaches to addressing the problems of the poor southern states.

26. ***Raising Savings and Productivity***. Strengthening these fundamentals of growth will motivate much of the Bank Group program in finance and private sector development.

27. *Strengthening the Tax System*. Part of the increase in national savings must come from higher public savings. Restraining expenditure growth and improving expenditure efficiency will remain important, but tax reform to raise more revenue also will be necessary. This is particularly so given the large new expenses the Government faces in the years ahead because of social security reform and banking system support (para. 16).

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

(i)

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks*	Instruments IBRD	Instruments IFC
Overarching Development Objective: Raising the level of human welfare for all Mexicans and reducing poverty. Incidence of poverty to be reduced by about 3 percentage points by 1999 (latest estimate 34% in 1992).					
GROWTH WITH STABILITY Lack of a stable macroeconomic foundation.	• Policies supporting financial stability and competitiveness not followed consistently, especially in the context of increased and more volatile international capital flows. • Financial stability undermined also by serious banking system weaknesses (reflecting deficient incentive, regulatory and supervisory framework).	**Maintain Macroeconomic Stability** • Adhere to macroeconomic policies supportive of financial stability, competitiveness, and sustainable growth. • Promote sound financial sector development (see below).	• Compliance with IMF stabilization program. • GDP growth around 5% by 1999. • Inflation below 10% by 1998. • Average export growth at twice GDP growth rate or more in 1997-99 • Gross national savings 22% of GDP by 2000 (16% in 1994).	Annual CEMs Macro Policy Dialogue, Policy Notes, Monitoring	
Low and unstable growth. GDP grew only 3 % p.a. over the 5 years preceding the recent financial crisis (2% if averaged over 10 years), and plunged 6.9% in 1995 as a result of the crisis.	Weak fundamentals of growth: • Low and declining national saving rate. – Inadequate mobilization of public savings, including through the tax system. – Disincentives to private saving from a defined benefit, PAYG pension system.	**Strengthen Fundamentals of Growth** **(a) Mobilize Savings** **Fiscal Policy** • Increase public savings; reorient tax system toward consumption. **Pension System Reform** • Shift from defined-benefit PAYG system to fully-funded, defined- contribution system for private/public sector workers. • Support implementation of new pension system through appropriate regulations and strengthened monitoring and enforcement capacity.	• Broaden VAT base; increase VAT revenue to GDP ratio. • Enactment of new Social Security Law and legislation governing pension fund management, and of appropriate regulatory framework and investment regime for AFORES. • Restructure INFONAVIT. • Extend pension reform to public sector workers (ISSSTE).	CEM on Savings (97) Contr. Savings I (97) CEM on Savings (97) Contr. Savings II (98) Contr. Savings III (99	TA and equity support to AFOREs
	– Fragile and underdeveloped financial system, providing inadequate security, access and instrument diversity to savers/investors.	**Financial System Development** • Restore health of **commercial banking system** by: accelerating resolution of troubled banks and portfolios; improving prudential regulation and supervision, incentives and market discipline. • Support development of **capital markets** by: reforming market for housing finance; deepening and diversifying markets for securities. • Strengthen **financial market infrastructure**: reform legal/regulatory framework for secured lending; upgrade regulatory and supervisory framework of securities markets; further develop ancillary financial information services. • Expand access to and efficiency of **rural financial markets**. • Rationalize the role of **development banks** and improve their financial viability.	• Adoption of OECD-comparable disclosure and accounting standards, prudential regulations, capital rules. • Newly established Asset Disposal Agency (VVA) fully functional. • Phase-out of comprehensive deposit insurance. • Define narrower, viable role for Government (FOVI, INFONAVIT, FOVISSSTE) in housing finance. • Issuance of quality mortgage and non-mortgage-backed securities. • Functioning collateral and credit registries. • Credit and rating information readily available. Disclosure rules followed on public offerings. • Pilot program initiated to improve delivery of rural financial services. • Phase-out Government support for BANRURAL and FIRA by: liberalizing interest rates; reducing subsidy dependence index. • Implementation of action plan for development banks agreed under FSRLI. Cessation of first tier lending.	FSRL I (ongoing), Banking ESW (97) Ongoing FTAL FSRL II (97) Housing Sector III (97) Guarantees ESW Ongoing FTAL ESW Financial Infra. (99) Rural Finance TA (97) Rural Finance (99) CEM on Public Credit Programs (98)	Venture Capital Loan Restructuring Credit TA Equity Investments TA support and underwriting facilities Venture Capital Funds

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks*	Instruments (ii) IBRD	IFC
	• Generally low level and growth of productivity.	**(b) Increase Productivity**			
	– Limited development of SME segment of industry; enterprise problems exacerbated by current financial distress.	**Environment for Private Enterprise** • Facilitate restructuring/debt workouts/exit of distressed enterprises.	• Reform of regulatory/institutional framework for bankruptcy/liquidation/foreclosure/securitization.	Ongoing FTAL/ESW Fin. Infra. (99)	Credit lines TA on Corporate Restructuring Direct Lending
		• Enhance competition by supporting efficient growth of SMEs through: improved access to finance; technology diffusion; regulatory reform to provide level playing field.	• Increased, market-based financial flows to SMEs. Increased SME participation in exports, including indirectly through subcontracting.	Ind. Pol. Study (98) PSD Competitiveness TA (98)	Venture Capital Funds Institution-Building, e.g. leasing, factoring
	– Structural reforms (trade and investment deregulation, competition, privatization), though significant, did not go far enough, or not complemented by necessary institutional strengthening (as in financial sector).	• Extend trade and investment (domestic and foreign) deregulation and the privatization program.	• Further simplification of domestic trade and investment regulations at federal/state/local levels, and further liberalization of foreign investment regime. • Roll-back of tariff increases implemented in 1995 in response to financial crisis (on textiles, clothing, footwear, leather products). • Significant progress on privatization of petrochemical plants; completion of ongoing privatization in telecommunications; progress on privatization in other infrastructure sectors (see below).	Productivity CEM (97) Ind. Pol. Study (98) ESW PTAL (96)	Individual projects
	– Inefficiencies in infrastructure provision including lack of appropriate policy and regulatory framework for private participation.	**Infrastructure** • Accelerate restructuring and privatization in transport and energy sectors. • Improve public provision and financing of transport infrastructure; attract long-term private finance at federal/state levels; enhance infrastructure planning/implementation capacities at state level. • Strengthen municipal water and sanitation utilities and promote private participation.	• Improved legal/regulatory framework for private participation in ports, railways, airports, power, oil and gas. • New infrastructure financing mechanisms (e.g. road maintenance fund). • Improved urban transport services in medium cities/MCMA. • Water Master Plans prepared for 155 municipalities; water systems expanded in Southern States; pilot initiated for concessioning arrangements in municipalities.	PTAL (96) Federal Roads (97) Trans. & Dist. (97) Water & Sanitation II (ongoing), III (99) SSI (98) Guarantees Infr. Policy Notes	Privatization TA Individual projects, esp. in newly opened sectors Infrastructure Fund
	– Labor market rigidities and lack of a modern training system.	**Labor Market/Training** • Improve incentives for employment in formal sector; increase coverage and quality of labor market information; modernize labor-industrial relations	• As part of social security reform, tax wedge on payroll reduced.	Contr. Savings I, II (97,98) Health Reform (98) Training Assessment, other ESW (97) Ongoing projects	
		• Expand access to training for displaced/unemployed workers; improve quality and relevance of training through increased private participation; promote continuous on-the-job training in SMEs.	• More unemployed workers receiving scholarships through PROBECAT; SME workers receiving training through CIMO increased. • Labor competency standards for occupational clusters developed under private sector leadership; independent certification agencies established.		
	– Agricultural/rural productivity constrained by uncertain land tenure and property rights and inefficiencies/gaps in rural infrastructure and producer services.	**Agriculture/Rural Development** • Develop rural agricultural markets; increase security of land tenure, water and property rights.	• Increased role of producer marketing organizations; land titling/registration expanded; registry of water rights established.	ESW, Water Management (96), DRD II (ongoing) Other Ongoing Projects Rural Poverty Report (97), Agr. Policy Notes Nat. Res. Manag. (98) CEM on Poverty (99)	Venture Capital Microlending projects in export-oriented enterprises
		• Better target agricultural research/extension/rural infrastructure	• Design of competitive grants fund for research and extension completed.		
		• Promote income-generating programs.	• Non-timber forest products fund established to pilot income-generating activities for communities with forestry resources.		

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

(iii)

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks*	Instruments IBRD	Instruments IFC
Risks to long-term sustainability of growth arising from environmental stress.	Environmental concerns not effectively integrated into economic and sector policy. Environmental strategy/priorities not clearly defined and widely disseminated. Deficiencies in institutional framework: • Weak institutional capacities of environmental agencies, especially at state and municipal levels. • Lack of clear division of institutional responsibilities and framework for decentralization. • Coordination problems on cross-sectoral environmental issues. • Incentive distortions from legal/regulatory deficiencies, e.g. unclear/insecure water rights.	**Improve Environmental Management** • Agree and establish environmental priorities. • Strengthen environmental institutions at federal/state/municipal levels. • Establish foundation for effective management of industrial pollution. • Formulate regulatory framework for solid waste management. • Promote greater cross-sectoral participation to reduce air pollution in MCMA. • Improve natural resource management by: improving water use through establishment of water markets and transfer of existing water infrastructure to water users; promoting sustainable use of forestry resources.	• Dissemination of environmental priorities. • Roles clarified and responsibilities transferred to subagencies. • Pilot Pollution Release and Transfer Register started; demo SME project on environmental management systems implemented; cross-sectoral Industrial Pollution Working Group established. • Federal/local regulations for solid waste management issued. • Integrated transport and air quality management strategy developed for MCMA. • Water availability increased/losses reduced/quality improved; mechanisms to approve water rights transfers established; river basin councils established. • TA/training program for community groups on forest management initiated.	ESW (97, 98) Northern Border/other ongoing projects, Env. TA II (98) ESW, Seminars, Non-lending Services Solid Waste II (ongoing) Pollution Control (99) Water Management (96) Nat. Res. Manag. (98) ESW	Support to private waste management projects
SOCIAL DEVELOPMENT Persistence of high poverty. Overall and extreme poverty incidence 34% and 8%, respectively, in 1992, compared with 31% and 6% in 1984. Poverty incidence likely rose with recent financial crisis. Concentration of poverty in rural areas (47% incidence in 1992) and in Southern States.	Low, erratic economic growth (see above). Low effectiveness of Government social expenditure programs (safety nets/nutrition, education, health) in building the human capital of the poor: • Expenditure on social services high (55% of federal programmable spending) but impact constrained by poor targeting and low expenditure efficiency. • Access to basic social services expanded but service quality remains deficient. • Safety nets especially inadequate in rural areas. • Deficiencies in public administration undermining service delivery: lack of effective decentralization; inefficiency, resource leakages, poor accountability.	**Better Target and Improve Quality of Basic Social Services** **Social Safety Net/Nutrition** • Cushion impact of financial crisis on the poor, especially on the unemployed/underemployed in marginal rural areas. • Improve targeting and type of food subsidies. **Health** • Improve access to basic health services for the poor by targeting lowest income states. • Establish a financially viable health insurance system under the new Social Security (IMSS) law. • Increase role of private sector in delivering health services. • Decentralize more responsibilities to states and adopt more equitable system of federal budget transfers to states. • Ministry of Health shifts increasingly from service delivery to regulatory and quality control functions	• Private short-term employment provided to 600,000 people in first year through PESE, self-targeted to the poorest through payment of 80% of minimum wage. • Generalized urban food subsidies replaced with targeted subsidies; overhead costs of targeted subsidies reduced by shifting from in-kind to cash transfer system. • Nutrition program for mothers and children under 5 years initiated in poor rural areas; combined deworming, school feeding and micro-nutrient program implemented in rural primary schools. • Basic health care package introduced in 11 poorest states. • Incentive/structural changes in IMSS health system to limit fiscal costs; transparent, sustainable financing mechanisms in place for delivery of IMSS health services. Financing and delivery of health services separated. • Pilot alternative scenarios for public/private mix. • Agreed decentralization, supported by TA, in place; allocation criteria revised for federal transfers, complemented by an improved monitoring system. • Inspectors/MIS monitoring placed in states; parameters of licensing defined for health service providers/licensing procedures initiated for hospitals and laboratories.	PROSSE (ongoing) Poverty Assessment (97) Rural Poverty (97) Nutrition (98) CEM on Poverty (99) Policy Notes Basic Health II (96) Poverty Assessment, Other ESW (97) Health Reform (98) CEM on Poverty (99) Basic Health II (96) Basic Health II (96) Health Reform (98), ESW	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

(iv)

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks*	Instruments IBRD	Instruments IFC
		Education • Increase access to and quality of basic education, especially in poor rural areas. Focus investments on most cost-effective inputs (teaching materials, teachers and supervision) in an integrated manner.	• In PARE states with poorest education indicators: primary education repetition reduced, primary completion rate increased; retention of teachers in isolated rural areas increased; coverage of non-formal initial (0-4 years) education services increased. • New equitable budget system for federal transfers to states established.	PROSSE (ongoing), Primary Education II (ongoing), Primary Education III (98), Poverty Assessment (97); CEM on Poverty (99); Other ESW	
	Potential for development of the productive sector in poor regions, especially in the South, inhibited by: • Deficient rural land and financial markets, and limited access to supportive rural infrastructure. • Inadequate involvement of private sector in efforts to develop the productive sector in poor regions. • Insufficient participation of civil society and the poor themselves (especially women, indigenous people) in the design and implementation of poverty reduction programs. Weak development of the poor's social capital (community/producer organizations).	**Expand Income-Earning Opportunities in Poor Regions, especially Southern States** • Work with private enterprise and civil society to identify and tackle constraints to development of productive sector in these regions. • Improve targeting of agricultural/rural development programs that affect the poor, especially indigenous communities and rural women. Encourage increased community participation in development.	• Action Program initiated to address identified constraints to productive sector development in two Southern States (Chiapas, Oaxaca), involving increased private participation. • Targeting/effectiveness of programs such as PRODUCE, PROFORESTAL improved/monitored.	(SSI) (98) Policy Notes IDF Rural Poverty Report (97); CEM on Poverty (99); Other ESW	Credit Line Direct Lending Private Equity and Venture Capital Funds (Fondo Chiapas) TA
MODERNIZATION OF THE STATE Public institutional framework has important weaknesses, as it has been slow to adapt to the changing role of government in development.	Liberalization of markets not underpinned by strengthening of regulatory and institutional framework to ensure markets function efficiently and fairly in supporting private sector development: • Weak prudential regulation and supervision in financial sector. • Accounting, auditing and reporting standards not adequately upgraded and enforced. • Slow modernization of commercial laws (e.g. property rights, bankruptcy, securitization) and judicial system.	**Strengthen Institutional Underpinnings of Markets** • Strengthen regulatory, legal and institutional framework underpinning financial markets and private commerce.	• Continued progress on prudential regulation and supervision of financial markets, accounting and reporting standards, commercial laws (bankruptcy, securitization, etc.). • Progress on legal/judicial reforms to improve enforceability of contracts.	FSRL II (97) Financial Infra. (99) Ongoing FTAL, ESW Non-lending Services	
	Public administration increasingly in need of modernization, to support efficient execution of a narrower, more focused role of government: • Federal budget system in need of reform, to support improved expenditure and performance management. • Insufficient progress on administrative and fiscal decentralization. Weak institutional capacities and accountability at the local level. • Need to develop more modern, professional civil service, to improve quality of governance.	**Modernize Public Administration** • Modernize budgetary process at federal level. • Decentralize more fiscal and functional responsibilities to state and municipal levels, backed by enhancement of institutional capacities and accountability at these levels.	• Improved framework for medium-term expenditure management; improved performance management through budget; stronger auditing arrangements. • Actions on fiscal and functional decentralization within an agreed/coherent overall strategy for decentralization. • State and municipal capacity building programs under implementation. • Improved utilization of property taxation.	ESW (97), IDF, Seminars. State & Municipal Management TA (98) SSI (98)	

**The attainment of the performance benchmarks, of course, will depend on many factors–degree of implementation of the proposed strategy and agenda, overall macroeconomic environment, incidence of shocks (external or domestic). We will use the benchmarks as inputs into an evaluative framework within which to monitor outcomes, analyze reasons for attainment/non-attainment of objectives, and feed this assessment back into the strategy and agenda for the following years.*

Important reforms implemented since the early 1980s have modernized Mexico's tax system and improved its efficiency. However, the system needs to generate more revenue to support Mexico's stabilization and growth objectives. The centerpiece of further tax reform should be the strengthening of the VAT, which would both bring in more public revenue as well as improve incentives for private saving and investment by shifting the balance of revenue collection from income toward consumption. Currently, because of a narrow base and extensive noncompliance, revenue from the VAT is only about 3 percent of GDP (compared with 6 percent in Argentina and over 8 percent in Brazil and Chile). Reform of the VAT needs to include a broadening of the tax base by drastically limiting the extensive zero rating and exemptions now allowed, a rise in the tax rate, and improvement in tax compliance. Tax administration needs to be strengthened in general. At the subnational level, more effective use needs to be made of the property tax which remains greatly underutilized in Mexico. The Government is preparing a set of tax reform proposals and the Bank will support this effort through ESW and technical assistance.

28. *Reforming the Pension System*. The Bank is working closely with the Government on a major pension system reform. With effect from 1997, the pay-as you-go system for private sector workers will be replaced by a fully-funded, defined-contribution system composed of private pension funds (AFORES), a reform that can give a major boost to private savings. Progress benchmarks over the next three years include the establishment of laws and regulations governing the new private pension funds and their investment regime, a fundamental restructuring of INFONAVIT (the housing component of the pension system), and the extension of pension reform to public sector workers. Bank support will include technical assistance on regulatory issues and adjustment operations to assist with the transitional fiscal costs of pension reform. IFC will assist through advisory services, equity support to AFORES, and acting as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable partners.

29. *Ensuring Sound Financial System Development*. Given its importance to the restoration of financial stability and growth, the financial sector (including the banking system, specialized financial institutions and the capital market) accounts for about a quarter of the Bank's proposed lending program and also about one-third of IFC's planned investments. Managing the crisis in banking remains a priority, but Bank Group support will shift increasingly to strengthening the underlying regulatory and institutional framework to ensure sound future development of banks and of the financial system more broadly. Toward this end, the Bank, in coordination with IFC and IDB, has worked out with the Government a comprehensive sector strategy and a program of support.

30. For the *banking system*, the strategy broadly has three elements: (i) expediting the resolution of problem banks and bank assets and limiting fiscal costs (accelerated resolution of intervened banks, proactive encouragement of sale/merger/consolidation of weak banks, early disposal of impaired portfolio acquired by Government); (ii) improving the incentive regime and reducing moral hazard (ensuring adequacy of genuine private risk capital, phase-out of the comprehensive liability protection, avoidance of new subsidy schemes); and (iii) strengthening the regulatory and institutional underpinnings (prudential

regulation and supervision, accounting and reporting standards, legal framework for bank-borrower interaction, commercial laws including bankruptcy and securitization). Efforts in these areas will build on the progress already achieved under the first Financial Sector Restructuring Loan (Box 1). Bank instruments to support these efforts include analytical work and technical assistance and a second financial sector adjustment operation. IFC will provide complementary technical assistance as well as long-term loan and equity investments, including loan syndication and equity funds mobilization, to support bank restructuring and facilitate investment by new foreign partners.

31. Complementing these priorities, the Bank and IFC will support key elements of the reform agenda for the broader financial system. First, the financial system in Mexico remains dominated by commercial banks, but the establishment of a privately managed pension system will open important new opportunities for the development of the *capital market*. In addition to supporting sound development of the new pension system (para. 28), the Bank Group will promote capital market growth through: reforming housing finance by restructuring, phase-out or privatization of public housing finance institutions (principally FOVI, INFONAVIT and FOVISSSTE); developing the markets for mortgage and asset-backed securities; fostering the development of non-bank financial institutions such as mutual and venture capital funds, leasing and factoring; and upgrading capital market regulatory and informational infrastructure—strengthening of accounting and disclosure rules, collateral laws, credit and rating information, and the technical capacities of regulatory agencies. In these efforts, the Bank and IFC will complement each other, with the former focusing more on improving the regulatory and institutional framework and the latter on facilitating actual investments and transactions (such as supporting the first institutions in mortgage finance and asset securitization). Second, the Bank is helping the Government draw up a reform program, including pilot initiatives, to develop rural financial markets that remain characterized by uneven coverage, high segmentation and low efficiency. Third, the Bank will continue to provide advice on reform options for rationalizing the role of development banks that still account for about one-third of banking system assets. To the extent they are privatized, IFC could help these institutions orient themselves to the market.

32. *Improving Environment for Private Enterprise*. More vigorous, efficient growth of the private sector is an objective that cuts across the development agenda. Details of the Bank Group assistance strategy in key areas of private sector development are in the Private Sector Strategy paper (Attachment 1), but the strategy essentially has two elements. The first priority is to respond to the immediate problems for private enterprise resulting from the financial crisis. Restoring the banking system to health so it can resume its financial intermediation role and support recovery in private investment is a priority, as outlined above. A related priority is the restructuring of viable enterprises that are financially distressed by a combination of recession and high interest rates. Small and medium-scale enterprises (SMEs) have been particularly hard hit. The second element of the Bank Group strategy is to remove constraints to private sector development that are longer-term in nature and predate the crisis: continuing regulatory and administrative barriers to trade and investment, particularly at state and municipal levels; inadequacies of

the commercial legal framework, that especially disadvantage SMEs, encourage "crony capitalism" and contribute to a concentrated industrial structure; bottlenecks to the privatization program; infrastructure deficiencies; and skill constraints. Removing these constraints will also help attract more foreign direct investment that is beneficial to productivity growth and contributes to macroeconomic stability by bringing in longer-term capital that is less susceptible to volatility than short-term portfolio flows.

33. The Bank will support these goals through: ESW and technical assistance on productivity, competitiveness, industrial policy, and judicial system reform; a financial infrastructure loan aimed, *inter alia*, at improving the legal framework for financial restructuring (bankruptcy, liquidation, foreclosure, securitization); and operations supporting increased private participation in infrastructure, and skill development (see below). IFC will focus on supporting privatization initiatives and increasing market-based financial flows, particularly to SMEs, through technical assistance and financial investments (both direct investments in a few larger SMEs and indirect support through credit lines and venture capital funds). The Bank Group strategy will seek to further privatization both in sectors previously opened to private enterprise and in sectors that so far have remained largely closed, including petroleum. A priority for the Government in the immediate future will be to resolve the legal and political problems that have held up progress on the planned privatization of a number of petrochemical plants.

34. *Upgrading Infrastructure*. Among the major Latin American countries, Mexico perhaps has the least developed physical infrastructure. Deficiencies in infrastructure—in access, efficiency, quality—constitute a major constraint to productivity, competitiveness and growth. Infrastructure development, therefore, will remain an important area of Bank Group involvement. However, the focus of support will shift to promoting increased, more efficient private participation. The greatest opportunity for expanding and improving infrastructure services lies in removing statutory restrictions on competition, reducing intrusive government regulations and price distortions, and promoting private participation within an appropriate regulatory environment. At the same time, more efficient public investment and operating modalities are needed for those services that will not attract private financing (e.g., secondary roads, low-income housing) or will remain within public purview at least for a while (e.g., power transmission and distribution, road maintenance).

35. Bank Group support to infrastructure accordingly will have two emphases: privatization and development of regulatory capacities in transport, telecommunications, energy, and water and sanitation; and improvements in the planning, financing and management of public infrastructure. Through the PTAL (Box 1), the Bank will provide technical assistance to improve the regulatory framework for private participation—restructuring options for introducing competition, concession design, bidding rules, tariff policies, appropriate use of government guarantees. The Bank's guarantee instrument will be used to attract more private financing into infrastructure. In all sectors where the Bank may lend to support public infrastructure development, such as road transport and power, the aim will be to improve the overall sector policy regime and institutional capacities, rather than limiting attention to the investments directly financed by the loans. Two critical

criteria for Bank assistance for public infrastructure will be: whether it complements and promotes private participation; and whether it improves services in the underserved, poorer areas. Increasing private role in power and water and sanitation will be particular priorities, as these sectors have lagged behind others in privatization. Key will be the restructuring/privatization of the power monopoly (CFE), removal of regulatory bottlenecks to private entry and efficient pricing, and establishment of a transparent framework fostering competition. An improved regulatory regime for private participation and a quickened pace of privatization would pave the way also for increased IFC investment activities in infrastructure, with the IFC supporting private infrastructure investments with long-term funds that might otherwise be difficult to obtain. For model or pilot infrastructure privatization projects in newly opened sectors, IFC's transaction design experience will be made fully available.

36. *Modernizing Labor Markets and Training*. In the aftermath of the 1994 crisis, reemployment and retraining programs to cushion the impact on displaced workers were a priority. With a recovery now under way, Mexico needs to resume the longer-term agenda of modernizing labor markets and the training system necessary to compete in rapidly changing international markets. Through formal and nonformal analytical work and ongoing projects, the Bank will assist the Government in identifying options for improving the regulatory environment in the labor market—reducing rigidities such as high non-wage costs of formal sector employment and regulatory/legal constraints to flexibility in labor use, improving labor market information, modernizing labor-industrial relations. In training, Bank support will seek to strengthen public training institutions and improve incentives for provision of training by private enterprises to upgrade their workers' skills.

37. *Raising Rural Productivity*. Raising rural productivity is important both to growth and poverty reduction. The Bank will support this objective through a step-up in its non-lending services as well as through selective lending operations. Areas of emphasis will be: raising the efficiency of rural agricultural markets via improvements in the policy and regulatory framework and promotion of producer marketing associations; improving the efficiency of SAGAR's investment program and rationalizing farm subsidy programs (e.g., PROCAMPO); increasing the impact on the poor of rural income-generating programs (PRODUCE, PROFORESTAL); assessing the suitability of the new land titling program for *ejido* lands (PROCEDE) for the rural poor and indigenous communities; and supporting institutional reform, especially institutional strengthening at the state and municipal levels to underpin ongoing decentralization in agriculture. A planned sector operation focused on raising agricultural productivity will seek to promote, *inter alia*, increased private participation in the provision of services such as research and extension. Close collaboration with IFC will be important in that effort. Also, through the planned Southern States Initiative, the Bank and IFC jointly will support the development of private rural productive activities in the poor states of Chiapas and Oaxaca (para. 47).

38. ***Improving Environmental Management***. Dealing with environmental problems is particularly hard during a major recession. Over the past year, the financial crisis has significantly reduced funding for environmental programs, and several Bank-supported

projects have been cut. Against this background, the Bank's urban environmental strategy (dealing with 'brown" issues) will follow a three-track approach. The first track concentrates on satisfactorily implementing the Bank's current portfolio; the second focuses on providing urgent institutional strengthening to the Environment Ministry, and supporting decentralization by providing technical assistance at the local level; and the third aims to maintain and deepen the dialogue on specific urban/industrial environmental issues through a variety of non-lending services. The Bank will work closely with the IFC on issues relating to the regulatory and institutional framework for industrial pollution and waste management and in the promotion of private environment-related investments.

39. In natural resource management ("green" issues), Bank assistance will focus on: providing technical assistance and training to forestry communities on sustainable resource management; and improving water use through clarifying water rights and promoting the role of water users' associations in O&M.

Social Development

40. In addition to promoting stronger, sustainable economic growth, as outlined above, the Bank Group will support poverty reduction through improving the effectiveness of programs specifically targeted to the poor. Bank support will have two main thrusts: improving the targeting and efficiency of basic social services; and better tapping the productive potential of the poor regions. These objectives will be pursued through a substantial strengthening of ESW, selective lending operations, and improving portfolio quality including restructuring existing operations. A poverty assessment, a rural poverty report, and work relating to the Southern States Initiative, all to be completed in FY97, will provide a comprehensive analytical basis for an enhanced policy dialogue. Across Bank interventions, a common theme will be increased civil society participation, especially by the more vulnerable groups (rural women, indigenous communities).

41. ***Improving Social Services***. With Government social spending already large, the Bank assistance strategy will focus on improving the quality, efficiency, and sustainability of this spending and increasing its poverty impact.

42. *Social Safety Net.* Through ESW and a proposed nutrition project, the Bank will support ongoing Government efforts to rationalize the various nutrition and food subsidy programs, including consolidating these programs, linking nutritional programs with basic health care and education, and correcting the imbalance in social safety net programs against rural areas (where most of the extreme poor live). Also, building on the lessons learned in PROSSE (Box 1), the Bank will seek to improve rural employment programs.

43. *Health.* The Government has launched a major effort to redesign the financing and delivery of health care. As part of this effort, the Basic Health II project approved in FY96 is supporting measures to improve the coverage and quality of health services, particularly in the eleven poorest states, and to decentralize responsibilities to states to improve service delivery. The new social security law that takes effect in 1997 includes, in addition

to pension system reform (para. 28), important changes in the financing of health insurance for private workers. A priority is to ensure that the new structure that results from this reform is efficient and financially sustainable. Proposed Bank health sector ESW and lending will assist in this task through analysis of alternative modes of health financing and delivery, demonstration projects, and support to related institutional reform.

44. *Education*. With a national primary school enrollment rate of 98 percent, the key issue is to raise the quality and efficiency of basic education, particularly in the poorest states which still have high levels of drop-out and repetition and low levels of cognitive achievement and absorption in secondary education. Through the ongoing Primary Education project and a proposed basic education project, the Bank will assist in improving the quality of school entrants through expansion in pre-school education targeted toward the poorest states, upgrading primary education through investments in cost-effective inputs (teaching materials, in-service teacher training), and expanding access to low-cost lower secondary education in under-served rural areas (e.g., through TV).

45. ***Unleashing the Productive Potential of Poor Regions***. The incidence of poverty is highest in the southern states (65 percent compared with a national average of 34 percent in 1992), and has been rising. While these states account for about 15 percent of Mexico's population, they contain well over half of those classified as extremely poor. The poverty rate in their indigenous communities is alarmingly high at around 80 percent. Despite relatively high levels of public expenditures in recent years, deficiencies in the design and implementation of government programs, including limited local and private sector participation, have led to disappointing results on the ground, failing to make these states fuller participants in national economic growth.

46. The *Southern States Initiative (SSI)* aims at better tapping the productive potential—in agriculture, forestry, industry—of the two poorest southern states of Chiapas and Oaxaca through an innovative multi-sectoral approach that emphasizes increased private sector and community participation and more decentralized government decision-making. The SSI, being prepared in close collaboration with the federal and state governments, community and private sector representatives, and IDB, will introduce a greater regional emphasis in Bank Group operations in Mexico, responding to the high regional concentration of poverty.

47. Based on ongoing analytical work, the SSI envisages a two-pronged Bank Group assistance strategy. The first priority is to restructure the existing Bank portfolio in these states (11 projects) to make it more responsive to local development needs. Second, selective new Bank Group interventions will be identified to help mobilize private investment in productive activities. The Bank would provide financing for key infrastructure and technical assistance to state and local governments to build capacities for better service delivery, improve the regulatory and incentive regime for business, and establish institutional mechanisms for consultation with the private sector. Complementing this, a sharper focus on the quality and targeting of basic human resource development services will both contribute to local productivity and increase access of the local

population to earning opportunities outside the region through migration. IFC would provide financing and technical assistance to enhance SME and microenterprise access to finance (e.g., through the Fondo Chiapas, a venture capital fund) and possible direct investment in identified projects. The Bank and IFC together, in partnership with the Government, will organize a task force including representatives of local and international business community and civil society to develop specific ideas for promoting private productive activities in these states, including attracting foreign investment.

Modernization of the State

48. Second-generation, institutional reforms will feature more prominently in Bank operations. The present Administration's strong commitment to these reforms expands opportunities for Bank-country partnership. Besides the institution-building components in individual projects, as indicated above, the Bank will support broader, systemic institutional reform associated with a changing role of government in development.

49. ***Strengthening the Institutional Underpinnings of Markets***. With the liberalization of markets, the government's role shifts from the exercise of direct controls to strengthening the legal and institutional framework underlying markets to ensure they function efficiently and fairly in supporting private enterprise. Much of the Bank Group's assistance to the financial sector will be aimed at beefing up financial and capital market infrastructure (prudential regulation and supervision, accounting and reporting standards, financial and commercial laws), as noted above. In addition, the Bank will support, mainly through non-lending services, government initiatives in modernizing the judicial system.

50. ***Modernizing Public Administration***. Besides providing an efficient market setting for private enterprise, the apparatus of the state needs to be modernized to improve the delivery of services that, even with an increased private role in the economy, will remain in the public domain, e.g., basic social and infrastructure services. The Bank will help in this effort, mainly through ESW and technical assistance, on two important fronts, building on ongoing work. First, we will support the modernization of the federal budget system, to improve links between planning and budgeting and upgrade financial and performance management. Second, we will support ongoing government initiatives to decentralize responsibilities for local services to state and municipal administrations. The Bank is currently working on these initiatives with sector ministries, particularly in health and education. Planned analytical work on intergovernmental fiscal relations responds to the need to ensure that decentralization initiatives in individual sectors take place within a sound, coherent overall framework for fiscal decentralization. Key issues are: making federal transfers more efficient and equitable; mobilizing local revenues to reduce heavy state and municipal dependence on the federal budget; and strengthening fiscal accountability. This will be complemented by technical assistance to strengthen state and municipal capacities for fiscal management. The Bank will also explore with the Government its interest in Bank support for civil service reform more broadly.

Portfolio Management

51. Bank portfolio performance, which had generally been good, has been adversely affected since the 1994 crisis by fiscal constraints, high domestic interest rates that have reduced demand for funds onlent to states and municipalities, and an acceleration of fiscal and administrative decentralization. Problem and "at risk" projects have increased and disbursements on the investment portfolio have declined (see Portfolio Matrix, Annex 1). To help restructure the portfolio to reflect new, post-crisis priorities, the Mexican authorities have canceled about $860 million of the Bank's portfolio since the previous CAS. The authorities may cancel additional as yet undetermined amounts during FY97-99. Bank borrowers are entitled to cancel unilaterally any loan amounts that remain undrawn (except to the extent of any outstanding special commitments); however, the Bank will review the project consequences of each cancellation to determine the cancellation's impact on the project and address such impact accordingly.

52. The reorganization and decentralization of the Bank's Mexico Department will facilitate a closer, more active dialogue with the client and a dynamic portfolio management strategy where operations are viewed as instruments that may be adjusted during implementation to improve effectiveness. This more flexible strategy is essential to better portfolio management in the present Mexican context of change in priorities and institutional setting. The Bank strategy to deal with problem projects as well as more generic portfolio management issues is outlined below.

53. *Decentralization.* The Government's new emphasis on decentralization has resulted in a shift of project implementation responsibilities. The affected projects will be restructured and the roles of line ministries, state and municipal governments, and development banks in the portfolio (present and future) will be reassessed. As procurement and disbursement responsibilities are being transferred to state and municipal governments, training will need to be provided to help them assume these functions effectively. While the Mexican constitution does not allow states to borrow directly from the Bank, we will consider entering into non-borrowing project implementation agreements with the executing states where feasible and in the interest of more effective project implementation and better results on the ground.

54. *Budget Process.* The attractiveness of Bank funding to implementing agencies is reduced by the requirement in the Mexican budget system that it be included within each agency's budget ceiling, thus not providing any "additionality" to the recipient. While this procedure is fiscally sound, agencies are likely to prefer the use of other, unconditional budget funds in order to avoid the burdens associated with the Bank procurement, disbursement and auditing processes. This incentive problem will be addressed in two ways: by ensuring that Bank involvement brings real value-added to the client, through quality inputs, and responds to the client's priorities; and by building greater flexibility in Bank operations through simplifying projects and conditionality and showing greater responsiveness to restructuring ongoing projects to reflect changing client priorities. Other

budget process issues, e.g., late release of budgeted funds, will be addressed as part of the broader dialogue on modernization of the budget system (para. 50).

55. *Resettlement and Participation.* As the Government does not have an overall agreed approach to resettlement and participation (of NGOs, civil society, indigenous people), the Bank has had difficulty with some ministries on projects involving resettlement or where participation issues have been important. To reach a common understanding on these issues, the Bank and Government have agreed to convene a workshop to discuss the Bank's operational directives and guidelines as well as the experience of other countries. The Bank will continue to endeavor, as much as possible, to involve stakeholders outside the Government in project design and implementation.

56. *Procurement and Auditing.* A training program aimed at improving procurement skills of staff at executing agencies, especially at state and municipal levels, will be discussed with the Government. To improve the timeliness and quality of audits, and in anticipation of the need for states to implement externally funded projects in the near future, we will: broaden the mandate of the regional audit staff to develop financial management and audit strategies with our clients; strengthen capacity in the Mexico office to follow up on disbursements and audits and provide feedback to executing agencies; and ensure that ARCS is sufficiently updated to be a useful instrument to team leaders.

57. *Development Impact and Benchmarks.* Performance benchmarks agreed within the CAS framework (Table 3) will be used to monitor the impact on the ground. Intermediate targets for FY98 on portfolio implementation will be: problem projects below 10 percent (23 percent in FY96); average duration as problem projects before restructuring or closing not more than 3 months; and average time from Board approval to effectiveness not more than 3 months.

58. The 1994 crisis also affected the IFC portfolio; however, as the long-term fundamentals of the companies represented in the IFC portfolio remain strong, the impact is viewed as temporary and reversible as the economy recovers. IFC's portfolio performance in Mexico has in the past been good. Mexico has one of the lowest cancellation and droppage ratios in the Corporation. The loan and equity returns have been moderately above IFC's average and interest collection has been 100 percent (see Annex 4 for details). The strengthening of IFC's field office will be used to bolster expertise transfer during the implementation phase of projects.

VI. INSTRUMENTS OF PARTNERSHIP

59. As outlined above, the proposed country assistance program will deploy the full range of Bank Group instruments—Bank lending and non-lending services, guarantees, portfolio management, IFC's investment and advisory activities. Within this range, there will be some shifts in the mix of instruments in order to tailor the Bank Group program closely to the changing development agenda and client needs.

60. The role of *non-lending services* in the Bank's country program will be enhanced, responding to client demand for more policy analysis and advice. Increased emphasis will be placed on nonformal economic and sector work (ESW) that is demand driven and responds quickly to policymakers' specific analytical needs, such as policy notes and working papers. Stepped-up macroeconomic monitoring (para. 25) would contribute to the dialogue on macro policy and contingency planning. Formal ESW will be directed at filling major knowledge gaps in important areas of the country assistance program—productivity, financial and capital market development, effectiveness of poverty programs, decentralization (Annex 2). The impact of ESW will be enhanced through closer interaction with policymakers and wider dissemination (seminars, workshops). The relocation of the Bank's Mexico Department to the field will help with these objectives. The Bank does face constraints in Mexico in broadening participation and dissemination to stakeholders outside the core Government agencies, but we will continue to exert efforts in that direction. For example, in the ongoing work on the Southern States Initiative, the Bank has been able to broaden participation to include local governments and civil society. The Bank's analytical work and policy dialogue will be responsive to the constraints to private sector development that IFC surfaces in its interaction with private businesses. IFC also will step-up its advisory services, especially in capital market development.

61. Delivering an expanded program of non-lending services that are of sufficiently high quality to be of value in a country like Mexico will require strengthening the Bank's country economic team. It will also require tapping more effectively resources in the Bank's research complex as well as building closer partnerships with outside institutions involved in analytical work on Mexico (including those in Mexico). These partnerships will be strengthened both through regular ESW and technical assistance operations. In dissemination and training activities, we will make greater use of the increased services being offered by the EDI.

62. Within the Bank's *lending* program, there will be a shift away from traditional projects toward sector investment loans—in finance, infrastructure, social services—that address broader issues of sector policy and institutional framework and expenditure priorities (Annex 2). The reason for this shift is threefold. First, with an expanding private sector role in the provision of public services, especially in infrastructure, an increasingly important focus of Bank operations will be to support the establishment of a policy and institutional framework conducive to private participation. Second, given the Mexican budget process, and the limited "additionality" of Bank funds (para. 54), sectoral programs provide a better means to influencing expenditure priorities than individual projects. Third, in coming years Mexico will be implementing major public institutional reforms such as decentralization that, because of their breadth, are better supported through sector operations. The increased emphasis on ESW will support the proposed shift to sector-based operations, and will be reinforced by the analytical work carried out directly in preparing these operations. Both together would contribute to a substantial enhancement of our country policy dialogue.

63. Focusing the lending program on fewer, well-chosen operations in key sectors of the country assistance strategy, and improved efficiency in portfolio management, would release more budgetary resources for non-lending services. Over FY97-99, about 40 percent of the Bank's Mexico Department's operational budget may be allocated to these services, compared with less than 25 percent over the preceding three years.

64. Increased private investment in infrastructure will be supported also through a more proactive approach to the use of Bank *guarantees* in mobilizing private financing (para. 35), along with IFC's syndicated loan mobilization program. The Bank has made an indicative provision for guarantees in its FY97-99 country assistance program of about 10 percent of the proposed total Bank lending. The gas, power and water sectors have been identified as the most promising initial candidates for the use of guarantees.

VII. SIZE OF BANK GROUP PROGRAM, COUNTRY RISK AND CREDITWORTHINESS

65. ***Base Case***. The Bank lending program approved under FY94 and FY95 CASs was for annual commitments of up to $1.5 billion (excluding the FY95 crisis year for which commitments of up to $2.5 billion were approved). The FY97 CAS proposes the same average level of baseline lending over the next three years, but it also proposes that the shortfall of close to $1 billion in FY96 (due to carryover of the preparation of some projects into FY97) be reprogrammed into the next three-year program. That would give total commitments of up to $5.5 billion over FY97-99. The proposed lending program presupposes that the policy framework remains sound, the major elements of the base case economic scenario are realized, and efforts to improve portfolio quality are sustained.

66. Given the high debt service payments Mexico faces during the next three years, when the bulk of the emergency financial assistance received in 1995 falls due for repayment, it is important for Mexico that the Bank maintain its disbursements at a high level. Of the proposed total commitments during FY97-99, about $1.25 billion could be in adjustment lending—to support financial system and social security reform. There are both balance of payments and fiscal grounds for adjustment lending during this period. It is envisaged that adjustment lending will no longer be necessary beyond this period.

67. ***Alternative Lending Scenarios***. Given exposure limitations, higher Bank lending than in the base case is not feasible even if Mexico's performance turns out to be better than assumed in the base case. This is not likely to be a constraint on Mexico because, in such a scenario, Mexico would enjoy improved access to world capital markets. Indeed, in these circumstances, Bank lending could decline relative to the base case in outer years.

68. The Bank's lending response to a downside economic scenario would depend on the causes of the deterioration in economic performance (Table 4). If the main cause is slippages in policy, lending would be lower. For example, in the downside scenario analyzed in Section IV, where follow-up on the reform agenda in the financial sector is slow and piecemeal, lending could fall to around two-thirds of the base-case level, perhaps

even lower. In the extreme case where policy slippages were grave enough to reverse progress in restoring macroeconomic stability and call into question the country's overall creditworthiness, a prospect considered unlikely, lending could be limited only to critical programs in poverty reduction and human resource development. Such a scenario could result, for example, from a major loss of fiscal discipline and an associated rapid build-up of public debt or a serious erosion of external competitiveness through currency overvaluation. Lower lending could also result if there is insufficient progress on improving portfolio quality. The foregoing suggests three main triggers for lower lending: slippages in macroeconomic management (specific macroeconomic policy targets to form part of a continuing IMF program); failure to press ahead resolutely with financial sector reforms; and lack of progress in addressing key constraints in portfolio management.

69. If, in contrast, the deterioration in economic performance results mainly from an exogenous shock, and the Government's policy response is adequate, a temporary rise in Bank lending may be necessary. If the shock causes an external financial crisis, which opens a large balance of payments financing gap, the additional financing needed would come mainly within the framework of an IMF program. Resources available to respond to such financial emergencies are being increased through the enlargement of the GAB. The Bank's role as a source of additional fast-disbursing financing in this situation would be limited, focused on cushioning the impact on the poor, such as the PROSSE loan made during the recent crisis to protect critical social programs (Box 1). The amounts involved would be relatively small and should not alter significantly the projected path of Bank exposure to Mexico. This is the only possibility we envisage where Bank lending could be somewhat higher than in the base case. Canceling undisbursed amounts of previous loans that may not remain a priority in a crisis to create room for more quick-disbursing lending, if necessary, would also be an option, as was done in 1995.

Table 4: Alternative Bank Lending Scenarios

Cause of deviation from base case →	Negative shocks		Policy slippages
Bank lending response →	Limited, temporarily higher lending, if policy response adequate	Lower lending, if policy response inadequate	Lower lending

Note: Higher and lower lending is defined relative to the base case.

70. ***Country Risk and Creditworthiness***. With an export-led revival of growth and continued progress on the adjustment program, the base case scenario envisages Mexico's creditworthiness indicators to recover in coming years from the impact of the recent crisis. This outlook is sensitive to internal and external risks—banking system, adverse developments in export and capital markets. However, in the most likely alternative scenarios that can be envisaged based on these risks, Mexico's economic situation, though weakening relative to the base case, is not expected to deteriorate to a point where Mexico is unable to meet its debt service obligations (see Section IV). A larger shock causing a more serious financial crisis cannot of course be ruled out, such as a political shock triggering a major capital outflow. But Mexico is reducing its vulnerability to such

risks. It is strengthening its reserve position and improving the maturity profile of its debt. Its current policies—a floating exchange rate, more responsive monetary management, tighter fiscal discipline—position it better to deal with capital market volatility. The present Administration's political and social reform agenda should contribute to making the political and social fabric more resilient. And, as noted above, provided Mexico's economic policies remain on track, it should be able to obtain additional balance of payments support if that became necessary in the event of a major shock.

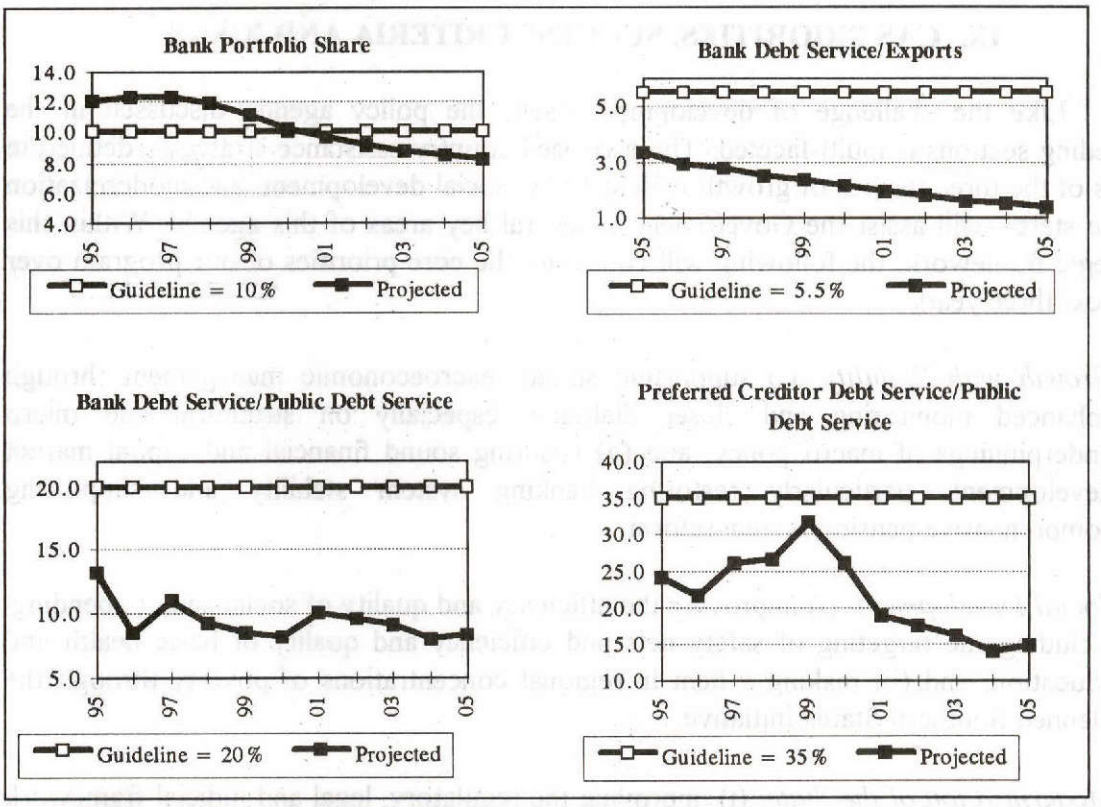
71. Mexico is taking steps to smooth the hump in debt service it faces in 1998-99, related to the 1995 US-IMF financing package. It is making early repayments in 1996 of $7 billion to the US and $1 billion to the IMF, made possible by several successful bond issues this year, including a $6 billion issue of 5-year notes. Mexico's return to international capital markets within a year of the 1994 financial crisis stands in sharp contrast to the 1982 debt crisis when it took the country nearly seven years to regain access to voluntary international private capital flows, attesting to Mexico's stronger fundamentals and more resolute policy response to the crisis than in the 1980s. Another early repurchase to the Fund is planned for 1997. Mexico is discussing a three-year EFF arrangement with the Fund for 1997-99, that would support the continuation of its adjustment program and also reduce net repurchases to the Fund in that period. While debt service would still rise in 1998-99, it should be manageable, given these steps and the projected economic outlook. Beyond this period, the debt service ratio is expected to decline steadily (Annex 5).

72. Bank exposure in Mexico is high. At the end of FY96, Mexico had the largest IBRD debt outstanding and disbursed, amounting to $13.3 billion and constituting 12.1 percent of the total IBRD portfolio. With the proposed base case lending program, Bank exposure in Mexico will remain around 12% through 1998 but then decline steadily to about 10% by the year 2000 and continue to fall in later years. This exposure outlook is similar to what was discussed and endorsed as part of FY95 CAS. While the proposed lending program would keep Bank exposure above the 10% guideline for a few years, the proposed lending is necessary to support adjustment and reforms that would allow an orderly reduction in the exposure. Bank exposure is expected to remain within the other exposure guidelines (Chart 2).

73. ***IFC Investment Program***. In response to the present widespread corporate financial distress and the emerging private sector financing needs as the economy recovers, IFC plans to increase its investment in Mexico appreciably in the next three years. A total of about $1 billion in investments is planned over FY97-99. In addition, IFC expects to mobilize about $1.2 billion through related syndications. At the end of 1995, IFC's Mexico portfolio amounted to about $650 million and represented 7.6 and 6.6 percent of total investments disbursed and held, respectively. These exposure levels make IFC's Mexico portfolio the fourth largest in the Corporation, but allow head room for an increase in investment. Planned IFC investments are an integral part of overall Bank Group assistance program in support of private sector development, as outlined above. The bulk of the planned IFC investments in FY97-99 will be in financial/capital market

development and manufacturing (about 30 percent each) and infrastructure (20 percent), with the balance in petrochemicals and agribusiness (Annex 4). The sectoral composition of planned IFC investments will reflect two important strategic thrusts: an increased focus on the promotion of SMEs within manufacturing; and support to private investment in newly opened infrastructure sectors. Another strategic emphasis will be to enhance the catalytic effect of IFC investments.

Chart 2: Bank Exposure Ratios



VIII. COLLABORATION WITH OTHER ORGANIZATIONS

74. Mexico's current stand-by arrangement with the IMF is on track. It has been extended by six months, to February 1997, to provide time for discussion of a three-year extended arrangement (EFF) that would succeed the stand-by and provide continued Fund support to and monitoring of Mexico's adjustment program (para. 71). Bank-Fund collaboration will remain active in macroeconomic management and will intensify in structural reform (para. 25). The EFF program is likely to incorporate several areas of structural reform—social security, taxation, financial sector reform, privatization, intergovernmental fiscal relations, reform of subsidy programs—where close Bank-Fund collaboration will be essential.

75. Collaboration with the IDB has increased in the past two years. The Bank's response to the Mexican crisis was closely coordinated with the IDB. In the period ahead,

major areas of collaboration will include the financial system, social security reform, and the Southern States Initiative—all priority areas in our CAS. Our lending program includes several parallel loans. Over the next three years, IDB commitments are expected to average about $1.2 billion a year. Besides lending operations, collaboration is increasing in non-lending services. The present Administration's emphasis on institutional reform is opening new areas for collaboration, e.g., in decentralization. Collaboration in the field will intensify with the relocation of the Bank's Mexico Department to Mexico City. We have consulted with the IDB at several stages of the preparation of this CAS.

IX. CAS PRIORITIES, SUCCESS CRITERIA AND RISKS

76. Like the challenge of development itself, the policy agenda discussed in the preceding sections is multi-faceted. The proposed country assistance strategy—defined in terms of the three themes of growth with stability, social development, and modernization of the state—will assist the Government in several key areas of this agenda. Within this strategic framework, the following will constitute the core priorities of our program over the next three years:

- *Growth with Stability*: (i) supporting sound macroeconomic management through enhanced monitoring and closer dialogue, especially on structural and micro underpinnings of macro policy; and (ii) ensuring sound financial and capital market development, particularly restoring banking system stability and supporting comprehensive pension system reform.

- *Social Development*: (i) improving the efficiency and quality of social sector spending, including the targeting of safety nets and efficiency and quality of basic health and education; and (ii) making a dent in regional concentrations of poverty through the planned Southern States Initiative.

- *Modernization of the State*: (i) improving the regulatory, legal and judicial framework to facilitate private enterprise, foster competition, and provide a level playing field; and (ii) supporting an orderly and efficient process of fiscal and administrative decentralization.

77. Performance benchmarks we will use to evaluate progress in these priority (and other) areas are set out in the CAS Matrix (Table 3). The critical test of the success of the proposed country assistance strategy will be its effectiveness in reducing poverty, the objective that overarches the Bank Group program.

78. The proposed country assistance program entails several important risks for the Bank Group. Financial risks arise from the existing large exposure and from an economic outlook which, though improving, remains fragile and vulnerable to shocks and policy slippages, as discussed in the preceding sections. But the risks are not only financial; the institution's reputational capital also is at stake. Mexico is a large and important client country trying to emerge from a major financial crisis that continues to be the focus of

much international attention. The Bank is, and is seen to be, closely involved in supporting Government efforts in crisis management and reform in some major policy areas, a partnership that will become closer with the placement of the Bank's Mexico Department in the field. A key, and visible, area of Bank support is the rehabilitation of a financial system shaken by a severe banking crisis. A tougher, longer-term challenge involving close Bank engagement is the reduction of Mexico's high poverty and income inequality and acute regional disparities in development. The proposed Southern States Initiative constitutes a bold, innovative move to face this challenge head-on, in a setting that is socially and politically a difficult one. Potential rewards in these areas of Bank assistance are high, but so are risks. This CAS has argued that these risks are well worth taking. But both the financial and reputational stakes for the Bank Group—and for Mexico—make it essential that the job is done well.

X. AGENDA FOR BOARD CONSIDERATION

79. The Board may wish to comment on the following CAS conclusions:

- Assisting Mexico recover from the financial crisis remains a priority, but Bank Group support increasingly should focus on the longer-term development agenda.

- Achieving better results on the ground in reducing Mexico's high poverty, both in its national and regional dimensions, is imperative and the CAS must treat that as its central challenge.

- Second-generation, institutional reforms today are at the forefront of Mexico's development agenda and crucial to the effectiveness of the Bank Group portfolio.

- Evolving development agenda and client needs call for enhancing the role of non-lending services in the Bank Group program.

- There will be a strategic shift in the IFC program toward the promotion of small and medium-scale enterprises and support to private investment in newly opened infrastructure sectors.

- The proposed country assistance program is subject to important risks, but the risks are worth taking in view of the likely benefits.

James D. Wolfensohn
President

By:

Caio Koch-Weser

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ANNEXES

Annex 1: Mexico Country Assistance Strategy
Bank Portfolio Matrix

In the medium-longer term, we expect the Mexico portfolio to resume its status as one of the strongest in the Bank.

- As shown in the table below, a higher number of projects at risk in FY95-96 and lower disbursements on investment loans in FY96 resulted from the crisis, reflecting Mexican budget constraints that have reduced counterpart funding in Bank projects and high domestic interest rates that have reduced demand for Bank funds onlent to state and municipal entities.

♦ *Risks/Rewards and the Bank's FY97-99 CAS.* The Bank's strategy for the next three years reflects a transition period as Mexico continues to deal with the impact of the crisis yet increasingly focuses on the longer term goals of reviving growth and reducing poverty. Overall, the proposed portfolio represents a balanced mix of risks and rewards. Investments in the financial sector, which remains fragile, carry a relatively high risk, but are a priority and promise a potentially high return in terms of contribution to restoration of financial stability and growth. The major risk in infrastructure is the Government's fulfillment of the ongoing privatizations and its subsequent ability to attract private participation in the provision of infrastructure services. Additional risks for infrastructure, environment and public sector operations, including an initiative in the Southern States, arise from the decentralization, resettlement and participation issues that are involved. Yet these operations are important to the long term viability of the development program.

♦ *Portfolio Management.* The Mexico Pilot with delegation of authority and increased field presence will allow the Bank to deal proactively in addressing the following issues:

- In response to the Government's decentralization policy, affected projects will be restructured. The roles of line ministries, state and municipal governments, and the development banks will be reassessed.
- A broad-based strategy will be adopted to promote sustainable development in the Southern States, in which the private sector and civil society will play a prominent role. The capacity and transparency of public sector management will also be strengthened.
- Environmental issues will be highlighted in the policy dialogue, and ongoing projects will be restructured to reflect new conditions.
- Problems predating the crisis will also need to be addressed, in particular the budgeting process affecting the Bank portfolio.
- Major implementation targets for end-FY98 include: % of problem projects—less than 10%, length of stay as problem projects before restructuring or closing—not more than 3 months, and average time Board to effectiveness—not more than 3 months.

Portfolio Performance	FY93	FY94	FY95	FY96
Volume of Projects Under Implementation (US $ M) (end of year, disbursed plus undisbursed)	8,097	8,668	9,489	7,296
Number of Projects Under Implementation	45	43	41	35
Percent of problem projects (rated U or HU for past year)				
Development objectives	3	7	7	6
Overall status/Implementation Progress	5	7	17	23
Canceled during FY (US$M)	57.3	8.2	29.9	644
Disbursements (US $M)	1201	997	1,113	1,473 (o/w 973 investment)
Disbursement ratio (%) (investment projects only)	31.3	22.7	26.3	21.7
Completed projects rated unsatisfactory by OED	5	4	3	NA

Projects at Risk			Proposed Projects FY 97-99		Risk/Reward (Low/Med/High)
Problem Projects as of 6/30/96	US$M	Action	Growth with Stability	FY	
Envir./Nat. Resources	24	✓	*Pension System Reform*		
Northern Border Environment	208	✓	Contractual Savings I	97	Low/High
Medium Cities Transport	200	✓	Contractual Savings II	98	MediumHigh
Solid Waste II	60	✓	Contractual Savings III	99	Medium/High
Agricultural Technology	90	✓	*Finance/Cap. Markets Development*		
Urban Transport I	91	✓	Financial Sector Restructuring II	97	High/High
Decentralization II	500	✓	*Rural Productivity*		
Sub-Total Problem Projects	**1,173**		Rural Financial Markets TA	97	Low/High
			Rural Financial Markets II	99	Medium/High
% of Active Committed Portfolio	13		Agricultural Productivity	99	Medium/High
% of Projects	23		*Infrastructure*		
			Housing Sector III	97	Medium/High
Potential Problem Projects			Federal Roads	97	Medium/Medium
Transport Air Pollution	220	✓	Transmission & Distribution.	97	Medium/Medium
Primary Education II	372	✓	Infrastructure Guarantees	98,99	Medium/High
Sub-Total Potential Problem Projects	**592**		Water & Sanitation III	99	Medium/High
			Environment/Natural Resources		
Total Projects at Risk	**1,765**		Environmental TA II	98	Low/High
			Pollution Control	98	High/High
% of Active Committed Portfolio	24		Natural Resources Management	98	Medium/High
% of Projects	30		*Sub-total* as *% of Total Lending Program 65*		
Bankwide Projects at Risk (as of 4/5/96):			Social Development		
% of Active Committed Portfolio	30		Primary Education III	98	Low/High
% of Projects	33		Nutrition	98	High/High
			Health Sector	98	Medium/High
			Southern States Initiative	98	High/High
			Sub-total as % of Total Lending Program 25		
			Modernization of the State		
			PSD Competitiveness TA	98	Low/High
			State & Municipal Management TA	98	Medium/High
			Financial Infrastructure	99	Medium/High
			Science & Technology	99	Medium/Medium
			Sub-total as % of Total Lending Program 10		
			Total Lending Program $5.5 billion		
			Note: The lending program is allocated above against the CAS thematic categories according to their predominant impact. It must be noted, however, that the impact of most of these projects cuts across these categories. For example, most projects listed under "growth with stability" and "social development" have institutional components that contribute to "modernization of the state."		

Projects at Risk include (i) projects categorized as "problem" projects and (ii) projects categorized as "potential" problem projects. The latter are defined as projects with satisfactory IP and DO ratings but which suffer from two or more of the following problems (see Prem Garg, EXCQA, Portfolio Improvement Program, Memo of April 10, 1996):

1. Counterpart Funding Constraints (rating 3 or 4)
2. Slow Disbursements (disbursement level < half of the original or revised forecast)
3. Effectiveness Delays (> 12 months after Board approval)
4. Financial Performance Problems (rating of 3 or 4)
5. Non-Compliance with Covenants (rating of 3 or 4)
6. Project Management Problems (rating of 3 or 4)
7. Extended Problem Status (> 2 consecutive years)
8. Procurement Problems (rating of 3 or 4)
9. Risky Countries (> 50% unsatisfactory commitments for operations closed during past 5 years) and no major change in economic management
10. Risky Instruments (>33% unsatisfactory commitments for operations closed during past 5 years)

CAS Decision: Balancing Risks and Rewards



Annex 2: Bank Lending and Non-Lending Program, FY 97-99

(a) Lending and Guarantees	
FY97	
Lending	Technical Assistance
Contractual Savings I	Rural Financial Markets
Financial Sector Restructuring II	
Housing Sector III	
Federal Roads	
Transmission & Distribution	
FY98	
Lending	Technical Assistance
Contractual Savings II	Environment
Southern States Initiative	PSD Competitiveness
Nutrition	State & Municipal Management
Primary Education III	
Health Sector Reform	
Natural Resources Management	
Guarantees	
Infrastructure	
FY99	
Lending	
Contractual Savings III	
Rural Financial Markets II	
Financial Infrastructure	
Water & Sanitation III	
Science and Technology	
Agricultural Productivity	
Pollution Control	
Guarantees	
Infrastructure	

(b) Non-Lending Services

	Fiscal Year
Growth with Stability	
Macroeconomic Management	
Macro Monitoring/Policy Notes	97-99
Private Capital Inflows & Financial Integration	97
External Debt/Asset Liability Management	97
Savings/Financial Sector	
CEM: Savings	97
CEM: Public Credit Programs	98
Financial Sector/Capital Markets ESW	97-99
Productivity	
CEM: Restructuring and Productivity	97
Industrial Policy	98
Infrastructure Policy Notes	97-99
Training Assessment	97
Informal Labor Markets	97
PROCAMPO (Agricultural Policy)	97
PROCEDE (Agricultural Policy)	97
PRODUCE (Agricultural Policy)	98
Agricultural Supply Response	98
Land Markets in Rural Mexico	98
Regulatory Issues in Water Sector	98
Regulatory Issues in Rural Markets	99
Environment	
Industrial Pollution Prevention	97
Environmental Priorities and Decentralization	98
Ground Water Study	99
Social Development	
Poverty Assessment	97
Rural Poverty	97
Follow-up Policy Notes on Poverty Studies	98
Maize and Tortilla Policy	98
CEM: Structural Reform and Poverty Alleviation	99
Social Services for Marginalized Groups	99
Southern States Initiative	97-98
Pre-School Education Review	97
Education Decentralization	99
Fiscal Costs of Health Insurance Reform	97
Financing Health Services	98
Gender and the Rural Economy	97
Modernization of the State	
Fiscal Management/Decentralization	97
Federal Budget Process Reform	97
Corporate Legal Framework/Judicial Reform	99
Science & Technology	99

Notes: (1) The above list includes both formal and non-formal ESW tasks. More tasks, especially non-formal tasks, will be added for FY98 and FY99. The list does not include non-ESW non-lending services, such as seminars and conferences, whose role also is programmed to expand. The list also does not include substantial analytical work supported by technical assistance loans. Two such TA loans are ongoing (FTAL, PTAL). Four TA loans (Rural Financial Markets; PSD Competitiveness; State and Municipal Management; and Environmental Decentralization) are in the program for FY97-99, as shown in the previous page. (2) Non-lending tasks are arranged above according to the main thematic categories used in the CAS, but it must be noted that the contribution of many of the tasks cuts across these categories. For example, the financial sector related work is shown above under growth with stability but will also contribute to modernization of the state as much of this work involves strengthening the regulatory, legal and institutional framework underpinning financial and capital markets.

Annex 3: Mexico Bank Fact Sheet, FY 1994-1999

	Past			*Current*	*Planned*[a]	
Category	**FY94**	**FY95**	**FY96**	**FY97**	**FY98**	**FY99**
Commitments (US$m)	1530.0	2387.4	526.5	1930.0	2170.0	1400.0
Sector (%)[b]						
Agriculture	13.1	3.6	35.4	1.6	2.8	32.1
Education	26.9	11.1	0.0	0.0	12.9	0.0
Elec.power,oth.engy.	0.0	0.0	0.0	20.7	4.6	0.0
Environment	24.1	0.0	0.0	0.0	2.3	21.4
Finance	0.0	43.5	0.0	41.5	11.5	51.7
Multi Sector	0.0	0.0	0.0	0.0	18.4	0.0
Pop/health/nutrition	0.0	0.0	58.9	0.0	30.0	0.0
Public Sector Mgmt	0.0	20.9	5.7	13.0	3.7	32.1
Social Sector	0.0	20.9	0.0	0.0	0.0	0.0
Transportation	0.0	0.0	0.0	18.1	4.6	0.0
Urban Development	13.1	0.0	0.0	18.1	4.6	0.0
Water Supply & Sanit	22.9	0.0	0.0	0.0	4.6	14.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Lending instrument (%)						
Adjustment loans[c]	0.0	41.9	0.0	41.4	11.5	0.0
Specific investment loans and others	100.0	58.1	100.0	58.6	88.5	100.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Disbursements (US$m)						
Adjustment loans[c]	197.0	0.0	500.0	1251.0	500.0	200.0
Specific investment loans and others	800.0	1112.9	973.2	1216.0	940.0	901.0
Repayments (US$m)	1007.1	1222.9	1461.4	1494.0	1533.0	1624.0
Interest (US$m)	907.4	959.0	951.1	1036.0	1038.0	1012.0

a. Ranges that reflect the base-case (i.e., most likely) scenario. For IDA countries, planned commitments are not presented by FY but as a three-year-total range; the figures are shown in brackets. A footnote indicates if the pattern of IDA lending has unusual characteristics (e.g., a high degree of frontloading, backloading, or lumpiness). For blend countries, planned IBRD and IDA commitments are presented for each year as a combined total.

b. For future lending, rounded to nearest 0 to 5%. To convey the thrust of country strategy more clearly, staff may aggregate sectors.

c. Structural adjustment loans, sector adjustment loans, and debt service reduction loans.

Note:

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

Annex 4: Mexico - IFC Portfolio and Investment Program

Portfolio Status. As of June 30, 1996, IFC's Mexico portfolio involved 40 clients and stood at $652 million, of which $582 million (89%) related to loans and about $70 million (11%) to equity participations. Undisbursed amounts totaled $59 million. From a country exposure standpoint, IFC's Mexican portfolio is the fourth largest of the Corporation, after being the largest at the beginning of the 1990's. As of June 30, 1996, it amounted to 7.6% and 6.6% of total investments disbursed and held, respectively, by the Corporation worldwide. Sector-wise, IFC's outstanding investments are largest in general manufacturing (56%), chemicals/petrochemicals (17%), capital markets (15%), infrastructure (8%), and mining (4%).

Notwithstanding the difficult economic environment prevailing in Mexico, none of IFC's investee companies is in default and the collection rate on the loan portfolio remains firm at 100%. The financial yield and risk-adjusted financial yield[1] on the Mexican loan portfolio amounted to 4.2% and 5.1%, respectively, in FY96 compared with 3.8% and 3.2% for IFC as a whole.

Largely due to the devaluation of the *peso*, unrealized capital gains on the equity portfolio decreased sharply from a pre-crisis level of about $120 million to $68 million in August 1996. As the long-term fundamentals of the companies represented in IFC's equity holdings remain sound, this downturn may be viewed as temporary and reversible as the economy recovers. Profitability-wise, the equity portfolio ended FY96 with a return on average capital employed of 1.7% compared with 8.1% for IFC's equity portfolio as a whole. This low performance resulted primarily from IFC's decision to hold on to its unrealized capital gains until fuller recovery of the local stock market. Over the FY92/FY96 period the average equity return in Mexico was 16.6% vs. 13.0% for IFC as a whole.

Recent and Planned Investment Program. During FY96, IFC's Mexican activities included the processing of 10 transactions for which funds totaling $733 million were mobilized for the private sector.[2] Of this total, IFC's own-account approvals amounted to $243 million of which $194 million related to loan operations, $38 million to equity and quasi-equity participations, and $11.1 million to interest and currency swaps.

Taking into account the emerging needs of the private sector and the development agenda proposed in this CAS, IFC intends to significantly increase its investment activities and portfolio exposure in Mexico in the coming years. Reflecting the sizable long-term financing needs of the corporate sector, IFC anticipates that through FY99 its activities could increase from 10 to 14 projects per year while estimated gross approvals could reach $700-800 million annually, including $300-350 million for IFC's own account. Such

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1 Income contractually due, dividends, capital gains and service/financial fees, minus borrowing costs, if applicable.

2 In FY95, IFC's investment activities included 9 operations for which financial support of $189 million was extended, including $75 million for IFC's own account.

a program would result in the processing of 40-44 projects involving estimated gross commitments of $2.2 billion through FY99, of which about $1 billion would be for IFC's own account. Sector-wise, over 50% of the program would go to financial market development and general manufacturing, and the balance to infrastructure, petrochemicals and agribusiness. The share of infrastructure could increase substantially with a comprehensive privatization program in this sector.

Mexico: IFC Investment Activities

Category	Actual		Planned a/		
	FY95	FY96	FY97	FY98	FY99
IFC Net Approvals (US$m)	75	243	300	350	350
Sector (%)					
Agribusiness	0	0	5	5	10
Financial Sector	14	42	30	30	25
Petrochemicals	0	16	15	15	15
Infrastructure	2	0	15	20	20
Manufacturing	51	40	30	30	25
Oil/Gas/Mining	33	2	5	0	5
Total	100	100	100	100	100
Investment Instrument (%)					
Loans	84	84	85	85	85
Equity	16	16	15	15	15
Total	100	100	100	100	100

Notes
a/ Includes quasi-equity types of both loan and equity instruments.

The non-financing program is going to increase with additional resources devoted to joint advisory work with the Bank, in particular in the financial and infrastructure sectors.

Annex 5: Mexico - Key Economic Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
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	100.0	100.0	100.0	100.0
Agriculture[a]	9.1	8.9	8.4	8.2	8.0	8.2	..	..	..	..	..	..
Industry[a]	30.3	29.6	29.1	28.2	28.1	27.8	..	..	..	..	..	..
Services[a]	60.6	61.4	62.5	63.6	64.0	64.0	..	..	..	..	..	..
Total Consumption	78.3	79.7	81.0	81.0	81.6	77.7	78.7	78.0	77.3	76.7	76.3	75.1
Gross domestic investment	22.8	23.4	24.4	23.2	23.5	19.4	19.2	20.6	21.9	23.7	24.2	26.3
Government investment	4.8	4.5	4.1	4.1	4.2	4.1	3.8	4.1	4.3	4.6	4.6	4.8
Private investment	13.6	14.7	16.3	15.9	16.1	12.3	12.0	13.2	14.3	15.8	16.1	17.6
Increase in stocks	4.5	4.2	3.9	3.2	3.1	3.1	3.3	3.3	3.3	3.3	3.4	3.9
Exports (GNFS)[b]	15.6	13.6	12.4	12.2	12.7	24.0	26.2	27.8	29.2	30.1	30.7	31.3
Imports (GNFS)	16.7	16.8	17.9	16.4	17.8	21.2	24.1	26.5	28.4	30.5	31.1	32.7
Gross domestic savings	21.7	20.3	19.0	19.0	18.4	22.3	21.3	22.0	22.7	23.3	23.7	24.9
Gross national savings[c]	19.8	18.4	17.0	16.9	16.0	18.7	17.9	19.0	20.0	21.6	22.1	24.3
Memorandum items												
Gross domestic product (US$ million at current prices)	247,057	290,529	334,356	367,581	377,112	250,038	289,920	305,128	324,538	348,739	376,597	556,562
Gross national product per capita (US$, Atlas method)	2,450	2,981	3,490	3,810	4,090	3,320	2,964	2,897	3,223	3,445	3,658	5,100
Real annual growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	4.4%	3.6%	2.9%	0.7%	3.5%	-6.9%	3.0%	3.5%	4.0%	5.0%	5.0%	5.3%
Gross Domestic Income	5.6%	3.2%	3.2%	0.8%	3.4%	-11.1%	2.3%	3.1%	3.6%	4.7%	4.8%	5.1%
Total consumption	5.5%	4.8%	3.7%	0.4%	3.5%	-11.7%	0.4%	0.8%	2.1%	3.4%	4.0%	4.5%
Private consumption	6.1%	4.9%	3.9%	0.2%	3.7%	-12.9%	1.0%	1.2%	2.3%	3.5%	4.0%	4.5%
Real annual per capita growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	0.5%	1.6%	0.9%	-1.2%	1.6%	-8.6%	1.1%	1.7%	2.2%	3.3%	3.4%	3.7%

(Continued)

Annex 5: Mexico - Key Economic Indicators (Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Balance of Payments (US$m)												
Exports (GNFS)[b]	38,411	39,695	41,451	44,872	50,717	63,532	76,070	84,948	94,695	105,119	115,434	174,227
Merchandise FOB	30,390	30,905	32,259	35,453	40,416	53,362	65,047	72,923	81,138	89,896	98,781	148,078
Imports (GNFS)[b]	41,215	48,725	59,681	60,473	71,136	55,203	69,937	80,734	92,258	106,427	117,253	182,047
Merchandise FOB	31,272	38,184	48,193	48,924	58,880	46,274	57,816	67,574	77,065	89,197	98,405	152,521
Resource balance	-2,804	-9,030	-18,230	-15,601	-20,419	8,329	6,133	4,214	2,437	-1,308	-1,819	-7,819
Net current transfers (including official current transfers)	3,978	2,745	3,386	3,640	4,011	3,965	4,101	4,354	4,520	4,525	4,803	10,601
Current account balance (after official capital grants)	-7,451	-14,892	-24,438	-23,399	-29,419	-655	-3,563	-4,967	-6,276	-7,163	-7,735	-11,254
Net private foreign direct investment	2,633	4,761	4,393	4,389	10,973	6,964	5,800	6,000	6,400	7,100	9,600	9,700
Long-term loans (net)	9,224	4,171	51	3,227	4,271	7,817	354	1,836	363	1,749	78	-1,802
Official	4,181	1,392	620	20	-624	10,341	-7,113	-385	-2,718	-3,343	-1,088	-123
Private	5,043	2,779	-569	3,207	4,895	-2,524	7,467	2,221	3,080	5,092	1,166	-1,680
Other capital (net, including errors and omissions)	-1,175	14,099	21,168	21,724	-4,216	-3,275	-1,991	1,308	1,155	1,570	3,813	6,622
Change in reserves[d]	-3,231	-8,139	-1,174	-5,941	18,391	-10,851	-600	-4,177	-1,642	-3,256	-5,756	-3,266
Memorandum items												
Resource balance (% of GDP at current market prices)	-1.1%	-3.1%	-5.5%	-4.2%	-5.4%	3.3%	2.1%	1.4%	0.8%	-0.4%	-0.5%	-1.4%
Current account balance (% of GDP at current market prices)	-3.0%	-5.1%	-7.3%	-6.4%	-7.8%	-0.3%	-1.2%	-1.6%	-1.9%	-2.1%	-2.1%	-2.0%
Reserves in months of imports of goods	3.8	5.6	4.7	6.2	1.3	4.4	3.2	3.1	2.7	2.4	2.5	3.6

(Continued)

Annex 5: Mexico - Key Economic Indicators (Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Public finance (as % of GDP at current market prices)[e]												
Current revenues	27.0	25.8	26.1	25.4	25.6	26.9	25.4	25.5	25.7	26.0	26.2	26.6
Current expenditures	26.3	22.5	20.6	21.8	21.8	23.1	22.6	22.8	22.5	22.4	22.2	21.6
Current account surplus (+) or deficit (-)	0.7	3.3	5.5	3.6	3.8	3.8	2.8	2.7	3.2	3.6	4.0	5.0
Capital expenditure	3.8	3.9	4.0	3.3	4.2	3.7	3.5	3.7	3.8	3.9	4.2	4.9
Overall Balance	-3.1	-0.6	1.5	0.3	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3	0.1
Monetary indicators												
M2/GDP (at current market prices)	26.3	30.7	31.3	32.0	34.9	38.5	..	..	..	..	..	..
Growth of M2 (%)	46.2	47.1	20.3	13.4	21.3	38.7	..	..	..	..	..	..
Private sector credit growth / total credit growth (%)	83.7	105.2	161.5	193.3	139.9	43.1	..	..	..	..	..	..
Price indices(1980 =100)												
Merchandise export price index	87.3	82.3	84.9	86.4	95.8	110.6	112.1	115.1	118.7	122.1	125.1	139.8
Merchandise import price index	134.4	135.6	137.1	138.5	141.7	153.5	151.0	154.7	158.9	162.8	166.7	188.2
Merchandise terms of trade index	65.0	60.7	61.9	62.4	67.6	72.0	74.2	74.4	74.7	75.0	75.0	74.3
Real exchange rate (US$/LCU)[f]	128.8	117.5	107.4	101.5	105.3	152.8	135.0	135.0	135.0	135.0	135.0	135.0
Consumer price index (% growth rate) (period average)	26.7%	22.7%	15.5%	9.8%	7.1%	34.9%	39.0%	19.8%	10.8%	8.0%	6.0%	5.0%
Consumer price index (% growth rate) (end-of-period)	29.9%	18.8%	11.9%	8.0%	7.0%	51.3%	27.0%	12.5%	9.0%	7.0%	5.0%	5.0%
GDP deflator (% growth rate)	29.8%	21.8%	14.7%	9.9%	7.4%	35.4%	33.8%	17.8%	9.8%	7.2%	5.6%	4.9%

a. GDP components are at market prices.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated non-financial public sector.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Annex 5: Mexico - Key Exposure Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Total debt outstanding and disbursed (TDO) (US$m)[a]	104,439	114,065	112,227	127,436	136,125	161,096	159,048	159,731	160,730	161,155	159,889	173,482
Net disbursements (US$m)[a]	17,637	10,117	2,162	4,798	7,475	16,466	-6,295	-2,629	-2,581	-3,107	-4,463	-410
Total debt service (TDS) (US$m)[a]	11,316	13,545	20,822	21,931	19,938	29,206	39,280	34,481	41,118	45,909	47,374	50,296
Debt and debt service indicators (%)												
TDO/XGS[b]	25.9	249.5	238.6	254.7	239.9	229.7	191.4	173.4	157.2	142.8	129.5	91.4
TDO/GDP	42.3	39.3	33.6	34.7	36.1	64.4	54.9	52.3	49.5	46.2	42.5	31.2
TDS/(XGS + current transfers)	26.7	31.9	46.4	45.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4	27.2
IBRD exposure indicators (%)												
IBRD DS/public DS	16.2	16.6	11.2	15.5	15.1	13.2	8.4	11.0	9.1	8.2	7.8	8.3
Preferred creditor DS/public DS	39.3	36.5	22.9	33.3	31.1	24.1	21.5	25.9	26.2	31.0	24.9	14.6
IBRD DS/XGS	3.6	4.0	4.0	3.8	3.5	3.4	3.0	2.8	2.5	2.4	2.2	1.4
Share of IBRD portfolio	11.4	11.7	12.1	11.9	11.8	12.0	12.3	12.4	11.9	11.1	10.2	8.2
IFC (US$m)												
Loans	119	69	67	53	133	63	194	310	340	375	400	420
Equity and quasi-equity[c]	20	60	64	36	21	12	38	75	85	90	100	105
MIGA												
MIGA guarantees (US$m)	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.

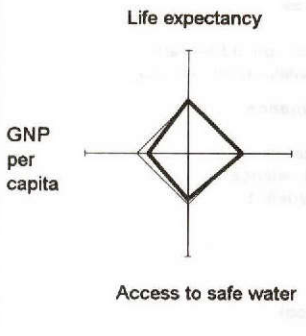
b. "XGS" denotes exports of goods and services, including workers' remittances.

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

Annex 6: Mexico at a Glance

POVERTY and SOCIAL	Mexico	Latin America & Carib.	Upper-middle-income
Population mid-1995 *(millions)*	91.8	481	442
GNP per capita 1995 *(US$)*	3,320	3,320	4,300
GNP 1995 *(billions US$)*	304.9	1,597	1,901
Average annual growth, 1990-95			
Population *(%)*	1.9	1.8	1.7
Labor force *(%)*	2.9	2.4	2.1
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	34	..	..
Urban population *(% of total population)*	75	74	74
Life expectancy at birth *(years)*	70	68	69
Infant mortality *(per 1,000 live births)*	35	41	36
Child malnutrition *(% of children under 5)*	11	..	..
Access to safe water *(% of population)*	78	80	86
Illiteracy *(% of population age 15+)*	13	14	13
Gross primary enrollment *(% of school-age population)*	112	110	107
Male	114	..	..
Female	110	..	..

Development diamond*

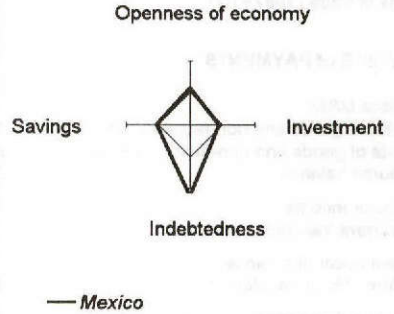


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1994	1995
GDP *(billions US$)*	94.4	183.6	377.1	250.0
Gross domestic investment/GDP	22.3	20.8	23.5	19.4
Exports of goods and non-factor services/GD	5.7	15.5	12.7	24.0
Gross domestic savings/GDP	19.0	25.9	18.4	22.3
Gross national savings/GDP	17.1	22.1	16.0	18.7
Current account balance/GDP	-4.4	0.4	-7.8	-0.3
Interest payments/GDP	1.2	5.1	2.4	3.9
Total debt/GDP	19.3	52.8	36.1	64.4
Total debt service/(exports + current transfers)		52.4	36.4	43.3
Present value of debt/GDP	..	..	32.7	..
Present value of debt/exports	..	..	219.4	..

	1975-84	1985-95	1994	1995	1996-99
(average annual growth)					
GDP	5.1	2.0	3.5	-6.9	3.9
GNP per capita	2.0	0.3	1.2	-10.8	..
Exports of goods and nfs	12.5	5.2	7.3	28.4	10.3

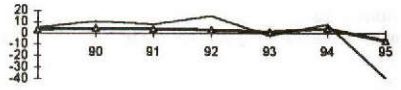
Economic ratios*



STRUCTURE of the ECONOMY

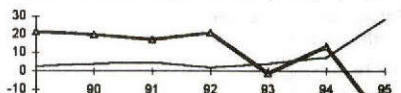
	1975	1985	1994	1995
(% of GDP)				
Agriculture	10.8	9.1	8.0	8.2
Industry	29.9	33.5	28.1	27.8
Manufacturing	21.9	23.5	19.7	19.8
Services	59.4	57.4	64.0	64.1
Private consumption	71.6	64.8	70.0	67.3
General government consumption	9.3	9.3	11.6	10.4
Imports of goods and non-factor services	9.0	10.4	17.8	21.2

Growth rates of output and investment (%)



	1975-84	1985-95	1994	1995
(average annual growth)				
Agriculture	3.2	0.3	4.2	-3.8
Industry	5.2	2.4	4.1	-8.0
Manufacturing	4.4	2.8	3.6	-6.4
Services	5.3	2.0	3.4	-6.7
Private consumption	4.1	3.8	3.7	-12.9
General government consumption	6.6	1.2	2.5	-4.1
Gross domestic investment	2.4	3.7	7.8	-39.5
Imports of goods and non-factor services	2.8	13.3	12.9	-27.6
Gross national product	4.5	2.2	3.1	-8.7

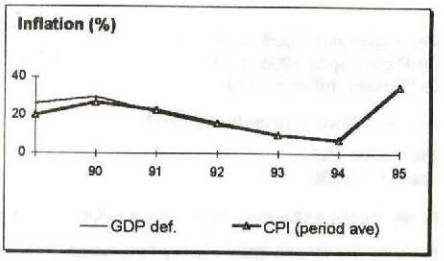
Growth rates of exports and imports (%)



* 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.

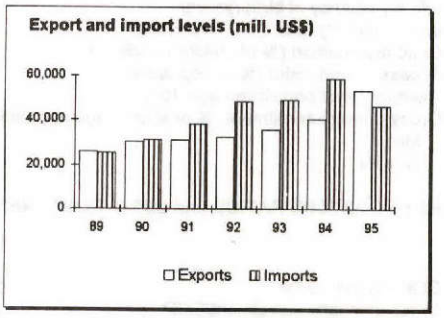
PRICES and GOVERNMENT FINANCE

	1975	1985	1994	1995
Domestic prices				
(% change)				
Consumer prices (period average)	..	57.7	7.1	34.9
Implicit GDP deflator (period average)	15.5	56.2	7.4	35.4
Government finance				
(% of GDP)				
Current revenue	..	31.5	25.6	26.9
Current budget balance	..	-1.6	3.8	3.8
Overall surplus/deficit	..	-6.2	-0.4	0.1



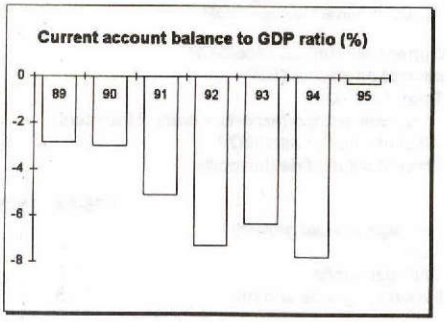
TRADE

	1975	1985	1994	1995
(millions US$)				
Total exports (fob)	..	22,931	40,416	53,362
Fuel	..	14,767	7,445	8,422
n.a.	..	..	..	..
Manufactures	..	6,245	29,936	40,379
Total imports (cif)	..	14,533	58,880	46,274
Food	..	1,082	9,510	5,335
Fuel and energy	..	..	..	..
Capital goods	..	3,165	13,322	8,697
Export price index *(1987=100)*	..	125	110	122
Import price index *(1987=100)*	..	99	119	123
Terms of trade *(1987=100)*	..	127	93	99



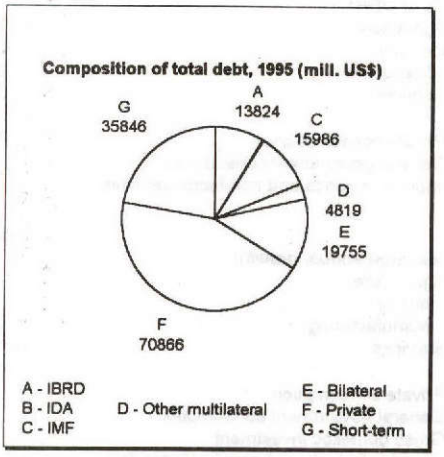
BALANCE of PAYMENTS

	1975	1985	1994	1995
(millions US$)				
Exports of goods and non-factor services	6,066	27,726	50,717	63,532
Imports of goods and non-factor services	8,466	19,915	71,136	55,203
Resource balance	-2,400	7,811	-20,419	8,329
Net factor income	-1,783	-8,996	-13,012	-12,948
Net current transfers	59	1,986	4,011	3,965
Current account balance, before official transfers	-4,124	801	-29,419	-655
Financing items (net)	4,327	-3,222	11,028	11,505
Changes in net reserves (- = increase)	-204	2,421	18,391	-10,850
Memo:				
Reserves including gold *(mill. US$)*	1,897	4,997	6 300	16,870
Conversion rate *(local/US$, period average)*	1.25E-02	0.3	3.4	6.4



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1994	1995
(millions US$)				
Total debt outstanding and disbursed	18,231	96,867	136,125	161,096
IBRD	1,123	4,034	13,038	13,824
IDA	0	0	0	0
Total debt service	2,613	15,293	19,938	29,206
IBRD	116	597	1,990	2,375
IDA	0	0	0	0
Composition of net resource flows				
Official grants	8	78	47	..
Official creditors	381	809	-623	10,341
Private creditors	3,365	-831	4,985	-2,424
Foreign direct investment	609	491	10,973	6,964
Portfolio equity	0	0	4,088	519
World Bank program				
Commitments	310	928	2,815	1,877
Disbursements	188	840	943	1,733
Principal repayments	39	335	1,065	1,411
Net flows	150	505	-123	322
Interest payments	78	262	924	964
Net transfers	72	243	-1,046	-642



Attachment 1

MEXICO
COUNTRY ASSISTANCE STRATEGY
PRIVATE SECTOR STRATEGY

I. INTRODUCTION

1. This Private Sector Strategy Paper (PSS) addresses selected issues that are relevant to Mexico's private sector development, as an important input to the country's overall strategy to recover from the recent crisis, reduce poverty and achieve sustained growth. The PSS is a supporting document of the Country Assistance Strategy (CAS), which attempts to provide a comprehensive assessment of the country's overall development needs and Bank Group assistance strategy.

2. Efforts to promote private sector development permeate virtually every Bank Group operation identified in the CAS. The PSS, however, focuses in more detail on five areas deemed important for private sector development at this stage: strengthening the banking sector, developing non-banking and capital markets, enhancing the competitiveness of Mexican corporations particularly in the SME sector, improving infrastructure and correcting regional development imbalances.[1] These areas reflect both the current priority needs of the Mexican private sector, as well as the proposed allocation of Bank Group resources for private sector development in Mexico over the FY97-99 period.

3. The PSS is organized in four sections: the next section describes the local private sector and presents an overview of the current business environment in Mexico. The third section summarizes Government actions to promote the private sector and the fourth section describes the Bank Group's strategy to assist the Government in removing the remaining constraints to private sector development.

II. THE PRIVATE BUSINESS ENVIRONMENT

General Profile

4. The macroeconomic reforms instituted by the Mexican authorities over the past decade have significantly elevated the role of the private sector. The sale of Government-owned enterprises and the re-privatization of the banking sector have played an important part, but most critical has been the opening of the economy to international competition.

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1 These sectors do not preclude active participation in other important areas such as agribusiness and small scale mining.

5. Characterized by a fairly diversified productive base, the Mexican private sector presently accounts for 70% of GDP and 86% of total employment. Data on output trends and productivity growth suggests a duality within the Mexican private sector. A large traditional sector, comprising mainly small and medium sized firms, employs a large fraction of the labor force but accounts for a much smaller portion of output and exports. Productivity improvements in this sector have been slow and output growth sluggish. In contrast, the modern sector has experienced faster productivity growth, and stronger output and export performance.

6. **Growth Patterns**. The evolution of private sector activity in Mexico mirrors the evolution of GDP in general. GDP growth has been moderate overall since the liberalization efforts began and has varied significantly across sectors, as productive activities have adjusted with differing degrees of success to structural changes. As shown in Table 1, agricultural growth remained flat while industry and services each grew by about 3.0% p.a. Within manufacturing, some industries experienced slow or even negative growth (e.g. textiles, clothing, footwear, wood products, agro-industry) while export-oriented industries (e.g. automobile assemblies and autoparts, electrical and electronic goods, petrochemicals and steel) showed the most dynamic performance.

Table 1
MEXICO
Gross Domestic Product and Sectoral Growth Rates

	GDP Share (%)	GDP Average Growth Rate	
Sector	*1995*	*1985-94*	*1995*
Agriculture	7.6	0.5	-3.8
Industry	32.7	3.1	-8.0
Mining	3.7	1.2	-0.7
Manufacturing	22.6	2.4	-6.4
Construction	4.6	2.0	-22.0
Electricity, Gas & Water	1.8	4.5	3.1
Services	59.7	2.3	-6.7
Trade & Restaurants	23.3	2.2	-14.4
Trans., Warehouse & Comm	7..9	4.5	-1.9
Finance, Insurance & Fixed Assets	12.4	3.5	0.4
Community, Social & Personal Services	16.1	1.4	-2.4

Source: Calculations based on National Accounts series, INEGI.

7. The recent economic recession has had strong repercussions on sectoral developments. Mexico's overall index of industrial production declined in 1995, as did agricultural output and services. Within the industrial sector, the construction industry experienced the most severe contraction as a result of a sharp decline in public infrastructure projects and private investment. Output of all major manufacturing sectors declined with the exception of basic metal industries which grew by 9%. Notwithstanding a flat growth performance within the mining sector as a whole, iron ore and other non-metallic metals experienced real growth rates between 13% and 15%, reflecting the positive role of direct and indirect exports in these mining activities.

8. The past decade also witnessed a significant shift in the nature and distribution of exports. As detailed in Table 2, manufactured exports have replaced oil as Mexico's main

source of export earnings. In addition to the dynamism of manufactured exports growth, this evolution also reflects a halving in world oil prices since 1982. Agricultural exports have remained constant at around 5-6% of the total, with rising sales of fresh fruit and vegetables offsetting declining revenues from traditional export crops such as cotton and coffee.

Table 2
MEXICO
Structural Changes in Mexican Exports
(percentages)

Year	Manufactured Exports/ Manufacturing GDP	Manufactured Exports/ Total Exports (excluding in-bond)	Petroleum Exports/Total Exports (excluding in-bond)
1982-83	10.5	17.5	74.5
1986-87	23.6	37.7 *	50.9 *
1994	32.0	68.9	21.2
1995	53.8	73.2	17.4
*1985-87			

Source: El Indicador Bursatil

9. The *peso* crisis has reinforced the above trends, as exports have taken up the slack in domestic demand. In US dollar terms, total merchandise exports increased by 31% in 1995, with manufacturing exports experiencing a 47% surge and the "*Maquiladora*" (in-bond) industry growing by 18%. This high export growth continued through the first half of 1996, facilitated by the sharp improvement in Mexico's price competitiveness and strong diversification into non-traditional exports.

10. **Recent Performance.** Following a major recession in 1995, the country's prospects for faster growth and lower inflation have improved in 1996. The disciplined fiscal and monetary policies required to stabilize the economy, however, have limited the credit available to the private sector. Uncertainties about the future performance of the Mexican economy also have led to a significant contraction of international credit and have forced companies to become more resourceful in their search for overseas funding. Medium to long-term external financing today for private entrepreneurs is largely limited to the securitization of export receivables. The foreign syndicated loan market remains largely closed, while the bond market is only starting to recover with limited issues involving a few premier companies. This situation has severely complicated the private sector's capacity to meet its investment needs.

11. The *peso* crisis has caused widespread corporate distress as Mexican enterprises have been hit within a relatively short time with high real interest rates and weak domestic demand. Unprecedented declines in output and difficulties experienced in passing raw material cost increases to customers have depressed operating profits. The domestic credit crunch and the closing of foreign credit markets have caused severe financing shortfalls and consequent liquidity difficulties as well. Resulting losses have further eroded already over-leveraged balance sheets.

12. Payment delays within the private sector have resulted in an accumulation of receivables, while lower sales have caused an undesirable build-up of inventories. Both

have led to dramatic declines in liquid assets at a time when credit to finance current assets is not readily available. Even among companies that have managed to show positive net incomes, there are many examples of firms which cannot meet payments to suppliers and creditors alike and which continue to face inadequate liquid balances, depressed cash flows, and pressing debt service obligations. With the dramatic reduction in conventional domestic and foreign credit, lenders have become increasingly reluctant to refinance existing debt, leading many companies to bankruptcy. This widespread corporate problem has forced many companies to focus on continuing debt servicing and rollover issues rather than in addressing the operational and asset restructuring needs of their businesses. Private investment fell 34% in 1995, the most pronounced fall in the last 15 years.

13. The above operational strains have widened performance differentials within the private sector. Large productive concerns have weathered the crisis better than their smaller counterparts and companies that serve the domestic market have been more seriously affected than those which diversified into exports.[2] The small and medium scale enterprise sector (SME) has been particularly hard pressed. The non-tradable sector has been hurt the most due to the combined impact of a sharp decline in domestic demand, production cost increases, and limited access to international capital markets. On the brighter side, commodity and other basic import substitution industries have been helped as their foreign competitors have been effectively priced out of the market. The incipient recovery and decline of market interest rates observed in mid-1996, also are expected to improve the overall financial situation of both private corporations and banks.

14. The liberalization effort in Mexico has improved the environment for foreign investment. Foreign direct investment increased from $US2.6 billion in 1990 to US$11 billion by 1994. Even in the midst of the recession of 1995, foreign direct investment continued at US$7.0 billion. Foreign direct investment has introduced many modern technologies and management practices, particularly in manufacturing. Portfolio equity investment also increased significantly, rising from US$2.0 billion in 1990 to a peak of US$10.7 billion in 1993. The political and economic uncertainties associated with the financial crisis reduced net equity inflows to US$0.5 billion in 1995. Net bond placements showed a more exaggerated pattern with net redemption in 1995 of US$14.4 billion.

III. THE GOVERNMENT AND THE PRIVATE SECTOR

15. Over the last fifteen years, Mexico has pursued a long process of economic reforms directed at promoting private sector-led growth and shrinking the role of the state. As part of that agenda, the Mexican authorities have engaged in fiscal reforms accompanied by trade liberalization. This effort was formalized in the NAFTA agreement

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2 Detailed information illustrating the impact of the above crisis on enterprise performance by size category is scarce. The available evidence, based on electricity sales as a proxy for industrial activity, suggests that micro, small and medium sized firms have been the hardest hit. Electricity sales to this particular group dropped by 20% in 1995 while they increased marginally by 1% among the largest Mexican corporates.

which came into effect in January 1994. The competitive atmosphere was enhanced by liberalization of the law on foreign investment, which permits majority foreign ownership in certain sectors. The reprivatization of the commercial banks, elimination of credit controls, and reduction of the role of government development banks and trust funds were meant to allow the private sector a greater role in allocating resources. Tax reform, industrial deregulation, improved intellectual property rights, a privatization program in mining and steel, telecoms, roads and ports, and extensive agricultural reforms provide further evidence of Mexico's adjustment.

16. In addition to launching a comprehensive economic stabilization program, the Government has taken a number of actions over the past year to maintain public confidence in the banking system. The Laws of Credit Institutions, Brokerage Houses and Financial Groups were amended to permit greater foreign involvement and participation in the financial sector. The National Securities and National Banking Commissions were merged to strengthen bank supervision and ensure the application of uniform accounting and regulatory standards among financial institutions. Finally, a number of legal reforms were introduced to facilitate the securitization and sale of bank loan portfolios to third parties, lift banking secrecy to provide potential purchasers with detailed information on credit risk, and clamp down on the practice whereby banks lend money to themselves and to members of groups to which they belong.

17. The Government also launched various programs to contain the deterioration of banks loan portfolios and maintain adequate capitalization within the banking system. FOBAPROA, the banking support fund administered by the Banco de Mexico, intervened in ten banks and provided assistance to other banks through various support mechanisms. Reflecting the critical role which the banking sector must play in the economic recovery process, these support programs have thus far primarily addressed the risk of systemic bank failure. Now, increasing attention is being given by the Mexican authorities to establishing a base for recovery of the corporate sector. In recent months, the Government initiated programs to facilitate the restructuring of financially distressed enterprises on a case-by-case basis. The UCABE program, designed to resolve stalled debt negotiations, has targeted companies with roughly US$150-500 million of bank debt.[3] A second program would provide equity to distressed small-and medium-scale enterprises through NAFIN.

Constraints to Private Sector Development

18. While recent Government actions and initiatives will contribute to the ongoing economic recovery process, additional reforms are needed to induce a broad-based modernization of the economy and private sector. Key areas that need to be addressed immediately are banking and corporate restructuring. Over the longer term, major constraints include: infrastructure bottlenecks, underdeveloped capital markets, regional imbalances, continuing regulatory barriers to trade and investment particularly at state and

3 UCABE's financial instruments include: (a) a debt swap mechanism that allows a debtor to obtain a 22.5 percent reduction in the amount owed, without causing a corresponding 22.5 percent book loss to the creditor; and (b) debt swap alternatives to enable banks to swap exposures among themselves on a one-for-one basis.

municipal levels, low skill levels, and inadequacies of the commercial legal framework and judicial system that especially disadvantage SMEs and contribute to a concentrated industrial structure.

19. In those key areas where the Bank Group plans to collaborate in assisting the Government, the following Government actions are required:

- **Banking.** Some liquidation and consolidation of Mexico's banking system may be necessary. While every effort to resist bank failure is appropriate, ultimately the health of the overall system will call for some adjustment to avoid contaminating potentially salvageable banks. The basis for this adjustment ideally should be market-based, i.e., voluntarily sought by shareholders and creditors. The authorities need to both (a) place a cap on the financial relief provided and (b) establish a termination date on the period of forbearance with respect to failure to honor contractual obligations. Problems of "willingness to pay" need to be eliminated so that "ability to pay" can be effectively addressed.

- **Corporate Restructuring.** Mechanisms need to be put in place to enable the timely and impartial enforcement of contracts. This is a *sine qua non*. Otherwise, perverse market expectations will thwart the best efforts of the authorities in other areas. A specific set of actions in this regard would include improvement of title registry and recordation, measures to enable the perfection of security interest, the strengthening of bankruptcy provisions and the strengthening of legal and administrative procedures regarding asset foreclosures. In addition, special financing facilities need to be established, aimed at financing the transfer of assets from distressed enterprises and financial institutions. Once borrowers are convinced that the authorities are not likely to encourage contractual leniency after the current relief has been exhausted, such facilities will help them realize at least partial value for distressed assets—an outcome that has been unavailable to date.

- **Capital Markets.** Actions are needed to strengthen and diversify Mexico's capital markets in order for them to contribute over the longer-term to improved stability and efficiency in the process of resource allocation

- **Infrastructure**. The legal and regulatory framework for private provision of power, and water and sanitation needs to be improved. Stalled petrochemical privatizations also need to move ahead. These sectors provide important infrastructure services for private sector activity, and if they are not reformed, private sector growth will suffer.

- **Regional Development**. Mexico's uneven regional development remains a severe obstacle to sustained and balanced growth. Government initiatives are needed to reduce poverty in these areas by accelerating private sector led growth and improving the delivery and management of basic social services.

IV. THE BANK GROUP STRATEGY

Strategic Framework

20. Since the devaluation of the *peso*, the Bank Group's assistance to the Mexican private sector has been of a crisis-response nature where efforts have been primarily aimed at containing the financial crisis and stabilizing the environment for corporate development. As Mexico is likely to remain in a difficult state of transition for much of the next three years, the Bank Group's private sector strategy will continue to focus on the immediate priorities of the Mexican private sector. At the same time, however, the Bank Group will begin to focus on those areas that need to be strengthened to ensure sustained private sector growth in the medium to long-term.

21. Given its critical importance to the economic recovery process, the *financial sector* will continue to account for a significant part of the Bank Group's economic and sector work program, investment and lending activities, and policy dialogue with the Mexican authorities. While the *banking sector* will remain the top immediate priority, the Bank Group's support will increasingly shift to strengthening the regulatory and institutional framework needed to ensure the future development of the banking system and diversify further the range of financial institutions and financial products. Beyond the financial sector, high priority will also be assigned to assisting the *corporate sector in restructuring* its troubled enterprises, in particular SMEs.

22. Medium to long term issues to which the Bank Group will assign high priority relate to the general constraints to private sector development predating the crisis, particularly *infrastructure* deficiencies and excessive *regional concentration* of productive activities. While infrastructure development will remain a key area of Bank Group involvement, the focus of support will shift to promoting increased and more efficient private participation. Activities to achieve more balanced regional development will feature a new Southern States Initiative which aims to foster growth and poverty reduction in the poorest two states through an enhanced role of the private sector.

23. The above strategic areas for Bank Group intervention are key to sustained growth, employment generation, and poverty alleviation. The rationale behind their selection and details of the Bank Group's strategy to be pursued for each through FY99 are presented in the subsequent sections. Matrices relating to each strategic area and providing summary information on the objectives, actions, benchmarks, and instruments which will be part of the proposed Bank Group's agenda are included at the end of each section.[4]

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[4] IFC's involvement in each individual transaction will need to be tested against IFC's project selection criteria as described in Annex 1.

1. The Banking Sector

24. The *peso* devaluation of December 1994 has had both immediate and long-term adverse effects on the capacity of the system[5] to respond to the needs of the private sector. The Government has currently intervened in 10 banks and the 12 largest banks still in private hands are struggling to meet adequate capital adequacy levels.

25. The systemic weaknesses from which the banking sector currently suffers were already evident when the banks were privatized in 1991-92. The new bankers inherited unprepared personnel and weak internal systems and controls, particularly in the area of credit analysis. In some cases, banks were sold to controlling shareholders lacking lending experience and access to technical expertise. Moreover, the new owners were under considerable pressure to record high earnings, having paid multiples of between three and four times book value for their ownership interests. In the rush to compete for market share, lending exploded to levels many times the economy's growth rate, with much of the credit expansion in consumer lending. Consumer lending was already growing in the three years preceeding privatization. Not surprisingly, portfolio quality suffered, becoming particularly evident toward the end of 1994.

26. The *peso* devaluation accentuated the above portfolio trends and weaknesses of the banking system. Mexico's commercial banks posted a net loss of N$37.9 billion (US$6.0 billion equivalent) in 1995 and of N$16.3 billion (US$2.0 billion equivalent) through March 1996. Past due loans increased by 73% from N$57 billion to N$98.7 billion in 1995. Available data also reveal that during the first half of 1996 the commercial banks' loan portfolio deteriorated further with the ratio of past due loans to gross loans reaching an estimated 15% as compared to 7.3% at year-end 1994, and 14% at year-end 1995 (excluding FOBAPROA purchases).

TABLE 3
Mexico
Structure of Commercial Banking System
(N$ million as of end-March 1996)

Bank Groups	Number of Banks	Assets	Gross Loans	Direct Funding	Equity	Net Profit or Losses
Intervened Banks	8	136,897	142,318	98,795	-40,127	-13,975
Privatized Banks	12	886,189	553,388	506,934	54,767	-2,995
New Local Banks	15	36,062	18,742	14,335	6,421	293
Subs. of Foreign Banks	16	41,524	6,981	9,859	5,249	326
Banking System	51	1,100,672	720,429	629,923	26,310	-16,351

5 Fifty-four institutions comprise the Mexican commercial banking sector. Twenty are established banks (18 of which were privatized in 1991/2). The remaining banks in the system operate under charters issued since 1993. The Mexican banking system is characterized by extreme concentration and little foreign participation. Three large banks -Banamex, Bancomer and Serfin- represent about 46% of total system assets, the seventeen other established banks represent about 48% of the system and the newly chartered banks, 6%.

27. Since early 1995 the Government has tightened banking supervision and provided financial support to the banking system. While these actions contributed to an improvement in the banks' capitalization, the deterioration in their loan portfolios—as stated earlier—has not yet been firmly contained. Further actions need to be taken in the following areas:

- *Accounting and Reporting Practices.* There remains a lack of unbiased, transparent and timely financial reporting. Accounting and loan classification practices continue to overstate profitability and obscure the true condition of banks. The practice of "quick-fix" restructuring to eliminate arrears and avoid reclassifying troubled loans of major debtors also results in overstatement of loan quality and inadequate provisioning. Finally, Mexican GAAP encourages the overstatement of profits and thus biases capital adequacy calculations[6].

- *Legal and Regulatory Framework.* Laws governing commercial transactions are no longer adequate to meet the complex requirements of a global economy. The Bankruptcy Law, in particular, needs improvement. It has proven to be an ineffective instrument for managing orderly workouts or liquidation of troubled companies. Its complicated procedural requirements, together with certain of its substantive provisions, have impeded the ability of lenders to force debtors into bankruptcy and have contributed to delay enterprise restructuring agreements and the disposition of impaired banking assets needed for a comprehensive rehabilitation of the banking system. Additionally, the Law on Negotiable Instruments and Credit Transactions limits the financing options available to companies through banks and non-bank intermediaries, and thus prevents private sector entities from entering into mutually beneficial contracts.

- *Liability Protection.* Through FOBAPROA, the Government currently provides an implicit guarantee of all unsubordinated bank liabilities. As part of the rehabilitation of the Mexican banking system, such coverage should be limited to retail deposits below a certain threshold so as to encourage banking efficiency by subjecting banks to greater scrutiny from inter-bank lenders, rating agencies, large depositors and bond investors.

- *Regulation and Supervision.* Prudential regulatory norms and supervisory capacity are still inadequate. Although the authorities have introduced capital adequacy criteria more in line with BIS (Basle Accord) requirements, the inadequacies in accounting and reporting standards weaken the positive impact that capital adequacy criteria were designed to achieve.

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6 As part of the banking reform package supported by the ongoing IBRD's Financial Sector Restructuring Loan, the authorities will require banks to switch to international accounting standards starting with their year-end 1996 financial statements. However, private sector analysts believe it may take as long as a year thereafter before individual bank accounting systems fully implement the new system.

- *Financial Infrastructure Services.* The poor quality and lack of para-financial services constrain the modernization of the financial system. Improvements in this area would provide both regulators and financial sector participants with objective information necessary for sound evaluation of loans, borrowers and financial institutions.

28. **Bank Group Strategy—Banking Sector.** Through its Financial Sector Technical Assistance Loan (FTAL), the Bank Group has thus far contributed to the introduction of important improvements in regulation, supervision and institution building in the area of bank and non-bank intermediaries. Similarly, through the Financial Sector Restructuring Loan (FSRL), it has also addressed the most important short-term threats facing the banking system. Both of these efforts have encouraged reliance on market based solutions, greater incentives for market oversight of financial intermediaries, the introduction of new financial instruments, and the modernization of the legal/regulatory framework for lending.

29. To complement the above efforts, the Bank Group will, in the short-term, deepen its support of the banking sector with the objective of: (i) further improving accounting, reporting, and disclosure standards in the banking industry; (ii) bringing prudential regulations in line with international standards, and (iii) providing technical and financial assistance sufficient to assure the enactment of needed banking reforms. As part of that agenda, the Bank intends to process a second Financial Sector Restructuring Loan (FSRL II) in FY97. Through that new operation as well as a planned Financial Infrastructure Loan, it would build upon the progress achieved thus far in the banking system by assisting the economic authorities in:

- Operating an RTC type facility to divest bank assets held by the Government through FOBAPROA;
- Upgrading and modernizing public registries and credit bureaus;
- Updating the laws pertaining to credit and collateral, and undertaking needed reforms in bankruptcy laws and processes; and
- Improving the technical and supervisory capacity of regulators across the financial sector.

30. In addition to supporting the Bank's technical assistance and policy dialogue activities, IFC will seek to further expand its presence in the banking sector beyond the recent Banamex operation (FY96) through a combination of loans and equity investments. As part of this increased portfolio exposure, IFC would use commercial banks as vehicles through which to channel restructuring finance to the SME sector. The use of the country's strongest and largest banks will allow for wider distribution of IFC finance throughout the country, and IFC's equity participation should encourage foreign banks to

increase their investment in Mexico at this time. In addition to providing much needed financing, this instrument will aim to reinforce the use of strict financial discipline both in the banking and corporate sectors. Financial assistance will be completed by assigning a senior person to the field to actively transfer IFC's restructuring experience.

31. Over the medium-term, the Bank Group's assistance will aim to (i) bolster market discipline by reducing deposit insurance; (ii) broaden the use of international accounting standards; (iii) reduce arbitrage by closing loopholes within the financial regulatory framework; (iv) promote the development of private financial information gathering and reporting institutions; (v) deepen asset securitization through the establishment of private specialized financial institutions; and (vi) further develop micro and small enterprise lending.

MEXICO PRIVATE SECTOR STRATEGY: BANKING SECTOR DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Return of intervened banks and assets to private sector (Bank Resolution).	• Resolution (sale/merger/liquidation) of banks under government control, transfer of banks and assets to private management. • Adequately equip bank resolution agency (VVA) to manage and sell assets acquired by the government.	• Bring majority of currently intervened banks to point of resolution by year-end 1996; resolve remaining banks by end-July 1997. • Begin operations of VVA; disposition of assets in accordance with annual targets over next five years.	• Technical assistance through financing of international experts, seconded staff of RTC-type entities (FTAL). • Banking System ESW. • FSRL I, II.	• Technical assistance and advisory role to help authorities strengthen banking framework and establish RTC-type institution.
Strengthen prudential regulations, accounting and disclosure framework (rules and regulations).	• Introduction of revised bank accounting for year-end 1996 statements based on international GAAP. • Limitations on qualification of subordinated convertible debt as Tier I capital. • Revised capitalization rules, including market risk. • Revised loan classification rules.	• Prudential regulations and capital rules more comparable with OECD countries. • Accounting rules for banks and other financial institutions consistent with international standards (US GAAP). • Evidence (based on visits to banks) that banks are applying new standards.	• Technical assistance through financing of international experts (FTAL). • Advisory role to assist authorities to conform to international (Basle) standards (FTAL). • FSRL I, II. • Financial Infrastructure Loan.	• Technical staff participation.
Strengthen banking supervision.	• Further improvement in the staff, systems, equipment and permanent training programs of the CNBV. • Continued annual on-site inspection of major banks, diagnostic audits and better analytical use of examination and audit results.	• Evidence (through monthly reviews by IBRD) of tighter CNBV control of banking activities, including application of penalties/sanctions.	• Technical assistance, including seconded examiners from OECD countries (FTAL).	• Technical staff participation.

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Encourage market-based discipline through limitation of FOBAPROA coverage of bank liabilities.	• Development of a timetable for removing implicit government guarantee for securities, interbank lines and eventually large deposits of banks.	• Announcement in 1996 of plans to phase out certain coverage. • Implementation of phase-out, beginning with interbank liabilities in 1997 and progress in accordance with agreed timetable.	• Advisory role. • FSRL I, II.	
Modernize lending/securitization framework.	• Introduce changes in lending laws, particularly regarding secured transactions, title transfer and asset-backed securities.	• Evidence that lending secured by movable property, whole loan sales and asset-backed securities transactions are taking place at reasonable cost.	• Financing of domestic and international expertise (FTAL). • Financial Infrastructure Loan.	• Finance for financial institutions, including commercial banking, leasing and securitization, possibly also for credit bureaus and financial publications.
Reform the bankruptcy and work-out framework.	• Introduce laws and supporting regulations for bankruptcy, suspension of payments as well as voluntary work-outs.	• New legislation and rules drafted.	• Financing of domestic and international legal expertise (FTAL).	
Strengthen private commercial banks.	• Attract foreign equity financing for banks and the transfer of banking technology and systems. • Establish an RTC-type institution for the purchased loan portfolio and for insolvent banks. • Provide "financial work-out" expertise . • Rationalize prudential regulations across all activities spanned by financial groups and strengthen accounting and reporting requirements for financial groups, particularly the requirement to publish both consolidated and individual financial statements. • Accelerate measures to allow securitization of bank assets. • Mobilize resources for term finance and equity injections.	• Majority of commercial banks operating with improved capital adequacy and stronger financial and operating performance indicators. • Significant reduction in number and size of intervened banks. • Evidence of improved lending practices. • Evidence of greater use by banks of asset sales/ securitization schemes.	• FTAL (ongoing). • FSRL I, II.	• Credit lines to banks for restructuring finance (Banamex FY96 and Probursa FY97). • Investments in selected banks to strengthen Tier I and II capitalization. • Syndication of loans to banks (Banamex FY96). • Asset (loan) securitization (Banamex FY96).

2. Capital Markets and Specialized Financial Institutions

32. Mexico's financial markets have not yet attained the level of diversification and sophistication expected for such a large liberalized economy. Note from Table 4 below the extremely small share of total financial assets accounted for by specialized financial institutions in such areas as leasing, factoring, venture capital and insurance.

33. Given the nature and extent of existing capital market constraints, various tasks need to be addressed on a priority basis if local financial markets are to be developed and play a leading role in the ongoing recovery process. In addition to restoring the health of the banking sector and raising domestic savings, these tasks include: (i) securing an orderly transition to a funded pension system; (ii) strengthening the institutional framework for housing finance; (iii) rapidly expanding the financial services available to SMEs through such institutions as leasing and venture capital; and (iv) remedying the inefficiencies and lack of transparency of the equity and bond markets.

Table 4
MEXICO: Assets of Mexican Financial Institutions
(Millions of New Pesos and % of Total)

Type of Institution	Dec-93	%	Dec-94	%	Sep-95	%
Commercial Banks	556,678	50	799,880	47	872,554	52
Brokerage Firms	210,814	19	399,244	24	251,657	15
Development Banks (Gov't.)	195,424	17	336,488	20	409,727	24
Mutual Funds	80,481	7	61,234	4	61,611	4
Insurance	29,651	3	35,408	2	42,236	3
Others[1]	47,911	4	61,561	4	46,073	3
TOTAL	**1,120,959**	**100**	**1,693,815**	**100**	**1,683,857**	**100**

Source: CNBV
1/ "others" includes credit unions, factoring companies, leasing companies, warehousing companies, bonding companies and exchange houses.

34. ***Pension Reform and the Contractual Savings Industry.*** Without understating the other financial market constraints, the most pressing capital market issue involves the reform of the *Sistema de Ahorro para el Retiro* (SAR) into a privately-managed system. With a current base of 10 million affiliates, such a reform could potentially create the single largest financial industry in Mexico within a decade. For a vibrant private sector-managed contractual savings industry to be established, the current reform program will have to address key issues pertaining to: (i) transition costs; (ii) fiscal implications; (iii) system coverage; (iv) fee structure; and (v) competition.

35. As it stands, further work is required to encourage efficiency, economies of scale and public confidence. Mexico also needs to replace the Pay-As-You-Go (PAYG) system for public employees. Furthermore, pension contribution rates must be raised preferably through the transfer of the current INFONAVIT contributions to the funded pension system. Competition and efficiency in asset management must be encouraged by offering greater choice to workers regarding investment assets, vehicles, and providers. Finally, greater specialization is required with respect to investment objectives with commensurate

flexibility regarding admissible investment options. Concurrently with this last task, Mexico should eventually dismantle the artificial segmentation between the management of mandated savings (managed by AFOREs) and voluntary savings (managed by insurers, mutual funds, banks, etc.).

36. ***Housing Finance.*** Due to the flows of real assets involved, housing finance also has the potential to significantly influence the development of domestic financial markets. However, the persistent lack and high cost of such finance has remained an important social concern in Mexico by putting home ownership beyond the reach of most people. The main problem here is that Mexico does not have a coherent national housing policy. To the extent that the housing framework is marked by inefficiencies, the introduction of new financial products and creation of greater asset liquidity are impeded. The state has attempted to provide both housing and housing finance through multiple institutions and programs as well as through the *ad hoc* diversion of specific taxes. This has resulted in enormous fiscal costs, significant institutional failures, and sharply segmented markets.

37. ***Other Non-bank Financial Services.*** Sources of medium and long term funding from non-bank financial intermediaries are very limited. Although during 1995, 54 companies in Mexico were engaged in *leasing* with the 10 largest companies accounting for 72% of the total leasing portfolio, lease financing has not developed much beyond the consumer automobile market. The *factoring* market is served by some 31 factoring companies of which the top 10 companies account for 73% of related assets. In the cases of both leasing and factoring, companies belonging to large financial groups account for a large share of the respective markets. Payment performance is deteriorating in these markets as with commercial bank lending, causing many of the independent companies to disappear. Furthermore, given that senior financial group management is currently concerned with strengthening banks under their ownership, this is likely to divert attention away from other financial services. This is particularly detrimental to SMEs given the important role that leasing and factoring have in this sector. (In leasing, security enforcement is relatively easy, whereas the enforcement of a lien in a traditional bank loan can take a long time.) A competitive *venture capital* industry has not developed in Mexico and venture capital companies of the larger groups have not worked well, a phenomenon which may be partially attributed to a long tradition of directed credit by development banks.

38. ***Stock Market.*** Although it has always been a "thin" market and not an important source of new equity capital (company listings declined from over 200 in recent years to 184 today), the Mexican Bolsa had, prior to the 1994 devaluation, achieved international recognition as an important stock exchange among emerging market countries. The crisis, however, revealed a number of shortcomings in the legal and regulatory framework. Despite an efficient trading system and clearing and settlement for most listed securities, trading systems remain inadequate in the second-tier market. Illiquidity is a problem for many issues as well, given that the average monthly float of any issue traded on the Bolsa is about 30% of its market capitalization. Market capitalization is currently about one-third of GDP. Moreover, equities represent only about 5% of the volume of securities traded. Also, the stock market is dominated by 33 brokerage firms, of which four account

for 40% of total trading. About 40% of average daily trading is dominated by trading in the shares of 5 companies. These inadequacies significantly hinder the development of pension and mutual funds, the restructuring of enterprises and privatizations.

39. ***Bond Markets.*** Mexico's private bond markets—which had been attractive to international investors prior to the *peso* crisis—have since tumbled and virtually dried up. While the main reasons for this situation are to be found in inflation and interest rate uncertainties, they have also been compounded by structural problems, including the existence of multiple interest-rate bases (dollar, inflation linked, and nominal). Public debt management in the past was dominated by the pursuit of very short-term goals leading to large year-to-year fluctuations in interest rates. Also, the way public debt has been issued has not helped to create or maintain a full interest-rate spectrum, thereby hampering the development of private markets in interest-bearing securities. A private pension fund system would greatly enhance the development of the medium and long-term bond markets.

40. **Bank Group Strategy—Capital Markets and Specialized Financial Institutions.** Building upon the advisory services it has thus far extended on *pension reforms*, the Bank will encourage the formulation of an appropriate regulatory strategy. As it has done over the past year, IFC will continue to assist the Bank in remedying specific deficiencies of the regulatory framework. It will play also an institution-building role in private sector pension management companies and act as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable technical partners.

41. Regarding *housing finance*, the Bank Group will focus its support on three broad areas. *First*, the Bank will assist the Mexican authorities in articulating long-term national housing priorities and policies. *Second*, the Bank will assist the Government in redefining the role of existing housing finance institutions. This assistance would extend to formulating and implementing plans for the restructuring, phasing out or privatization of existing public institutions. *Third*, the Bank would support this program with appropriate financial assistance, including selective provision of Bank guarantees to enhance the funding capability and functions of public housing finance institutions. To the extent that the concerned entities are restructured and reoriented within a private sector framework, IFC would play institution-building, technical assistance, and "honest-broker" roles in helping these institutions become established market-driven players in the secondary housing finance market.

42. The Bank Group's strategy for development of Mexico's *equity markets* will initially entail in-depth analysis of the causes of underutilized use of stock markets. Such assistance will also involve identifying necessary reforms to improve: (a) second-tier market trading systems; (b) company reporting and disclosure requirements; (c) institutional investor guidelines; and (d) the regulatory and technical requirements associated with derivatives markets, securities lending, short selling, margin accounts and minimum margin requirements. While the Bank will focus on the technical aspects of the regulatory environment, IFC will: (i) promote the development of more efficient non-bank financial service institutions, particularly in leasing and factoring, as well as a more efficient and effective over-the-counter (OTC) market; (ii) promote a strong venture capital and private equity industry; and (iii) provide equity underwriting facilities.

43. In *debt markets*, the Bank will play a technical assistance role to help rationalize the structure of the public debt, remove interest-rate segmentation of debt securities markets and eliminate hindrances in the issuance of private debt securities and structured finance. IFC will support the development of orderly long-term credit markets through a two-pronged approach involving: (i) the selective use of bond underwriting facilities; and (ii) the promotion of markets for asset backed securities and the provision of equity finance, as well as technical assistance for asset securitization vehicles.

MEXICO PRIVATE SECTOR STRATEGY: CAPITAL MARKETS DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Ensure retirement with dignity through improved competition and efficiency in pension fund management and lower government liability	• Replace PAYG system for public employees, transfer INFONAVIT contributions to AFORES, greater competition in mandated savings management between banks, mutual funds, insurers and AFORES, and greater accountability through independent directors, education, and performance comparison.	• Coverage of private and public employees; phaseout of INFONAVIT; entry of experienced managers and banks, including foreign entities, into pension fund administration; liberal investment guidelines to encourage long term risk-taking; modifications of certain minimum guarantee provisions.	• Contractual Savings Loans I, II, III.	• Policy advice including TA on regulations, investment management guidelines and corporate governance. • Institution-building through participation in AFORE.
Lower cost of and improved access to housing finance.	• Determine long term housing finance strategy, target population, cost and fiscal affordability. Derive a consistent role for public housing finance institutions (phaseout, privatization, expansion, etc.)	• Preparation of housing finance strategy, determination of affordable subsidy/resource transfer to the housing sector, action plan and implementation for FOVI, INFONAVIT, and other housing finance institutions.	• Housing Finance Loan. • Guarantee. • Policy Analysis.	• Policy advice. • Equity investment in mortgage bank/mortgage securitization company, possibly complemented with insurance company investment.
Develop markets for mortgage- and asset-backed securities.	• Reform of registries and notaries, suasion by Central Bank for product standardization, sensible capital guidelines for ABS transactions, regulatory reforms to simplify vehicles, products, and transactions.	• Improved laws/regulations relating to notaries, registry, borrowers' consent, and issuance of typical ABS implemented across most states. Capital adequacy guidelines for ABS deals. Simpler and automatic approval of ABS issuance by banks and SOFOLs.	• Financial Infrastructure Loan. • Ongoing FTAL. • Policy Analysis.	• Policy advice. • Equity investment in asset securitization company.
Improve capacity to raise capital through stock markets, reduce cost of new capital, create exit mechanism for banks, government, and NAFIN.	• Increase number of listings; improve trading, liquidity, and self-regulation; targeted marketing to listable companies. Encourage listing of all large businesses (subsidiaries) rather than just the holding company. Rationalize investment guidelines of pension funds and insurance companies.	• Higher number of listings, market capitalization, and new equity offerings. Pension fund guidelines that encourage equity investment and liquidity.	• CEM on Savings.	• Underwriting facilities. • Small-cap funds. • Venture capital.

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Develop a long term domestic bond market and lower cost of capital.	• Develop a long term public debt issuance strategy. Homogenize government debt, extend yield curve, and create benchmark interest rate structure. Facilitate ABS/MBS markets. Allow institutional investors to develop bond markets.	• Adoption by market of uniform domestic interest rate benchmarks. Improved efficiency of bond markets in terms of new issuance, liquidity, maturity and interest rates.	• CEM on Savings	• Bond underwriting facilities. • Asset backed securities.
Improve efficiency of, and mobilization of savings by, insurance companies and mutual funds.	• Permit them to manage mandated retirement savings. Greater harmonization/supervision of similar operations of mutual and pension funds. Increase number of independent directors. Greater foreign competition.		• CEM on Savings. • Ongoing FTAL. • Seminars, study tours.	• Policy advice. • Equity investment in domestic insurance firm, mutual fund company.
Improved financial market infrastructure.	• Improved bankruptcy code and process, adoption of GAAP standards, improvements in collateral law and registries, development of credit bureaus and rating services, technical upgrading of principal regulators.	• Implementation of legal and market reforms.	• TA and sector work to identify more specific measures. • FTAL (ongoing). • Financial Infrastructure Loan.	• Policy advice. • Equity investment in supporting financial service companies such as credit bureaus.

3. Corporate Restructuring and Small and Medium Scale Industry

44. Extensive financial restructuring of the corporate sector represents a key determinant of economic recovery and future growth for the private sector in Mexico today. Financial restructuring is primarily required for the recapitalization of over-indebted companies which have become uncompetitive as a result of high financial expenses, and which are thus unable to raise new financing for adjustment and growth.

45. Mexico's *peso* crisis and ensuing recession also have created the need for important structural changes among Mexican corporates. The devaluation of the *peso* has opened up new export markets, requiring significant re-deployment of existing capacity to take advantage of new opportunities. Trade liberalization and increased international competition similarly require significant alterations in existing production facilities.

46. The need for operational and financial restructurings is particularly relevant in the SME sector. Even before the *peso* crisis, this sector lagged in modernization, product quality and production efficiencies. Lack of professional management in these largely family owned enterprises is a major problem. The crisis worsened the operating conditions across this sector, and in addition the banking system directed new credits towards the larger corporations.

47. Although critical for the success of the ongoing economic stabilization efforts, the corporate restructuring described above has not yet taken hold within the Mexican private sector. The main reasons are the illiquidity of the banking system, the associated unavailability of corporate credit and the inadequacy of Mexico's legal and regulatory framework. This has led to unprecedented "asset paralysis" within the private sector. While the Government has engaged in several debtor arrangements that have avoided a cascade of wholesale corporate defaults, the corporate expectations of further government sponsored assistance also have delayed negotiations between debtors and creditors.

48. **Bank Group Strategy—Corporate Restructuring and SMEs.** Strengthening the competitiveness of the private sector forms the core of the Banks Group's strategic agenda in Mexico. This entails responding to both the immediate financial restructuring needs as well as to the systemic problems of low productivity growth, asset redeployment and technological obsolescence.

49. To achieve the above objectives, the Bank—in cooperation with IFC—will provide the Government with the technical support needed to remove the legal and regulatory obstacles to the corporate restructuring process. Through the ongoing ESW program and Financial Technical Assistance Loan (FTAL) it will seek to both reform the regulatory and legal framework for bankruptcy, liquidation and foreclosure, as well as develop the legal environment required to expedite infusion of capital and redeployment of assets. Additionally, through a new Financial Restructuring Loan (FSRL II), the Bank intends to support the development of financial infrastructure and enterprise restructuring. In the medium term, the Bank is supporting the Government in promoting assistance through

ESW work on industrial policy and a PSD Competitiveness project, involving promotion of quality standards at the enterprise level and a more client oriented R&D infrastructure.

50. Building upon its earlier financial restructuring experience in Mexico, IFC's strategy will focus on providing tailored assistance to individual Mexican corporates. While it is impossible to generalize about the specific components of each restructuring in which IFC will participate, each effort will seek to reduce unsustainable corporate debt and liquidity burdens while improving resource utilization. Incremental investments in fixed assets and inventories as well as organizational and technological changes would be implemented to improve cash flow and secure long-term viability. Long term debt and equity needs would be addressed to both recapitalize poorly structured balance sheets and to finance incremental investments in fixed and working capital.

51. Because small and medium enterprises have been the hardest hit by recent economic events, IFC will devote greater resources to identifying economically sound SMEs that need special support to weather the current crisis and prosper under NAFTA. Its efforts will center on a two-pronged approach involving both wholesale and direct assistance.

- *Wholesale Approach.* As part of its overall financial sector and capital market development activities, IFC will work with local financial intermediaries or will help establish specialized institutions capable of providing restructuring assistance to medium and smaller enterprises. On the equity side, it will support private equity/venture capital funds such as the imminent Mexican Partners Fund and the Fondo Chiapas, while on the lending side this will be achieved through credit lines for on-lending or the provision of leasing services such as the recently approved BANAMEX and PROBURSA operations. Leasing and factoring operations will also be supported as a means to broaden the availability of equipment and working capital finance for SMEs.

- *Direct Assistance.* IFC will increase its direct assistance to promising "second tier" companies that need restructuring, to improve their competitiveness and access long-term capital. IFC will favor those situations where financing needs cannot be met purely from local sources and where its presence is catalytic in persuading parties to agree to a successful restructuring package. In such direct transactions, emphasis will be placed on providing restructuring assistance to firms with whom IFC does not have existing investments.

52. Although IFC's strategy will give priority to second tier companies, the special circumstances facing Mexico also dictate that it provide selective support to those larger companies which face unusual adjustment and investment financing constraints. Operations will be limited to those cases where IFC's support is essential to reaccess the international financial markets, or where innovative financial engineering or other forms of IFC value added and role are required to firm up project restructuring or project financing packages.

MEXICO PRIVATE SECTOR STRATEGY: CORPORATE RESTRUCTURING AND DEVELOPMENT FY 1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Promote debt workouts - return SMEs and other companies not covered by UCABE companies to a sound debt footing - at minimum government cost.	• Further develop the existing proposal for an RTC-type entity. Require it to farm out management of or auction off all loans and other assets in government hands to private sector. • Facilitate provisions of TA to enterprises in preparation of debt workout/reorganization plans.	• Non performing loan portfolio of Banking sector to be brought down to reasonable level after 3-5 years.	• Financial Infrastructure Loan.	• Direct financial and real restructuring support to individual companies. • Participation in SME venture capital funds. • Enterprise restructuring lines of credit involving local financial intermediaries.
Improve legal/regulatory framework for workouts and bankruptcy system.	• Focus on key legal/regulatory obstacles to development of asset-backed securities, secured transactions, etc. and related components of bankruptcy law .	• New legal frameworks with implementing regulations and institutional capacity to implement.	• FTAL (ongoing) • FSRL II.	• Participation in IBRD technical and advisory assistance.
Promote demand driven SME assistance.	• Facilitate TA to enterprises to build financial management and general business skills. • Improve technology level of enterprises through promotion of quality standards at enterprise level, in client-orientation of R&D infrastructure.	• More financial flows to SME sector, greater indirect participation in exports, more long-term subcontracting relations. • Number of enterprises with ISO-9000/14000 certification increased, productivity growth in technology intensive SME sectors.	• ESW on Industrial Policy • PSD Competitiveness • Additional support to CIMO (to support efficiency improvements in private companies). • Support of collective action (horizontal networking between enterprises).	• Participation in venture capital companies directed at SMEs. • SME credit lines to local financial intermediaries. • Equity and loan transactions involving individual SMEs.

4. Infrastructure

53. Mexico has the weakest infrastructure of all countries in Latin America with similar income levels. Many of the observed infrastructure deficiencies could be overcome through innovations in regulation, competition, and private ownership, as in Argentina and Chile. The Mexican Government has until recently monopolized infrastructure and prevented private investment in a number of critical infrastructure services. This has compounded Mexico's infrastructure constraints especially since the *peso* crisis, as Mexico had to scale down pubic expenditure for infrastructure projects due to the overriding importance of maintaining fiscal discipline and correcting critical macroeconomic imbalances in the economy. Government ownership of infrastructure also has been a major reason underlying the weak development of the Mexican equity market.

Table 5
MEXICO
Infrastructure Comparators for Latin America

Country	Income (per capita) 1993 Dollars	Electric Power (kwh/person) 1992	Telephone Mainlines (per 1000 persons) 1992	Population with access to safe water 1991 (% of total)
Venezuela	$2,840	3,404	91	89
Brazil	$2,930	1,570	71	96
Chile	$3,170	1,646	94	86
Mexico	$3,610	1,381	80	78
Argentina	$7,220	1,670	123	64

Source: World Development Report (1995).

54. Having recently acknowledged its inability to meet all of Mexico's infrastructure needs, the Government is recognizing the importance of privately owned and managed infrastructure services. Reflecting a renewed commitment to accelerate the privatization of such services, the Government took a number of positive steps in that direction over the past year. A Privatization Commission was created and the Constitution was amended to allow for private and foreign investments in telecommunications, satellite communications, gas distribution and storage, ports and airports, and railways. Bids were issued and some 92 concessions were awarded involving the country's leading port facilities and ports, including VeraCruz, Acapulco and Altamira. Strategic decisions concerning market structure and regulations were also taken in the railway sector where 12 investor groups have since registered for concessions to be awarded later this year. The opening of Mexico's long-insulated natural gas market took a major step forward with the unveiling of 11 metropolitan centers—including the critical Mexico City market—to privately owned pipeline distribution. Privatization of telecommunications has proceeded well as witnessed by the eight concessions for long distance communications, and the 158 applications for paging services and paging channels approved by the Government since September 1995.

55. Notwithstanding the above achievements, the Government's intentions and direction remain unclear in the power, petrochemicals, water and sanitation sub-sectors, where privatization has fallen short of expectations. Besides a firm political commitment and the development of transparent legal and regulatory frameworks, a range of other issues—relating principally to market structures, concession design, public procurement

rules, government guarantees, and tariff policies—need to be urgently resolved if the pace of private investment in these infrastructure activities is to be accelerated and adequate levels of financing are to be mobilized. A summary of these particular sub-sectors follows:

- In *power*, private generation and co-generation have not yet taken place although reforms to allow for such privatization were introduced in 1992. Causes for this situation include a lack of political will to privatize CFE, the absence of incentives for private investments and, most importantly, difficulties encountered by prospective investors in reaching critical contractual arrangements with the National Electricity Commission;

- In *water*, despite the fact that Mexico remains critically short of basic water treatment and distribution systems, large scale privatization has been hampered by restrictive state regulations, inadequate water tariff structures, the generally poor financial condition of most municipalities and weak technical capacity of local water authorities;

- In *petrochemicals*, the privatization of Pemex's secondary petrochemicals—which had been announced in early 1995—has encountered serious opposition from the Mexican Congress and is presently stalled. Authorities originally involved in the sale of the targeted 10 chemical complexes have been overtaken by political pressures.

56. **Bank Group Strategy—Infrastructure.** The principal challenge for the Government in expanding private infrastructure services is to promote effective competition, especially in those sub-sectors that exhibit natural monopoly characteristics. Within this strategic framework, the Bank Group and the Government have come to share the common view that the greatest opportunity for improving the quality and efficiency of infrastructure services lies in increasing private sector participation within an appropriate regulatory environment and removing statutory restrictions on competition. There is also agreement that more efficient public investment and more effective operating modalities are required for those services which will not attract private financing (e.g. secondary roads, urban traffic management, and low income housing) or which are to remain within the purview of the public sector at least during a transitional period (e.g. electricity transmission and distribution, road maintenance, and urban transport infrastructure).

57. In line with the above, the Bank will seek to further improve the planning, financing, and management of public infrastructure projects in those geographical areas and among those services which are unlikely to attract private sector support in the short run. To address existing regional development imbalances, such efforts will be predominantly oriented towards the Southern States and will involve the processing of a number of infrastructure projects in power transmission, road maintenance, rural roads, water systems and sanitation. As part of the ongoing Privatization Technical Assistance Loan (PTAL), the Bank will also assist the Mexican authorities in further strengthening

the legal/regulatory framework for privatization. While the Bank is already extending such technical assistance to the National Water Commission and the Energy Regulatory Agency, its efforts will be further broadened to include telecommunications and transport agencies.

58. The Bank, with IFC assistance as appropriate, is proposing to review jointly with the Ministry of Finance the range of reforms that are necessary to attract private financing and the implications for public financing. This would include evaluating investment considerations and risk perceptions across the various sectors, focusing on sector specific policy and regulatory risks and the terms available in the financial markets for projects in Mexico. This assessment should reveal which sectors could benefit from policy reforms and which would continue to require direct public support. This proposed task would be reinforced by ongoing work on concession design, bidding strategies, and pricing policy which the Bank is currently supporting with the sectoral agencies through the Infrastructure Privatization Technical Assistance Loan. The Bank would be prepared to back up the Government—through its guarantee authority—where, despite appropriate sector reforms, Government related risks and project size and gestation would prevent the structuring of a complete financing package without Government guarantee (see Box on next page).

59. Within this framework, IFC will work with private investors to expand its infrastructure pipeline, consistent with market demand and policy reforms, particularly in the sub-sectors cited above. IFC will undertake promotional work to ensure that investors and Government officials are fully aware of the range of products and services it offers. IFC will also assist the private sector in remedying some of the regulatory and financing constraints which have thus far held up the pace of privatization, mostly in the context of specific projects (as it is currently doing in the case of the Cancun water project in cooperation with Banobras). IFC can also advise Government officials, where appropriate, on the likely market response to alternative sectoral reforms.

60. IFC will also seek to complement and mobilize the resources of both local and foreign investors by offering the appropriate financing and capital market products to attract adequate equity investment as well as long term debt financing for the infrastructure sectors in Mexico. In this context, the establishment of one or more independently managed specialized funds to finance private sector infrastructure projects will be pursued. Bank support to these funds will be considered as appropriate. IFC will also seek to develop local capital markets to provide crucial domestic financing for infrastructure projects.

61. IFC's success in expanding and diversifying its infrastructure activities will depend heavily on the steps the Government will take to establish the regulatory framework required to attract domestic and foreign private investors in the sector. While the immediate opportunities lie in the sub-sectors where liberalization is the most advanced, IFC will also seek to initiate private power generation and assist in the privatization of water/sanitation and transport services as well.

62. *Petrochemicals.* When privatized, IFC will work with local and foreign investors to design sound project structures. IFC's role would be to give confidence to those partners (as many contractual arrangements on the input and output side will still be with Pemex) as well as to help in major funds mobilization.

Guarantees for Private Sector Participation in Infrastructure

Because of the newness of private participation across the infrastructure sectors in Mexico, there is a lack of precedents from successful projects on which lenders can evaluate credit and policy risks. Most projects proposed for private financing are of long gestation, requiring substantial amounts of long term debt, at maturities which far exceed those available in local financial markets and from international sources.Depending upon the market response to sectoral reforms, private financing may initially require some official support, particularly where Government remains directly involved (e.g. gas, power, water, municipal services), but also where new sector structures and regulations do not require direct government involvement but lack a proven track record (rails, airports, toll roads). The Bank, through its recently expanded guarantee authority, is prepared to back up Government if this leads to easier access to financing sources and better financing terms. At the same time, such support should be designed to minimize the government's risk exposure. The guarantee would be justified where the policy related risks are of a nature and projects of a size and gestation period that would prevent the structuring of a complete financing package even with support from IFC or other official financing and insurance agencies. The Bank would thus assume the role of guarantor of last resort, similar to its role as lender of last resort. Guarantees would be considered as a temporary measure to facilitate financing and execution of a few landmark transactions.

Based on discussions with prospective private sector lenders, judicious application of the Bank's guarantee authority will have a significant impact on direct investment in the infrastructure and energy sectors as: (i) commercial bank guarantee-covered resources can be additional to their normal country limits and (ii) guarantees are partial, leveraging more uncovered medium/long term debt than would otherwise be available. Guarantees could be developed on a project by project basis in those sectors deemed priority by the Government or on a sector-wide basis where a sectoral guarantee framework would be prepared and projects within the sector identified as eligible for guarantee coverage based on the attractiveness of the winning bidders offers.

A number of target sectors have now been identified in which Bank support in form of partial risk guarantees could be instrumental for attracting private investment.

- ***Gas Transport and Storage.*** Distribution has been deregulated and opened for private participation, and third-party access was introduced in April 1996. However, PEMEX remains the monopoly producer, and, within most of Mexico except for the border areas, the monopoly source of supply in southern and central Mexico. On the users' side, Government entities, such as CFE, are among the primary anchor customers. Moreover, the regulatory framework is new and untested. The Bank has been closely monitoring developments in the gas sector and sees good possibilities for the realization of several gas pipeline projects in the northern border states which could be candidates for Bank guarantee support, as well as concessioning Mexico City.

- ***Power.*** The regulatory framework for private participation has yet to be worked out. After further deregulation and demonopolization of CFE, at least in power production, there is good potential for private sector involvement and for guarantee support.

- ***Toll Roads and Other Transport.*** Provided the Government implements a regulatory framework that is based on a more equitable risk sharing with private sector parties, the Bank envisions good potential for private toll roads and for Bank guarantee assistance in the future. There may be scope for other transport projects on a stand alone basis, for example with concessions negotiated specifically for the project, i.e. urban transport.

- ***Water Supply and Treatment, Waste Disposal.*** These have proven to be the politically most sensitive sectors for privatization. The main issue is whether a regulatory framework can be designed and implemented that provides the basis for full cost recovery and adequate risk sharing between the public and private sectors.

MEXICO PRIVATE SECTOR STRATEGY: INFRASTRUCTURE DEVELOPMENT FY 1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Reduces infrastructure deficiencies which have posed a serious bottleneck to economic growth and international competitiveness by increasing private sector participation within an appropriate regulatory framework.	• Support the ongoing privatization process in telecommunications, ports, airports, railways, electricity and water and sanitation as well as secondary petrochemicals.	• Process completed in ports, railways , telecommunications. • Process underway in airports, water and sanitation, electricity and secondary petrochemicals.	• Sustained policy dialogue via: (i) supervision of PTAL; (ii) non-lending services; (iii) " just-in-time" ESW.	• Equity and loan support to specific projects in privatized infrastructure sectors.
	• Support the development of legal, regulatory and financing frameworks that are transparent and predictable and would efficiently attract private investment.	• Strengthened energy (CFE) and water (CNA) agencies. • Establish transport and telecommunications regulatory agencies. • New instruments and investors resulting from pension reform.	• Sustained policy dialogue via: (i) supervision of PTAL and FTAL; (ii) non-lending services; and (iii) "just-in-time" ESW.	• Support for IBRD technical and advisory assistance.
	• Attract more non-recourse, private finance for the provision of infrastructure services.	• Planned project interventions in gas, electricity, ports and water and sanitation. • Possible restructurings in toll roads and airlines. • Concession designs for water and municipal services piloted at state and municipal levels. • Implement infrastructure finance facility.	• Advice on concession design. • Infrastructure Guarantees (FY98-99) for specific sectors/ projects. • Dialogue on infrastructure finance facility.	• Equity and loan transactions involving specific projects. • Promotion of new financing instruments and facilities. • Technical and/or financial support to specialized infrastructure financing facilities.

5. Regional Development

63. Mexico's uneven regional development remains a serious obstacle to sustained and balanced private sector growth. Industrial activities are primarily concentrated in Mexico City and Monterrey and, to a lesser extent, within the triangle formed by these two cities and Guadalajara. Altogether the Central region—of which the Federal District is part—accounts for nearly 50% of GDP and 59% of commercial bank lending despite the fact that it covers only 8% of the national territory. Although a program intended to boost employment in the northern border area has in recent years led to the creation of a flourishing in-bond industry in the states of Baja California, Chihuahua, Coahuila, Sonora and Tamaulipas, overall government efforts to decentralize productive activities and foster more balanced regional development have thus far had modest results. With foreign investors seeking potential projects opened up by NAFTA, there are today renewed and promising opportunities to correct regional imbalances by promoting private sector development outside Mexico's major industrial centers. Given that the *maquiladora* sector is gradually moving away from the border areas, special emphasis should be also given—as part of these regionalization efforts—to identifying means to integrate more effectively the expanding *maquiladora* industries into the Mexican economy.

64. Although offering promising growth potential, a number of states severely trail the rest of the nation on basic social and economic indicators. This is particularly the case for the states of Chiapas and Oaxaca in southern Mexico, While rich in natural resources and climatic conditions, and strategically located next to Central America and the Gulf of Mexico, these states are the poorest in Mexico. GDP per capita is less than half the national average (US$1450 in Chiapas and US$1230 in Oaxaca in 1990, compared to US$3030 in Mexico), and social indicators are significantly lower than in the rest of the country. Population growth is more than double the national rate (4.5% in Chiapas vs. 2% for all of Mexico), infant mortality is about 50% higher, population per physician about double, and 62% of the population has not had elementary schooling compared to 29% for Mexico as a whole.

65. Social, economic and political conditions in the South have also deteriorated over the past decade. While the Mexican economy overall has grown, the real incomes of the Southern States have declined. In the northern region of the country, real expenditures were roughly constant from 1984 to 1989 for most households, then rose from 1989 to 1992, leading to positive growth between 1984 and 1992. In contrast, for the South there was a decline of 15-20% in the living standards of most households between 1984 and 1989, and then a further decline between 1989 and 1992 leading to an overall decline of about 30% between 1984 and 1992. The decline in the South held for almost all households.

66. Besides a lack of basic infrastructure, this unbalanced growth record can be largely attributed, on the one hand, to the different structure of the Southern States and, on the other hand, to the disappointing results of centrally controlled government programs implemented in these regions. These states are more dependent on agriculture than other regions and consequently have been relatively more afflicted by stagnating agricultural

prices in recent years. Highly fragmented land ownership and polarized political, social and economic structures have also resulted in few opportunities for advancement. Compounding this problem has been the fact that the federal interventions to assist the region—although significant in recent years[7]—have failed to support sustained economic growth and employment. Recurrent problems in the selection, design, management, and implementation of centrally controlled government programs have led to disappointing results on the ground. The main contributing factors to this situation have been: lack of integrated approach to regional development, excessive sectoral fragmentation of investment projects, lack of resource allocation transparency and project accountability at federal and state levels, weak local project implementation and supervision capabilities, and limited public administration and institutional capacity at the state levels.

67. **Bank Group Strategy—Regional Development.** In line with the Government's regional development objectives, the Bank will support a special initiative in the Southern States of Chiapas and Oaxaca, the two poorest states in the country. This initiative aims to reduce the level of poverty in the region by stimulating the acceleration of private-sector led growth and improving the delivery and management of basic social services. Under this initiative, the Bank—in cooperation with—IFC will assist the Government in setting up a task force that will work with the local and foreign business community and civil society to identify and tackle specific constraints to the development of local productive private sector activities. Further, the Bank will support this endeavor in several ways, including (a) funding complementary infrastructure for private sector investment initiatives and (b) providing technical assistance for public sector capacity building at state and local levels (see Box on the next page).

68. IFC will supplement the above Bank actions through targeted interventions in the region. Besides the structuring of a potential micro-enterprise project in Oaxaca, IFC will contribute towards alleviating the scarcity of long-term financing through funding of a small and medium scale enterprise credit line with one of the leading national banks represented locally. Additionally, it will help improve the private sector's access to equity finance by providing the Fondo Chiapas, a venture-capital fund investing in small and medium enterprises in the State of Chiapas, with the financial and technical assistance it presently needs to strengthen its long-term operational and institutional capabilities in that State. In association with Mexican corporates it will also seek to channel long-term financing in support of *ejidos* and indigenous communities participating in agricultural activities. Finally, with FIAS it will assist the State authorities in improving the local regulatory regime and incentives framework needed for the local private sector to operate on a competitive footing with the rest of the nation.

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7 Nationally, transfers from the federal government represent some 77% of consolidated expenditures of the states (85% and 93%, respectively, for Chiapas and Oaxaca). The majority of federal expenditure in Chiapas and Oaxaca are carried out under the Programa Nacional de Solidaridad (PRONASOL), a country-wide program that includes over 30 sub-programs.

The Southern States Initiative (SSI) Action Plan

The proposed SSI Action Plan consists of five broad elements:

- The Government will create a coordinating mechanism to establish a strategic plan to guide the development of the SSI, and to select, implement and monitor specific investments.
- The Government and the Bank will refocus ongoing projects relevant to the states of Chiapas and Oaxaca, to facilitate the immediate implementation of the SSI. Some eleven operations could be restructured, with a total value of approximately $360 million. In addition, the IDB has recently approved a program for small productive projects of $15 million.
- An agreement will also be reached to include specific components for the Southern States in new operations. Bank investment lending will be targeted to support infrastructure that complements private sector investments. Some eleven new investment operations will include specific components focused on Chiapas and Oaxaca.
- The Bank and the IFC, in partnership with the Government, will organize a task force to work with the business community and civil society to identify and tackle specific constraints to the development of productive activities.
- To ensure that funds are transferred to priority programs, civil society will participate in the design and implementation of the regional strategy, as well as the selection, financing and implementation of specific activities. These activities will be targeted geographically at areas with strong potential for the development of productive activities, and at priority areas, such as highly impoverished communities of small family farms.

MEXICO PRIVATE SECTOR STRATEGY: REGIONAL DEVELOPMENT FY 1997-99

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Foster productive activities in the least developed regions of the country.	• Work with government and private enterprise to identify and tackle constraints to development of productive sector in Southern States.	• Actions initiated to address identified constraints to productive sector development in Southern States, relying predominantly on private initiative.	• PHRD grant to: (i) identify constraints to private investment through workshops with private sector and government; (ii) support feasibility studies of public infrastructure identified to complement private investment.	• Technical assistance including FIAS.
	• Decentralization of industrial promotion through (i) introduction of system of matching grants to cofinance state industrial programs and (ii) creation of information system to coordinate federal, state and local level promotion efforts.		• PSD Competitiveness TA.	
	• Support private sector development in Chiapas/Oaxaca by: (i) improving the local investment climate, (ii) strengthening the capabilities of local financial institutions; (iii) increasing financial support to SMEs.	• Strengthened fiscal and regulatory framework for private investments, including enforcement of land ownership and property rights. • Strengthening of Fondo Chiapas financial resources and project development capabilities. • Structuring of agribusiness project involving indigenous communities. • Provision of microenterprise support.	• Southern States Initiative (SSI), ESW. • Bank loan for state and municipal government. • Policy analysis on incentive framework.	• Line of credit to leading financial intermediary. • Establishment of IFC-backed line of credit for SMEs. • TA and investment in Private Venture Capital Fund (Fondo Chiapas). • Loan transaction in agribusiness. • Line of credit/equity participation in a microenterprise project.

Annex 1

IFC's Project Selection Criteria

The Group strategy leads to a number of IFC advisory and investment transactions as shown in the IFC instruments column in the matrices at the end of each strategy subset. These transactions have to be tested against generally applied criteria of Development Impact, IFC role and Profitablility (of the project as well as for IFC as an investor and lender).

- The Development Impact Test is straightforward: the whole thinking behind the strategy design has been geared to developmental impact enhanced through close cooperation between the Bank and IFC in the design and implementation phase. The ERR as part of the Development Impact Test will eliminate most commercially unviable transactions.

- The IFC Role Test is more complex and can actually force IFC to withdraw from some very developmental projects. The IFC role test is the test of "no alternative domestic or foreign financing available" and the proactive involvement of IFC in several ways. In Mexico, this proactive involvement will come in particular through:

  - Funds mobilization from the international syndicated loan markets on maturity terms only IFC can achieve.

  - Transfer of international technical and financial expertise and complex project design experience demanded from IFC mainly by the medium scale sector. However, new financial products often need to be introduced first in larger corporations.

  - Partner of the foreign direct investor who has not been exposed to Mexico in the past, such as mid-size US, European and Japanese companies.

  - IFC as co-investor/lender in the newly privatized sectors joining domestic and foreign lead investors. IFC as generator of confidence is important for even strong partners due to untested regulatory environments, especially in infrastructure, oil, petrochemicals and gas. IFC often works through model transactions, which may at times lead to improvements in the regulatory framework. In other transactions, IFC can work within the framework undergoing reform.

  - Agent of change in corporate governance, actively improving reporting and auditing, protecting small shareholder interests, and opening share capital to the public.

- Creation of environmental awareness and assisting the client to meet the Bank Group environmental standards.

- The Profitability Test must assure that IFC can achieve an adequate return on its equity investments and loans together with sound credit security arrangements. This requires first commercially viable transactions and second an adequate risk/reward profile for IFC. These requirements can often delay the project structuring process, especially in the newly privatized sectors. It is not only for IFC's protection, but also for establishing best practices for future financing from the market.

IBRD 23547

MEXICO

National capital
State capitals
Principal cities or towns
Divided highways
Selected main roads
Railroads
Rivers
Principal airports
State boundaries
International boundaries

KILOMETERS 0 100 200 300 400 500
MILES 0 100 200 300

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FEBRUARY 1992

From: Joanne Salop

New

Mexico CAS: November 4 Meeting with Mr. Wolfensohn

1. The October 7 meeting that Mr. Wolfensohn chaired on the Mexico CAS concentrated on the following issues:

* Poverty in Mexico, its causes and concentration and what the Bank Group is doing to address it -- including in the Southern States Initiative and other activities.

* The tight leash on which the Government has tried to keep the Bank, the Bank's recent attempts to broaden its dialogue to other actors in Mexico including civil society, and the Government's reactions to these attempts.

* The Government's more relaxed attitude toward IFC activities, and IFC's ability to work in a practical on-the-ground way with high-profile issues, such as privatization, and other issues that are proving important for the economic recovery, such as enterprise restructuring and financing for small- and medium-scale firms.

* Mexico's creditworthiness and the risks to the Bank of the Mexico program, including in the financial sector.

* The process of preparing the joint Bank/IFC CAS, including the interaction between Bank and IFC staff and management and with the Government.

Because time at that meeting was so short, these issues were generally not discussed in very much depth.

2. The CAS was subsequently distributed to Executive Directors on October 15 for discussion on November 5. On October 22, the Government registered concerns about the document, citing several presentational concerns and substantive concerns in three areas:

* Bank involvement in legal and judicial reform.

* Privatization in general, and in the energy sector in particular.

* Bank dialogue and working relations with NGOs, civil society, and stakeholders.

The CAS is currently being amended and Executive Directors will now discuss it on December 17, along with the proposed Contractual Savings Loan and DEC's paper on the Bank's Response to Crises. (The latter grew out of the review of the Mexico program that the Managing Directors, Operations had requested DEC to undertake.)

3. Against this background, the following agenda items are proposed for the November 4 meeting:

First, the Region may wish to update the meeting on the

Government's concerns and the current state of play on the CAS. Do the former reflect new developments that will circumscribe the Government's room to maneuver on the policy front? Or do they simply reflect concerns with managing public opinion, given the fact that the CAS may find its way into the hands of the press.

Second, participants may wish to consider the implications of the concerns raised for the Bank's activities in Mexico and for the visibility risks of the new office in Mexico City. How are these risks to be be managed? An important thrust of the CAS was to open up the dialogue with other parties -- both inside and outside Government. Is this now to be put on hold? How does this affect our work on the Southern States Initiative and other social development activities that involve civil society?

Third, participants may wish to discuss the implications (especially of the concerns voiced about privatization) for IFC activities -- in light of the fact that some 20 percent of IFC's FY97 investments are programmed for the energy sector. Or is this an example of the phenomenon discussed on October 7, in which the policy issues of interest to the Bank may stall even as transactions embodying the policy may proceed with IFC's on-the-ground support?

Fourth, participants may want to follow-up on the discussion of the downside risks in the Mexico program and the links to the financial sector that was initated at the October 7 meeting. What are the risks of another financial crisis? What would such a crisis look like and what would be the implications for the financial sector? How would the Bank Group respond?

Fifth, participants may wish to discuss whether the CAS adequately reflects the lessons learned from the DEC review -- both in terms of emergency preparedness (per the above question) and in terms of pulling together the staff firepower to deliver sufficiently high-quality lending and non-lending services to satisfy our Mexican clients' needs.

(9/30) Memo from
Messrs. Burki & Adams

JDW: • This is the first Bank-IFC joint CAS (there will be a total of 7 this fiscal yr).
• I understand the process has been "challenging" - with difficulties / dissent within IFC & between IFC + the Bank. In the end, all worked out after the teething problems but we expect this to be a continuous learning exercise for both Bank & IFC.
• There will be quite a # (20+) of mgt/staff at this review, which you will chair. You will also chair the Board mtg (Nov 5).
• Your Mexico/Zedillo visit is slated for Nov 10–11.
10/4 @ MEXICO

THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: September 30, 1996

TO: Distribution

FROM: Shahid Javed Burki, LACVP (for SJB)
Daniel Adams, CLOVP DFA

EXTENSION: 82332
30665

SUBJECT: **Mexico: Joint Bank-IFC CAS - EXCOM Review**

1. Please find attached the draft Mexico CAS package. This package will be reviewed at an EXCOM meeting chaired by Mr. Wolfensohn that will be held on Monday, October 7, at 4.30 PM in conference room E-12-27. The Board date for the Mexico CAS is November 5.

2. The package includes the draft CAS and two major attachments: a Private Sector Strategy paper (PSS); and a paper summarizing lessons for the Bank based on an internal Bank review of the Mexican crisis.

3. The Mexico CAS is the first joint Bank-IFC CAS. The document integrates the Bank and IFC programs within a unified strategic framework, and the two staffs have collaborated closely in preparing it. The PSS, also prepared jointly, spells out in more detail key elements of the agenda for private sector development and Bank-IFC collaboration.

4. The Mexico CAS is also the first to be prepared under the new CAS procedures being piloted Bankwide. As part of these new procedures, it has benefited from an upstream EXC review chaired by Mr. Koch-Weser that was held on July 19. The PSS was reviewed at a meeting chaired by Mr. Frank on September 10. On the same day, the CAS package was discussed at a Regional Operations Committee meeting chaired by ourselves.

5. There is broad agreement with the Mexican Government on the development strategy and partnership with the Bank Group. Individual elements of the proposed country assistance strategy have been the subject of discussion with our Mexican counterparts for some time as part of our regular dialogue in respective sectors. We are treating the CAS as a 'living" document and are proposing further discussion in a retreat format in the near future where we hope to have a broader range of interlocutors on the Mexican side than has been the case so far.

6. We are also seeking a fuller, broader discussion of the PSS document that has been prepared as part of the CAS framework. The Government values IFC's past and present activities in Mexico, but also acknowledges that it itself could be more forceful in

promoting active partnerships and dialogue between IFC and the private sector. The PSS has not yet been the subject of much discussion with the private sector.

7. The Zedillo Administration so far has demonstrated a strong commitment to reform, both in adhering to a tough stabilization program in the face of a severe recession and in initiating significant institutional reforms. But, looking ahead, the development agenda outlined in the CAS will certainly test the Government's resolve in persevering with reform in circumstances that socially and politically will remain difficult, as well as the Government's implementation capabilities. One major challenge will be in maintaining the necessary restraint in macroeconomic policy in the face of popular and political pressures that are bound to intensify in the run-up to the general elections scheduled for July 1997. Another will be in pushing through critical structural and institutional reforms—those supportive of competition, the rule of law, and more open, decentralized and accountable government—that will inevitably face resistance from entrenched interests, especially from within the ruling party.

8. Mexico's prospective external financing requirements, including a hump in debt service during 1998-99, require that the Bank maintain a high level of disbursements over the next three years. The CAS proposes a Bank lending program of $5.5 billion over FY97-99. IFC expects to be able to increase its investments in Mexico to a total of about $1 billion over the same period, and expects to mobilize an additional $1.2 billion through syndications. Within its proposed lending program, the Bank plans a shift toward fewer, larger sector-based operations that focus on broader issues of sector policy and institutional framework and expenditure priorities. The Bank also plans to enhance significantly the role of non-lending services in its program, responding to client demand for more policy analysis and advice. These shifts toward more sector-type loans and more non-lending services will be mutually supportive and reinforcing, and should contribute to a substantial enhancement of our country policy dialogue.

9. The consolidation of the Bank lending program into fewer projects, together with improved efficiency in portfolio management that we hope to achieve, will release more of the Bank's administrative budget for non-lending services. Nonetheless, the present budgetary envelope for the Mexico program may prove inadequate to support the strengthening and upgrading of non-lending services that the CAS proposes, taking into account also the additional costs arising from the decentralization of the Bank's Mexico Department to the field. The budgetary implications of the country assistance strategy proposed in the CAS will need to be assessed carefully at the next budgetary review.

Distribution

Messrs.\Mmes. Wolfensohn, Einhorn, Frank, Kaji, Koch-Weser, Sandstrom, Salop, Horiguchi (EXC), Lindbaek (CEXVP), Iida (MIGEX), Shihata (LEGVP), Bruno (DECVP), Zhang (SECVP), Malloch Brown (EXTVP), Lafourcade, Dahlman, Qureshi, Swannack-Nunn (LAMXC), Paul, Cracco, Soladay (CLAD).

CAS

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MEXICO
COUNTRY ASSISTANCE STRATEGY

FY97-99

(EXCOM REVIEW DRAFT)

SEPTEMBER 30, 1996

CURRENCY EQUIVALENT

Currency Unit	=	Mexico New Peso (MexN$)
US$1.00	=	MexN$7.54 (September 30, 1996)

ABBREVIATIONS AND ACRONYMS

AFORES	Administradoras de Fondos para el Retiro
EDI	Economic Development Institute
EFF	Extended Fund Facility
ESW	Economic and Sector Work
FOVI	Fondo De Operacion Y Financiamento Bancario a la Vivienda
FOVISSSTE	Fondo para la Vivienda de los Trabajadores del ISSSTE (Government Workers' Housing Fund)
GAB	General Arrangements to Borrow
IDB	Inter-American Development Bank
IDF	Institutional Development Fund
INFONAVIT	Instituto del Fondo Nacional de la Vivienda de los Trabajadores (National Workers' Housing Fund Institute)
NAFTA	North American Free Trade Agreement
NGO	Non-Governmental Organization
O&M	Operations and Maintenance
PROCEDE	Programa de Certificacion de Derechos Ejidales y Titulacion de Solares Urbanos
PROCAMPO	Programa Nacional de Modernisation Del Campo
PRODUCE	The Agriculture Investment Program
PROFORESTAL	Productos Forestales Mexicanos
PROSSE	Programa de Servicios Sociales Esenciales (Program of Essential Social Services)
PTAL	Privatization Technical Assistance Loan
SAGAR	Secretaria de Agricultura Ganadera y Desarrollo Rural
SME	Small and Medium Enterprises
SSI	Southern States Initiative

Mexico
Country Assistance Strategy

Table of Contents

I. Introduction

II. Economic and Social Context

III. Mexico's Development Agenda

IV. Economic Outlook and Risks

V. Mexico-Bank Group Development Partnership

VI. Instruments of Partnership

VII. Size of Bank Group Program, Country Risk and Creditworthiness

VIII. Collaboration with Other Organizations

IX. CAS Priorities and Success Criteria

X. Agenda for Board Consideration

Annexes
1. Bank Group Budget Matrix
2. Bank Portfolio Matrix
3. Bank Program of Lending and Non-Lending Services
4. Bank Fact Sheet
5. IFC Portfolio and Investment Program
6 Economic and Exposure Indicators
7. Mexico at a Glance

Attachments
1. Private Sector Strategy Paper
2. The Mexican Crisis: Lessons for the World Bank

I. Introduction

1. The FY97 Mexico CAS is the first to be prepared under the new CAS procedures being piloted Bankwide, and is also the first joint Bank-IFC CAS. It contains several innovations and new emphases:

- This CAS has been prepared with a view to making this document the main driver of the Bank Group country program, the central tool for our partnership with the client and for managing our resources in the service of client needs and priorities.

- The new CAS emphasizes a shift of focus from inputs—projects, reports—to outputs—results on the ground. It does this by: defining development objectives and strategies in key areas of Bank Group[1] support with greater clarity and specificity; and establishing benchmarks against which to measure progress. The specific instruments of support the Bank Group will deploy—lending, investments, guarantees, advice, portfolio management—and the related allocation of our budget are articulated within this more strategic and results-oriented framework.

- Bank and IFC programs are integrated within a unified strategic framework. A jointly prepared Private Sector Strategy paper (Attachment 1) spells out in more detail key elements of the agenda for private sector development and Bank-IFC collaboration.

- The CAS has been formulated through a more participatory process involving the client. It will be a "living" document, with the strategy, performance benchmarks, and our instruments of support evaluated, together with the client, against actual results and adapted as necessary.

- The development agenda and the Bank Group assistance strategy are defined in a more thematic framework, focused on three core themes of growth with stability, social development, and modernization of the state, all linked together by the overarching objective of this CAS—raising human welfare and reducing Mexico's high poverty.

- Improving portfolio quality is an emphasis that cuts across the proposed strategy, and will be supported by another important innovative dimension of the CAS—the decentralization of the Bank's Mexico Department to the field. This change will help improve project implementation; allow a closer, more proactive policy dialogue; and facilitate stakeholder participation. IFC also is strengthening its field office.

2. The previous (FY95) CAS focused on the causes of the 1994 financial crisis and the Bank Group's response in the short term. This CAS has a longer horizon, addressing the challenges Mexico faces over the next several years in its transition from crisis to healthy growth. It spans the remainder of the term of the Zedillo Administration, which

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[1] "Bank Group" in this document refers to both IBRD and IFC while "Bank" refers only to the former.

ends in the year 2000. Lessons learned from the crisis, summarized in an accompanying paper (Attachment 2), underpin the strategy for the future.

II. Economic and Social Context

3. Mexico has responded to the financial crisis that erupted in 1994 with a strong adjustment program. The Government's program has comprised: a substantial tightening of monetary and fiscal policies; a large exchange rate adjustment through moving to a floating exchange rate regime; steps to deal with the severe distress in the banking system; initiation of further structural reforms (in social security, deregulation and privatization); and measures to strengthen the social safety net to cushion the impact on the poor. The Government program has been supported by a large international financial package.

4. Thanks to this adjustment effort, Mexico has made substantial progress in a relatively short period of time in restoring financial stability and creating conditions for a resumption of growth. Fueled by improved competitiveness resulting from the exchange rate adjustment, resurgent exports have drastically cut the current account deficit, correcting a fundamental imbalance underlying the 1994 financial crisis (Table 1). Inflation is on a downward course, dropping from a monthly peak rate of 8 percent in April 1995 to an average of 1.5 percent in recent months. The reduction of inflation has allowed the *peso* to stabilize and interest rates to decline, with the annual rate on the benchmark 28-day *cetes* falling from a peak of around 80 percent during the crisis to 25-30 percent in recent months. Improved investor confidence is reflected in progress in restoring Mexico's access to international capital markets, which has permitted Mexico to refinance some of its external obligations on more favorable terms and, together with the international assistance package, rebuild foreign reserves.

Table 1: Summary Economic Indicators

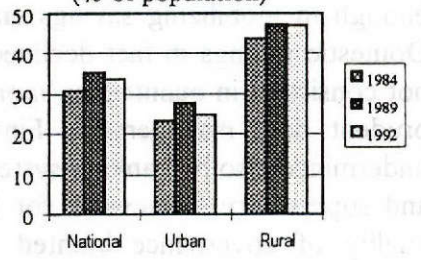
	Actuals		Est.	Projected				
	91-93	94	95	96	97	98	99	2000
Average Real Growth Rates %):								
GDP	2.4	3.5	-6.9	3.0	3.5	4.0	5.0	5.0
Exports (GNFS)	3.3	7.3	28.4	16.5	8.4	8.2	8.0	7.0
Shares of GDP (%):								
Gross domestic investment	23.7	23.5	19.4	19.2	20.6	21.9	23.7	24.1
Gross national savings	17.4	16.0	18.7	18.0	19.0	20.0	21.6	22.1
Non-financial public sector balance	0.4	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3
Current account balance	-6.3	-7.8	-0.3	-1.2	-1.6	-1.9	-2.0	-2.0
External debt	35.9	36.1	64.4	54.9	52.3	49.5	46.2	42.5
Other:								
Annual inflation (CPI, end of year) (%)	15.9	7.0	51.3	27.0	12.5	9.0	7.0	5.0
Real exchange rate (annual change, depreciation +) (%)	-7.6	3.8	45.2	-11.7	--	--	--	--
Gross intl. reserves/imports (mos.)	5.5	1.3	4.4	3.2	3.1	2.7	2.4	2.5
Debt service/ GNFS exports plus current transfers (%)	41.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4

5. The crisis and the adjustment it necessitated led to a sharp contraction in economic activity in 1995, with GDP falling by as much as 6.9 percent, domestic fixed investment plunging by 30 percent, and formal sector unemployment doubling. But a recovery is now under way, led by exports that continue to grow strongly and supported by an incipient revival in domestic demand as adjustment policies succeed in restoring financial stability. On present trends, GDP growth of around 3 percent is expected for 1996.

6. This improving outlook is contingent upon continued firm implementation of the Government's adjustment program. While investor confidence has recovered, it remains fragile and vulnerable to policy slippages and shocks. Also, the banking system problems remain a major concern. With the decline in interest rates and the upturn in economic activity, bank portfolios, afflicted by large non-performing loans, are beginning to stabilize. Government efforts in support of bank restructuring have helped strengthen bank capital positions and improve accounting practices and prudential controls. Nonetheless, the banking system remains fragile. Fiscal costs associated with the various Government bank support programs are currently estimated at around 9 percent of GDP in present value terms, and will be a source of pressure on an already tight fiscal position.

7. The recession in 1995 in all probability increased the incidence of poverty, from levels that were already high. High poverty rates have persisted nationally, but they are especially high in rural areas (Chart 1). The poverty picture is reflected in a highly unequal distribution of income; in 1992, the bottom 20 percent of the population received only 4.1 percent of income compared with 55.3 percent by the top 20 percent. Reducing these high levels of poverty and inequality is essential, not only on grounds of human welfare and equity but also to preserve social stability without which sustained economic progress cannot be achieved. The growth process needs to involve, and draw on the productive potential of, a broader mass of population and the lagging regions. Poverty is highly concentrated in the southern states, and it was rebellion in one of these states—Chiapas—that contributed to the economic instability in 1994. The recent rash of rebel activity originated in another poor southern state—Guerrero. Whatever may be the specific political factors associated with such unrest inimical to national stability, poverty provides a fertile ground for it. The rise in unemployment and the erosion of living standards caused by the recession are reflected also in a general increase in crime. Social discontent could mount if the still fragile economic recovery falters, raising the stakes for Mexico to consolidate and build on the recent economic gains.

Chart 1: Incidence of Poverty
(% of population)



Source: World Bank, *Mexico Poverty Assessment, 1996*

8. Political reforms—democratization, decentralization, rule of law—are a major element of the Zedillo Administration's agenda. These reforms will strengthen public institutions and are necessary for stronger, stable growth and more effective poverty reduction programs in the long run, but inevitably add to uncertainties in the short run.

President Zedillo faces strong resistance from entrenched interests, including from within the ruling party, to these reforms. Against this background, an important recent achievement is the enactment of a major electoral reform that supports the transition toward a more pluralistic political system. This reform will provide a more level playing field to political parties in the congressional elections scheduled for July 1997. Opposition parties are expected to strengthen their position in Congress in these elections. Mounting political pressures in the run-up to the elections will test the Government's determination to persevere with monetary and fiscal discipline. Creating a more democratic, open political system is important to another major thrust of the present Administration's institutional reform agenda—devolving more responsibilities to states and municipalities. Unaccompanied by effective democratization, decentralization runs the risk of decentralized authority being captured by powerful local elites.

III. Mexico's Development Agenda

9. The reforms of the mid- to late 1980s and early 1990s reoriented the economy toward market-led growth and international integration, and redefined private and public sector roles. Yet they did not deliver the expected rapid growth, poverty reduction and improvements in social welfare. Lasting macroeconomic stability also was not achieved, as the 1994 crisis makes clear. Why? Structural reforms, though significant, did not go far enough in mobilizing savings and increasing productivity, the fundamentals of growth. Domestic savings in fact declined. Macroeconomic management, though improving, was not consistent in maintaining monetary and fiscal discipline, external competitiveness, and prudent debt management. Financial stability and efficient resource allocation were undermined also by banking system weaknesses, reflecting a deficient incentive, regulatory and supervisory framework for banks. Public institutional weaknesses undermining the quality of governance blunted the edge of expenditure programs aimed at poverty reduction. How can Mexico do better? Analysis suggests the need to:

- pursue sound macroeconomic policies in a consistent and sustained manner, reducing Mexico's vulnerability to periodic financial crises;

- extend and deepen the structural reforms that Mexico has been implementing—opening up markets to true competition, increasing private sector participation in the economy, mobilizing domestic resources, reforming the financial system; and

- initiate new, second-generation reforms, with a focus on strengthening the institutional foundation for growth and development.

10. The central, overarching development objective is a broad-based improvement in the level of human welfare and reduction of Mexico's high poverty. This implies a development agenda with three core, interrelated themes: growth with stability; social development; and modernization of the state. Mexico's development strategy, articulated most recently in the National Development Plan 1995-2000 (the *sexenio* of the Zedillo Administration), captures this agenda well, emphasizing the same core themes. The Bank

Group agrees with the thrust of the Government strategy and the CAS outlines the development agenda, in common with the Plan document, within a framework defined by these three themes. The Country Strategy Matrix (Table 3) identifies the main performance issues in each of these thematic areas and outlines how the proposed development strategy would address the identified issues.

11. ***Growth with Stability***. Moving Mexico onto a higher and sustainable growth path is indispensable if serious inroads are to be made into Mexico's persistent and widespread poverty. A first priority is to consolidate the still fragile economic recovery. At the same time, reforms must continue that will support stronger growth in the medium term. Key elements of the agenda are:

- Maintaining fiscal and monetary discipline to underpin *macroeconomic stability*, together with an exchange rate policy that supports competitiveness.

- Strengthening the fundamentals of growth—*saving and productivity*. Key to mobilizing domestic savings to support higher investment will be: raising public savings, including through tax reform; and boosting private savings through successful completion of the pension system reform the Government has initiated, and sound development of financial/capital markets (especially rapid restoration of confidence in the banking system). Areas of emphasis in raising productivity will be: removing regulatory (trade, domestic and foreign investment) barriers to efficient private sector development, at federal and lower levels; fostering a competitive environment for small and medium-scale enterprises; strengthening infrastructure, especially through increased private investment; making labor markets more flexible and upgrading education and training; and improving the functioning of agricultural markets.

- Fostering longer-term sustainability of growth through improved *environmental management*, moving beyond the introduction of regulations to the promotion of necessary investments in environmental infrastructure and the development of institutions (national and local) and markets for sustainable development.

12. ***Social Development***. Stronger growth is essential to reduce poverty and inequality, but programs targeted to the poor also are necessary. Poverty in Mexico has remained persistently high, especially in rural areas where the incidence of poverty is almost twice as high as in urban areas, indicating that the programs adopted so far have not been very successful. A two-pronged effort is needed for greater effectiveness:

- Better targeting and improving the quality of *basic social services*—education, health, nutrition, safety nets. At about 55% of federal programmable expenditure, social sector spending in Mexico is large. The main challenge is increasing its effectiveness and efficiency. Recent initiatives by the Government to better target food subsidy schemes, improve social safety nets for the rural poor, and restructure the *Solidaridad* program that supports basic economic and social infrastructure development

(including a major decentralization of the program, recently renamed *Programa de Bienestar*, to the municipal level) are important steps in that direction.

- Promoting in an effective and sustainable way *the productive sector in the poor areas*, especially the southern states, to expand income-earning opportunities for the poor and thereby break the vicious circle of poverty—through agrarian reforms, development of rural financial markets, stronger private sector and community (including women, indigenous people) participation in the development of productive activities (agriculture, forestry, rural industry), and provision of basic infrastructure.

13. ***Modernization of the State.*** The agenda for reform in the coming years will be increasingly institutional in nature. An example is the financial sector. Past reforms focused on liberalization of controls. The next set of reforms must focus on strengthening prudential regulation and supervision, accounting and reporting standards, and bank management. Similarly, deregulation of controls on private investment and commerce—domestic and foreign—must be supported by legal and judicial reforms to provide a level playing field, ensure enforceability of contracts, and establish the rule of law. Such institutional reforms are essential to consolidate and make effective earlier reforms. In many countries, including Mexico, liberalization unaccompanied by timely institution-building contributed importantly to the banking system crises that developed. There are similar issues with respect to the machinery of government itself: the main problems with many public expenditure programs are not due to a lack of funding allocation but institutional deficiencies. Compared to earlier reforms, institutional reforms would be more complex and painstaking: for example, it is easy to tear up interest and credit controls but a lot harder to develop good regulatory and supervisory systems and train management and staff. The institutional agenda, accordingly, will have two main thrusts:

- Strengthening the *institutional underpinnings of markets* to ensure they function efficiently and equitably—institution-building in the financial sector; accounting, auditing, and reporting standards; commercial laws (property rights, bankruptcy, securitization); judicial reform.

- Modernizing *public administration* to improve the quality of governance and increase the effectiveness of public programs, e.g., improving the efficiency and transparency of the budget system, upgrading the civil service, and decentralizing responsibilities to state and municipal levels where that would improve service delivery—basic social services, local infrastructure—backed by steps to strengthen fiscal and institutional capacities and accountability at these levels.

IV. Economic Outlook and Risks

14. ***Base Case.*** The next few years represent a crucial transition for Mexico—from crisis to sustainable growth. Given steady progress on the above agenda, Mexico can build on its recent gains in stabilizing the economy and restoring growth. Growth in the next 2-3 years will likely be moderate, averaging 3-3.5 percent, with economic fragility diminishing

but continuing for much of this period. Provided Mexico successfully completes this transition, growth could rise to a higher plateau of around 5 percent in later years (projections are summarized in Table 1 and detailed in Annex 7). The projected gradual recovery of growth assumes that it will take time for gains in macroeconomic stability and market confidence to solidify and private investment to rebound, for the banking system to return to health, and for the structural and (especially) institutional reforms to bear fruit.

15. As imports recover with economic growth, the current account deficit will widen again. But if Mexico maintains the new dynamism of its exports by not allowing the competitive advantage conferred by the *peso* depreciation to be eroded, the deficit can be contained to below 2 percent of GDP, consistent with an improvement in Mexico's external debt indicators in the medium term. Besides containing the rise in external debt, Mexico is taking steps to improve its maturity profile. Debt service, nevertheless, will remain high in the next three years, especially in 1998-99 when the bulk of the crisis-related financing Mexico received is to be repaid, keeping the reserve position tight. To support faster growth, domestic investment will need to increase, but is projected to be financed mainly from higher domestic savings. The base case assumes that three fundamental lessons of the recent crisis—the need to maintain a competitive exchange rate, raise domestic savings, and prudently manage public debt—are well understood.

16. The base case economic outlook depends crucially on an orderly resolution of the banking system problems. The Government will need to move vigorously on the next phase of system reform (para. 30). A related challenge will be in fiscal management. Budgetary costs of bank support programs, together with the transitional fiscal costs of social security reform, could add up to 2.5-3 percent of GDP in each of the next several years. These additional expenditures will need to be absorbed without relaxing the fiscal discipline Mexico must maintain as part of its stabilization program.

17. ***High Case***. The growth outcome will depend fundamentally on the pace and comprehensiveness with which Mexico pursues the development agenda outlined in Section III. A real opportunity exists for achieving higher growth than forecast in the base case: the country's development potential is immense; major new growth opportunities are offered by NAFTA; and substantial structural reforms have been implemented since the late 1980s which have yet to yield their full growth dividend. An aggressive reform effort, that removes constraints to higher and more efficient private investment, can tap this potential, permitting growth to exceed 5 percent toward the end of the decade and allowing a faster reduction of poverty. Such an upside scenario has a parallel in Chile's experience, where the reform momentum triggered by a crisis similar to Mexico's helped put the country on a markedly higher growth path following the initial adjustment phase.

18. ***Low Case.*** The base case economic outlook is subject to two main risks: strains in the banking system; and the vulnerability of Government reform program to social and political disruption. A collapse of the banking system has been averted, but the crisis has left behind a highly fragile system. Improved macroeconomic conditions should contribute to a strengthening of bank portfolios, but a renewed deterioration is possible if the

economic recovery falters or if the Government fails to press ahead with financial sector reform. On the political front, the Government's adherence to a tight stabilization program in the face of a steep recession provides a reassuring demonstration of its commitment to adjustment. Nonetheless, political pressures will continue to test the Government's resolve, especially in the run-up to the 1997 elections.

19. A downside scenario was developed to examine the implications of an interplay of these risks. It assumes that a lack of political will keeps the Government from aggressively pursuing the agenda for restructuring the banking system and weaning it from public support programs. Fiscal costs of bank and debtor support continue to mount, reaching 15% of GDP in present value terms (they are assumed to be contained to about 10% in the base case). These higher costs show up as a rise in the fiscal deficit as political difficulties render the Government unable to absorb them without relaxing fiscal discipline. This sets off a vicious cycle of a renewed rise in inflation and interest rates, declining investor confidence, and a narrowing of access to foreign capital. With the rise in inflation, the *peso* initially appreciates in real terms but becomes increasingly vulnerable to volatility as investor confidence dips. The recovery from the crisis is protracted, with growth stagnating around 2 percent in the next 2-3 years. Mexico is able to continue to meet its external debt service obligations, but at lower income and import levels. An additional risk in this scenario is that the economy remains vulnerable to shocks over an extended period.

20. ***External Environment.*** Mexico's integration into international trade and capital markets has increased appreciably since the late 1980s. This brings important benefits—wider markets for trade, increased access to foreign capital and technology. But it also confronts policymakers with new challenges, as Mexico's experience vividly demonstrates. Especially important is the need for stricter discipline in macroeconomic management, including sound financial sector management, given the increased mobility and potential volatility of capital. For Mexico, with increased international integration, the payoffs to sound policies are larger, but so are the penalties for policy errors.

21. Mexico's exposure to external shocks—developments in export markets, foreign interest rates, capital flows—is sizable, but the country has taken steps since the 1994 crisis to reduce its exposure and vulnerability to such shocks. First, the surge in exports fueled by the restoration of a competitive exchange rate has substantially expanded the export base. Oil, whose price is particularly subject to volatility, remains a major source of exports and fiscal revenues, but its contribution has now dropped to 15-20 percent from around 30 percent in the mid- to late 1980s. Second, the large reduction in the current account deficit has reduced Mexico's dependence on capital inflows. Third, Mexico has been able to improve the maturity structure of its external debt, reducing its reliance on the more volatile short-term portfolio flows. The accumulated stock of nearly $30 billion in dollar-indexed short-term domestic securities (*tesobonos*), which played an important role in the financial crisis, has all been retired, mostly replaced with longer-maturity external debt. Fourth, the financial cushion available to absorb shocks, virtually depleted after the 1994 crisis, has been strengthened, through replenishment of reserves and restoration of access to international capital markets. A decline in external risk is also

indicated by some summary exposure indicators shown in Table 2. Despite these improvements, however, Mexico remains vulnerable to external shocks, especially over the next three years when the debt service will stay high and international reserves relatively low, requiring strict adherence to prudent macroeconomic policies.

22. New trade opportunities created by NAFTA are a key element in Mexico's export prospects. But NAFTA also brings challenges: firms must become more flexible and efficient to stand the test of increased competition, in domestic as well as export markets. With closer integration, the sensitivity to the U.S. economy rises. About three-quarters of Mexican exports now go the U.S. A strong resurgence of protectionist sentiment or a marked slowdown in growth in the U.S. market would have important implications for Mexico, though both appear unlikely at this time. U.S. electoral politics may temporarily slow the implementation of some aspects of NAFTA in 1996, but a serious backtracking on the agreement is considered unlikely. The medium-term growth outlook for the U.S. economy remains positive. At present levels, a 1 percent decline in U.S. GDP is estimated to lower Mexico's total exports by around $1 billion. As Table 2 indicates, another source of sensitivity to developments in the U.S. economy is interest rates. Some rise in U.S. rates in the period ahead is likely, but current forecasts do not point to a sharp surge.

Table 2: Summary Indicators of External Exposure

Source of Shock	Magnitude of Shock[1]	Annual Impact of Shock[2] (% of exports)	
		1994-96	1997-99
Terms of Trade	4.3% deterioration	6.2	6.5
International Interest Rates	290 basis points rise	3.6	2.4
Manuf. Export Volume	5.7% decline	2.7	3.1
Private Capital Inflows (excl. FDI)	$8.4 billion decline	11.9	8.0
Total[3]		24.4	20.0

[1]Measured as one standard deviation of three-year moving average of time series for past 10-15 years.
[2]Impact, in terms of exports of goods and services, of deterioration in the shock variable from the base case path over the three-year period by the indicated magnitude.
[3]These shocks are unlikely to occur simultaneously and so their impact is not additive; the total is shown merely to illustrate the change in overall exposure to these shocks over the two periods.

V. Mexico-Bank Group Development Partnership

23. The Bank Group assistance strategy for the next three years has been designed, in consultation with the Government, to support key elements of Mexico's development agenda outlined in Section III. The CAS Matrix (Table 3) maps Bank Group assistance strategy into the three core themes of this agenda—growth with stability, social development, and modernization of the state, all linked together by the overarching objective of raising human welfare and reducing poverty. The matrix relates Bank and IFC instruments of support to the main elements of this strategic framework and defines benchmarks against which performance will be monitored. The Budget Matrix (Annex 1) shows how the Bank and IFC plan to allocate their resources in support of this program. While details of the country assistance program are in the CAS Matrix, key features of, and issues in, the program are highlighted here. Four features cut across the program:

- As Mexico is likely to remain in a difficult state of transition from crisis to sustainable growth for much of the next three years, part of Bank Group operations will continue to focus on the short term and assist the Government in dealing with the crisis and its effects (Box 1 provides an update on the Bank Group's crisis response). Increasingly, however, the Bank Group will focus on operations that will help lay the basis for stronger growth and speedier reduction of poverty in the medium to long term.

- The agenda for private sector development will be pursued through more focused, concerted Bank and IFC efforts, utilizing the framework of a jointly prepared Private Sector Strategy (PSS, Attachment 1). Key areas of Bank-IFC collaboration, as detailed in the PSS, will be: banking, capital market, small and medium-scale enterprise restructuring, infrastructure, and regional development.

- A major emphasis across the Bank portfolio will be to improve portfolio quality and results on the ground—through better quality at entry and improved implementation.

- IFC will focus more on small and medium-scale enterprise development and ensure that its operations catalyze and not displace private investment.

Growth with Stability

24. A large part of the Bank Group lending and non-lending program over the next three years will support the fundamentals of sustainable growth: sound macroeconomic management, higher savings and productivity, and improved environmental management.

25. ***Macroeconomic Management***. Supporting sound macroeconomic management and financial stability will remain a major focus for the Bank. The Bank has stepped up its macroeconomic monitoring. In combination with enhanced surveillance by the IMF and more timely provision of economic data by the Government, this should help institute an improved warning system for any emerging problems and assist in contingency planning and policy dialogue. While the IMF will lead the dialogue on the stabilization program and exchange rate and liability management, the Bank Group will concentrate on issues relating to savings, investment and productivity; public expenditures; and financial sector management. Policy dialogue in these areas will be underpinned by analytical work carried out in the framework of both the ESW program and related lending operations, and supported by an enhancement of Bank analytical capacity.

26. ***Raising Savings and Productivity***. Strengthening these fundamentals of growth will motivate much of the Bank Group program in finance and private sector development.

27. *Strengthening the Tax System*. Part of the increase in national savings must come from higher public savings. Restraining expenditure growth and improving expenditure efficiency will remain important, but tax reform to raise more revenue also will be necessary. This is particularly so given the large new expenses the Government faces in the years ahead because of social security reform and banking system support (para. 16).

Box 1: Bank Group's Crisis Response in Mexico: An Update

Financial Sector Restructuring. A Financial Sector Restructuring Loan ($1 billion) has supported a substantial sector adjustment program. Bank supervision has been close. Measures supported by the second tranche released in July included: implementation of revised accounting standards for banks and other financial institutions that will assist supervisors in better assessing the condition of banks and also strengthen market-based supervision by providing investors with more transparent information; and issuance of revised capital rules for brokerage firms and agreement on an implementation schedule for credit exposure limits for development bank lending to commercial banks. Through an operation approved in July, including up to $100 million of IFC's own resources and up to $200 million in syndicated financing, IFC is helping Banamex, the largest commercial bank, develop a loan restructuring facility for viable medium-size enterprises.

Essential Social Services Loan (PROSSE). Out of a loan of $500 million, disbursements totaled $302 million by July. Under the loan, the Government committed to two courses of action: protecting budgetary allocations for high priority social programs targeted to the poor; and initiating a system of monitoring and evaluating social expenditures to increase their efficiency. PROSSE-related budget allocations rose from 5.67 billion pesos in 1995 to 8.76 billion pesos in 1996; and the finance secretariat has established a monitoring and evaluation unit for social expenditures.

Privatization Technical Assistance Loan. Disbursements have so far been modest under this $30 million loan, largely due to delay in privatization in electricity (the largest component of the loan) and secondary petrochemicals. But other privatizations are broadly on track—in telecommunications, railways, ports and airports. As the divestiture process winds down, greater attention is being given to regulatory and cross-sectoral issues.

Portfolio Restructuring. Since the 1994 crisis the Bank has restructured a number of projects with partial cancellations of about $860 million. Projects involving on-lending, especially in environment, were affected due to the reluctance of states/municipalities and private enterprises to borrow at the high interest rates prevailing in Mexico. Social sectors also were affected, due to the reduced dollar amounts needed to support the same level of peso expenditures and revised priorities following the crisis.

Non-Lending Services. The Bank has stepped up macroeconomic monitoring, and both the Bank and IFC have increased non-lending activities, including analysis of financial sector and enterprise restructuring issues and new approaches to addressing the problems of the poor southern states.

Important reforms implemented since the early 1980s have modernized Mexico's tax system and improved its efficiency. However, the system needs to generate more revenue to support Mexico's stabilization and growth objectives. The centerpiece of further tax reform should be the strengthening of the VAT, which would both bring in more public revenue as well as improve incentives for private saving and investment by shifting the balance of revenue collection from income toward consumption. Currently, because of a narrow base and extensive noncompliance, revenue from the VAT is only about 3 percent of GDP (compared with 6 percent in Argentina and over 8 percent in Brazil and Chile). Reform of the VAT needs to include a broadening of the tax base by drastically limiting the extensive zero rating and exemptions now allowed, a rise in the tax rate, and improvement in tax compliance. Tax administration needs to be strengthened in general. At the subnational level, more effective use needs to be made of the property tax which remains greatly underutilized in Mexico. The Government is preparing a set of tax reform proposals and the Bank will support this effort through ESW and technical assistance.

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
Overarching Development Objective: Raising the level of human welfare for all Mexicans and reducing poverty. Incidence of poverty to be reduced by about 3 percentage points by 1999 (latest estimate 34% in 1992).					
GROWTH WITH STABILITY Lack of a stable macroeconomic foundation.	• Policies supporting financial stability and competitiveness not followed consistently, especially in the context of increased and more volatile international capital flows. • Financial stability undermined also by serious banking system weaknesses (reflecting deficient incentive, regulatory and supervisory framework).	**Maintain Macroeconomic Stability** • Adhere to macroeconomic policies supportive of financial stability, competitiveness, and sustainable growth. • Promote sound financial sector development (see below).	• Compliance with IMF stabilization program. • GDP growth around 5% by 1999. • Inflation below 10% by 1998. • Average export growth at twice GDP growth rate or more in 1997-99 • Gross national savings 22% of GDP by 2000 (16% in 1994).	Annual CEMs Macro Policy Dialogue, Policy Notes, Monitoring	
Low and unstable growth. GDP grew only 3 % p.a. over the 5 years preceding the recent financial crisis (2% if averaged over 10 years), and plunged 6.9% in 1995 as a result of the crisis.	Weak fundamentals of growth: • Low and declining national saving rate. – Inadequate mobilization of public savings, including through the tax system. – Disincentives to private saving from a defined benefit, PAYG pension system.	**Strengthen Fundamentals of Growth** **(a) Mobilize Savings** **Fiscal Policy** • Increase public savings; reorient tax system toward consumption. **Pension System Reform** • Shift from defined-benefit PAYG system to fully-funded, defined- contribution system for private/public sector workers. • Support implementation of new pension system through regulations, strengthened monitoring and enforcement capacity.	• Broaden VAT base; increase VAT revenue to GDP ratio. • Enactment of new Social Security Law and legislation governing pension fund management, and of appropriate regulatory framework for AFORES. • Restructure INFONAVIT. • Extend pension reform to public sector workers (ISSSTE).	CEM on Savings (97) Contr. Savings I (97) CEM on Savings (97) Contr. Savings II (98) Contr. Savings III (99	TA and equity support to AFOREs
	– Fragile and underdeveloped financial system, providing inadequate security, access and instrument diversity to savers/investors.	**Financial System Development** • Restore health of **commercial banking system** by: accelerating resolution of troubled banks and portfolios; improving prudential regulation and supervision, incentives and market discipline.	• Adoption of OECD-comparable disclosure and accounting standards, prudential regulations, capital rules. • Newly established Asset Disposal Agency (VVA) fully functional. • Phase-out of comprehensive deposit insurance.	FSRL I (ongoing), Banking ESW (97) Ongoing FTAL FSRL II (97)	Venture Capital Loan Restructuring Credit
		• Support development of **capital markets** by: reforming market for housing finance; deepening and diversifying markets for securities.	• Define narrower, viable role for Government (FOVI, INFONAVIT, FOVISSSTE) in housing finance. • Issuance of quality mortgage and non-mortgage-backed securities.	Housing Finance (97) Guarantees ESW	TA Equity Investments
		• Strengthen **financial market infrastructure**: reform legal/regulatory framework for secured lending; upgrade regulatory and supervisory framework of securities markets; further develop ancillary financial information services.	• Functioning collateral and credit registries. • Credit and rating information readily available. Disclosure rules followed on public offerings.	Ongoing FTAL ESW Financial Infra. (98)	TA support and underwriting facilities
		• Expand access to and efficiency of **rural financial markets**.	• Pilot program initiated to improve delivery of rural financial services. • Phase-out Government support for BANRURAL and FIRA by: liberalizing interest rates; reducing subsidy dependence index.	Rural Finance TA (97) Rural Finance (99)	Venture Capital Funds
		• Rationalize role of **development banks** and improve their financial viability.	• Implementation of action plan for development banks agreed under FSRL I. Cessation of first tier lending.	CEM on Public Credit Programs (98)	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

(ii)

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
	• Generally low level and growth of productivity.	**(b) Increase Productivity**			
	– Limited development of SME segment of industry; enterprise problems exacerbated by current financial distress.	<u>Environment for Private Enterprise</u> • Facilitate restructuring/debt workouts/exit of distressed enterprises.	• Reform of regulatory/institutional framework for bankruptcy/liquidation/foreclosure/securitization.	Ongoing FTAL/ESW Fin. Infra. (99)	Credit lines TA on Corporate Restructuring Direct Lending
		• Enhance competition by supporting efficient growth of SMEs through: improved access to finance; technology diffusion; regulatory reform to provide level playing field.	• Increased, market-based financial flows to SMEs. Increased SME participation in exports, including indirectly through subcontracting.	Ind. Pol. Study (98) PSD Competitiveness TA (98)	Venture Capital Funds Institution-Building, e.g. leasing, factoring
	– Structural reforms (trade and investment deregulation, competition, privatization), though significant, did not go far enough, or not complemented by necessary institutional strengthening (as in financial sector).	• Extend trade and investment (domestic and foreign) deregulation and the privatization program.	• Further simplification of domestic trade and investment regulations at federal/state/local levels, and further liberalization of foreign investment regime. • Roll-back of tariff increases implemented in 1995 in response to financial crisis (on textiles, clothing, footwear, leather products). • Significant progress on privatization of petrochemical plants; completion of ongoing privatization in telecommunications; progress on privatization in other infrastructure sectors (see below).	Productivity CEM (97) Ind. Pol. Study (98) ESW PTAL (96)	Individual projects
	– Inefficiencies in infrastructure provision including lack of appropriate policy and regulatory framework for private participation.	<u>Infrastructure</u> • Accelerate restructuring and privatization in transport and energy sectors. • Improve public provision and financing of transport infrastructure; attract long-term private finance at federal/state levels; enhance infrastructure planning/implementation capacities at state level. • Strengthen municipal water and sanitation utilities and promote private participation.	• Improved legal/regulatory framework for private participation in ports, railways, airports, power, oil and gas. • New infrastructure financing mechanisms (e.g. road maintenance fund). • Improved urban transport services in medium cities/MCMA. • Water Master Plans prepared for 155 municipalities; water systems expanded in Southern States; pilot initiated for concessioning arrangements in municipalities.	PTAL (96) Federal Roads (97) Trans. & Dist. (97) Water & Sanitation II (ongoing), III (99) SSI (98) Guarantees Infr. Policy Notes	Privatization TA Individual projects, esp. in newly opened sectors Infrastructure Fund
	– Labor market rigidities and lack of a modern training system.	<u>Labor Market/Training</u> • Improve incentives for employment in formal sector; increase coverage and quality of labor market information; modernize labor-industrial relations	• As part of social security reform, tax wedge on payroll reduced.	Contr. Savings I, II (97,98) Health Reform (98)	
		• Expand access to training for displaced/unemployed workers; improve quality and relevance of training through increased private participation; promote continuous on-the-job training in SMEs.	• More unemployed workers receiving scholarships through PROBECAT; SME workers receiving training through CIMO increased. • Labor competency standards for occupational clusters developed under private sector leadership; independent certification agencies established.	Training Assessment, other ESW (97) Ongoing projects	
	– Agricultural/rural productivity constrained by uncertain land tenure and property rights and inefficiencies/gaps in rural infrastructure and producer services.	<u>Agriculture/Rural Development</u> • Develop rural agricultural markets; increase security of land tenure, water and property rights.	• Increased role of producers marketing organizations; land titling/registration expanded; registry of water rights established. • Design of competitive grants fund for research and extension completed.	ESW, Water Management (96), DRD II (ongoing) Other Ongoing Projects Rural Poverty Report, Agr. Policy Notes	Venture Capital Microlending projects in export-oriented enterprises
		• Better target agricultural research/extension/rural infrastructure			
		• Promote income-generating programs.	• Non-timber forest products fund established to pilot income-generating activities for communities with forestry resources.	Nat. Res. Manag. (98) CEM on Poverty (99)	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
Risks to long-term sustainability of growth arising from environmental stress.	Environmental concerns not effectively integrated into economic and sector policy. Environmental strategy/priorities not clearly defined and widely disseminated. Deficiencies in institutional framework: • Weak institutional capacities of environmental agencies, especially at state and municipal levels. • Lack of clear division of institutional responsibilities and framework for decentralization. • Coordination problems on cross-sectoral environmental issues. • Incentive distortions from legal/regulatory deficiencies, e.g. unclear/insecure water rights.	**Improve Environmental Management** • Agree and establish environmental priorities. • Strengthen environmental institutions at federal/state/municipal levels. • Establish foundation for effective management of industrial pollution. • Formulate regulatory framework for solid waste management. • Promote greater cross-sectoral participation to reduce air pollution in MCMA. • • Improve natural resource management by: improving water use through establishment of water markets and transfer of existing water infrastructure to water users; promoting sustainable use of forestry resources.	• Dissemination of environmental priorities. • Roles clarified and responsibilities transferred to subagencies. • Pilot Pollution Release and Transfer Register started; demo SME project on environmental management systems implemented; cross-sectoral Industrial Pollution Working Group established. • Federal/local regulations for solid waste management issued. • Integrated transport and air quality management strategy developed for MCMA. • Water availability increased/losses reduced/quality improved; mechanisms to approve water rights transfers established; river basin councils established. • TA/training program for community groups on forest management initiated.	ESW (97, 98) Northern Border/other ongoing projects, Env. TA II (98) ESW, Seminars, Non-lending Services Solid Waste II (ongoing) Pollution Control (99) Water Management (96) Nat. Res. Manag. (98) ESW	Support to private waste management projects
SOCIAL DEVELOPMENT Persistence of high poverty. Overall and extreme poverty incidence 34% and 8%, respectively, in 1992, compared with 31% and 6% in 1984. Poverty incidence likely rose with recent financial crisis. Concentration of poverty in rural areas (47% incidence in 1992) and in Southern States.	Low, erratic economic growth (see above). Low effectiveness of Government social expenditure programs (safety nets/nutrition, education, health) in building the human capital of the poor: • Expenditure on social services high (55% of federal spending) but impact constrained by poor targeting and low expenditure efficiency. • Access to basic social services expanded but service quality remains deficient. • Safety nets especially inadequate in rural areas. • Deficiencies in public administration undermining service delivery: lack of effective decentralization; inefficiency, resource leakages, poor accountability.	**Better Target and Improve Quality of Basic Social Services** **Social Safety Net/Nutrition** • Cushion impact of financial crisis on the poor, especially on unemployed/underemployed in marginal rural areas. • Improve targeting and type of food subsidies. **Health** • Improve access to basic health services for the poor by targeting lowest income states. • Establish a financially viable health insurance system under the new Social Security (IMSS) law. • Increase role of private sector in delivering health services. • Decentralize more responsibilities to states and adopt more equitable system of federal budget transfers to states. • Ministry of Health shifts increasingly from service delivery to regulatory and quality control functions	• Private short-term employment provided to 600,000 people in first year through PESE, self-targeted to the poorest through payment of 80% of minimum wage. • Generalized urban food subsidies replaced with targeted subsidies; overhead costs of targeted subsidies reduced by shifting from in-kind to cash transfer system. • Nutrition program for mothers and children under 5 years initiated in poor rural areas; combined deworming, school feeding and micro-nutrient program implemented in rural primary shcools. • Basic health care package introduced in 11 poorest states. • Incentive/structural changes in IMSS health system to limit fiscal costs; transparent, sustainable financing mechanisms in place for delivery of IMSS health services. Financing and delivery of health services separated. • Pilot alternative scenarios for public/private mix. • Agreed decentralization, supported by TA, in place; allocation criteria revised for federal transfers, complemented by an improved monitoring system. • Inspectors/MIS monitoring placed in states; parameters of licensing defined for health service providers/licensing procedures initiated for hospitals and laboratories.	PROSSE (ongoing) Poverty Assessment (97) Rural Poverty (97) Nutrition (98) CEM on Poverty (99) Policy Notes Basic Health II (96) Poverty Assessment, Other ESW (97) Health Reform (98) CEM on Poverty (99) Basic Health II (96) Basic Health II (96) Health Reform (98), ESW	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
		Education • Increase access to and quality of basic education, especially in poor rural areas. Focus investments on most cost-effective inputs (teaching materials, teachers and supervision) in an integrated manner.	• In PARE states with poorest education indicators: primary education repetition reduced, primary completion rate increased; retention of teachers in isolated rural areas increased; coverage of non-formal initial (0-4 years) education services increased. • New equitable budget system for federal transfers to states established.	PROSSE (ongoing), Primary Education II (ongoing), Primary Education III (98), Poverty Assessment (97); CEM on Poverty (99); Other ESW	
	Potential for development of the productive sector in poor regions, especially in the South, inhibited by: • Deficient rural land and financial markets, and limited access to supportive rural infrastructure. • Inadequate involvement of private sector in efforts to develop the productive sector in poor regions. • Insufficient participation of civil society and the poor themselves (especially women, indigenous people) in the design and implementation of poverty reduction programs. Weak development of the poor's social capital (community/producer organizations).	**Expand income-earning opportunities in poor regions, especially Southern States** • Work with private enterprise and civil society to identify and tackle constraints to development of productive sector in these regions. • Improve targeting of agricultural/rural development programs that affect the poor, especially indigenous communities and rural women. Encourage increased community participation in development.	• Action Program initiated to address identified constraints to productive sector development in two Southern States (Chiapas, Oaxaca), involving increased private participation. • Targeting/effectiveness of programs such as PRODUCE, PROFORESTAL improved/monitored.	(SSI) (98) Policy Notes IDF Rural Poverty Report (97); CEM on Poverty (99); Other ESW	Credit Line Direct Lending Private Equity and Venture Capital Funds (Fondo Chiapas) TA
MODERNIZATION OF THE STATE Public institutional framework has important weaknesses, as it has been slow to adapt to the changing role of government in development.	Liberalization of markets not underpinned by strengthening of regulatory and institutional framework to ensure markets function efficiently and fairly in supporting private sector development: • Weak prudential regulation and supervision in financial sector. • Accounting, auditing and reporting standards not adequately upgraded and enforced. Slow modernization of commercial laws (property rights, bankruptcy, securitization, etc.) and judicial system.	**Strengthen institutional underpinnings of markets** • Strengthen regulatory, legal and institutional framework underpinning financial markets and private commerce.	• Continued progress on prudential regulation and supervision, accounting and reporting standards, commercial laws (bankruptcy, securitization). • Progress on legal/judicial reforms to improve enforceability of contracts.	FSRL II (97) Financial Infra. (99) Ongoing FTAL, ESW Non-lending Services	
	Public administration increasingly in need of modernization, to support efficient execution of a narrower, more focused role of government: • Federal budget system in need of reform, to support improved expenditure and performance management. • Insufficient progress on administrative and fiscal decentralization. Weak institutional capacities and accountability at the local level. • Need to develop more modern, professional civil service, to improve quality of governance.	**Modernize Public Administration** • Modernize budgetary process at federal level. • Decentralize more fiscal and functional responsibilities to state and municipal levels, backed by enhancement of institutional capacities and accountability at these levels.	• Improved framework for medium-term expenditure management; improved performance management through budget; stronger auditing arrangements. • Actions on fiscal and functional decentralization within an agreed/coherent overall strategy for decentralization. • State and municipal capacity building programs under implementation. • Improved utilization of property taxation.	ESW (97), IDF, Seminars. State & Municipal Management TA (98) SSI (98)	

28. *Reforming the Pension System.* The Bank is working closely with the Government on a major pension system reform. With effect from 1997, the pay-as you-go system for private sector workers will be replaced by a fully-funded, defined-contribution system composed of private pension funds (AFORES), a reform that can give a major boost to private savings. Progress benchmarks over the next three years include the establishment of laws and regulations governing the new private pension funds and their investment regime, a fundamental restructuring of INFONAVIT (the housing component of the pension system), and the extension of pension reform to public sector workers. Bank support will include technical assistance on regulatory issues and adjustment operations to assist with the transitional fiscal costs of pension reform. IFC will assist through advisory services, equity support to AFORES, and acting as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable partners.

29. *Ensuring Sound Financial System Development.* Given its importance to the restoration of financial stability and growth, the financial sector (including the banking system, specialized financial institutions and the capital market) accounts for about a quarter of the Bank's proposed lending program and also about one-third of IFC's planned investments. Managing the crisis in banking remains a priority, but Bank Group support will shift increasingly to strengthening the underlying regulatory and institutional framework ensuring sound future development of banks and of the financial system more broadly. Toward this end, the Bank, in coordination with IFC and IDB, has worked out with the Government a comprehensive sector strategy and a program of support.

30. For the *banking system*, the strategy broadly has three elements: (i) expediting the resolution of problem banks and bank assets and limiting fiscal costs (accelerated resolution of intervened banks, proactive encouragement of sale/merger/consolidation of weak banks, early disposal of impaired portfolio acquired by Government); (ii) improving the incentive regime and reducing moral hazard (ensuring adequacy of genuine private risk capital, phase-out of the comprehensive liability protection, avoidance of new subsidy schemes); and (iii) strengthening the regulatory and institutional underpinnings (prudential regulation and supervision, accounting and reporting standards, legal framework for bank-borrower interaction, commercial laws including bankruptcy and securitization). Efforts in these areas will build on the progress already achieved under the first Financial Sector Restructuring Loan (Box 1). Bank instruments to support these efforts include analytical work and technical assistance and a second financial sector adjustment operation. IFC will provide complementary technical assistance as well as long-term loan and equity investments, including loan syndication and equity funds mobilization, to support bank restructuring and facilitate investment by new foreign partners.

31. Complementing these priorities, the Bank and IFC will support key elements of the reform agenda for the broader financial system. First, the financial system in Mexico remains dominated by commercial banks, but the establishment of a privately managed pension system will open important new opportunities for the development of the *capital market*. In addition to supporting sound development of the new pension system (para. 28), the Bank Group will promote capital market growth through: reforming housing

finance by restructuring, phase-out or privatization of public housing finance institutions (principally FOVI, INFONAVIT, and FOVISSSTE); developing the markets for mortgage and asset-backed securities; fostering the development of non-bank financial institutions such as mutual and venture capital funds, leasing and factoring; and upgrading capital market regulatory and informational infrastructure—strengthening of accounting and disclosure rules, collateral laws, credit and rating information, and the technical capacities of regulatory agencies. In these efforts, the Bank and IFC will complement each other, with the former focusing more on improving the regulatory and institutional framework and the latter on facilitating actual investments and transactions (such as supporting the first institutions in mortgage finance and asset securitization). Second, the Bank is helping the Government draw up a reform program, including pilot initiatives, to develop rural financial markets that remain characterized by uneven coverage, high segmentation and low efficiency. Third, the Bank will continue to provide advice on reform options for rationalizing the role of development banks that still account for about one-third of banking system assets. To the extent they are privatized, IFC could help these institutions orient themselves to the market.

32. *Improving Environment for Private Enterprise*. More vigorous, efficient growth of the private sector is an objective that cuts across the development agenda. Details of the Bank Group assistance strategy in key areas of private sector development are in the Private Sector Strategy paper (Attachment 1), but the strategy essentially has two elements. The first priority is to respond to the immediate problems for private enterprise resulting from the financial crisis. Restoring the banking system to health so it can resume its financial intermediation role and support recovery in private investment is a priority, as outlined above. A related priority is the restructuring of viable enterprises that are financially distressed by a combination of recession and high interest rates. Small and medium-scale enterprises (SMEs) have been particularly hard hit. The second element of the Bank Group strategy is to remove constraints to private sector development that are longer-term in nature and predate the crisis: continuing regulatory and administrative barriers to trade and investment, particularly at state and municipal levels; inadequacies of the commercial legal framework, that especially disadvantage SMEs, encourage "crony capitalism" and contribute to a concentrated industrial structure; bottlenecks to the privatization program; infrastructure deficiencies; and skill constraints. Removing these constraints will also help attract more foreign direct investment, that is beneficial to productivity growth and contributes to macroeconomic stability by bringing in longer-term capital that is less susceptible to volatility than short-term portfolio flows.

33. The Bank will support these goals through: ESW and technical assistance on productivity, competitiveness, industrial policy, and judicial system reform; a financial infrastructure loan aimed, *inter alia*, at improving the legal framework for financial restructuring (bankruptcy, liquidation, foreclosure, securitization); and operations supporting increased private participation in infrastructure, and skill development (see below). IFC will focus on supporting privatization initiatives and increasing market-based financial flows, particularly to SMEs, through technical assistance and financial investments (both direct investments in a few larger SMEs and indirect support through

credit lines and venture capital funds). The Bank Group strategy will seek to further privatization both in sectors previously opened to private enterprise and in sectors that so far have remained largely closed, including petroleum.

34. *Upgrading Infrastructure*. Among the major Latin American countries, Mexico perhaps has the least developed physical infrastructure. Deficiencies in infrastructure—in access, efficiency, quality—constitute a major constraint to productivity, competitiveness and growth. Infrastructure development, therefore, will remain an important area of Bank Group involvement. However, the focus of support will shift to promoting increased, more efficient private participation. The greatest opportunity for expanding and improving infrastructure services lies in removing statutory restrictions on competition, reducing intrusive government regulations and price distortions, and promoting private participation within an appropriate regulatory environment. At the same time, more efficient public investment and operating modalities are required for those services which will not attract private financing (e.g., secondary roads, urban traffic management, low income housing) or will remain within public purview at least during a transitional period (e.g., electricity transmission and distribution, road maintenance, urban transport infrastructure).

35. Bank Group support to infrastructure accordingly will have two emphases: privatization and development of regulatory capacities in transport, telecommunications, energy, and water and sanitation; and improvements in the planning, financing and management of public infrastructure. Through the PTAL (Box 1), the Bank will provide technical assistance to improve the regulatory framework for private participation—restructuring options for introducing competition, concession design, bidding rules, tariff policies, appropriate use of government guarantees. The Bank's guarantee instrument will be used to attract more private financing into infrastructure. In all sectors where the Bank may lend to support public infrastructure development, such as road transport and power, the aim will be to improve the overall sector policy regime and institutional capacities, rather than limiting attention to the investments directly financed by the loans. Two key criteria for Bank assistance for public infrastructure will be: whether it complements and promotes private participation; and whether it improves services in the underserved, poorer areas. Increasing private role in power and water and sanitation will be particular priorities, as these sectors have lagged behind others in privatization. An improved regulatory regime for private participation and a quickened pace of privatization would pave the way also for increased IFC investment activities in infrastructure, with the IFC supporting private infrastructure investments with long-term funds that might otherwise be difficult to obtain. For model or pilot infrastructure privatization projects in newly opened sectors, IFC's transaction design experience will be made fully available.

36. *Modernizing Labor Markets and Training*. In the aftermath of the 1994 crisis, reemployment and retraining programs to cushion the impact on displaced workers were a priority. With a recovery now under way, Mexico needs to resume the longer-term agenda of modernizing labor markets and the training system necessary to compete in rapidly changing international markets. Through formal and nonformal analytical work and ongoing projects, the Bank will assist the Government in identifying options for improving

the regulatory environment in the labor market—reducing rigidities such as high non-wage costs of formal sector employment and regulatory/legal constraints to flexibility in labor use, improving labor market information, modernizing labor-industrial relations. In training, Bank support will seek to strengthen public training institutions and improve incentives for provision of training by private enterprises to upgrade their workers' skills.

37. *Raising Rural Productivity.* Raising rural productivity is important both to growth and poverty reduction. The Bank will support this objective through a step-up in its non-lending services as well as through selective lending operations. Areas of emphasis will be: raising the efficiency of rural agricultural markets via improvements in the policy and regulatory framework and promotion of producer marketing associations; improving the efficiency of SAGAR's investment program and rationalizing farm subsidy programs (e.g., PROCAMPO); increasing the impact on the poor of rural income-generating programs (PRODUCE, PROFORESTAL); assessing the suitability of the new land titling program for *ejido* lands (PROCEDE) for the rural poor and indigenous communities; and supporting institutional reform, especially institutional strengthening at the state and municipal levels to underpin ongoing decentralization in agriculture. Through the planned Southern States Initiative, the Bank and IFC jointly will support the development of private rural productive activities in the poor states of Chiapas and Oaxaca (para. 47).

38. ***Improving Environmental Management.*** Dealing with environmental problems is particularly challenging during a recession. Over the past year, the financial crisis has significantly limited available resources for environmental programs, and several Bank-financed projects have been cut significantly. Against this background, the Bank's urban environmental strategy (dealing with "brown" issues) will follow a three-track approach. The first track concentrates on satisfactorily implementing the Bank's current portfolio; the second focuses on providing urgent institutional strengthening to the Environment Ministry, as well as supporting the decentralization effort by providing technical assistance at the local level; and the third aims to maintain and deepen the dialogue on specific urban/industrial environmental issues through a variety of non-lending services, drawing on the strengths of different parts of the Bank.

39. In natural resource management ("green" issues), Bank assistance will focus on: providing technical assistance and training to forestry communities on sustainable resource management; and improving water use through clarifying water rights and promoting the role of water users' associations in O&M.

Social Development

40. In addition to promoting stronger, sustainable economic growth, as outlined above, the Bank will support poverty reduction through improving the effectiveness of programs specifically targeted to the poor. Bank support will have two main thrusts: improving the targeting and efficiency of basic social services; and better tapping the productive potential of the poor regions. These objectives will be pursued through a substantial strengthening of ESW, selective lending operations, and improving portfolio

quality including restructuring existing operations. A poverty assessment, a rural poverty report, and work relating to the Southern States Initiative, all to be completed in FY97, will provide a comprehensive analytical framework for an enhanced policy dialogue. Across Bank interventions, a common theme will be increased civil society participation, especially by the more vulnerable groups (rural women, indigenous communities).

41. ***Improving Social Services.*** With Government social spending already large, the Bank assistance strategy will focus on improving the quality, efficiency, and sustainability of this spending and increasing its poverty impact.

42. *Social Safety Net.* Through ESW and a proposed nutrition project, the Bank will support ongoing Government efforts to rationalize the various nutrition and food subsidy programs, including consolidating these programs, linking nutritional programs with basic health care and education, and correcting the imbalance in social safety net programs against rural areas (where most of the extreme poor live). Also, building on the lessons learned in PROSSE (Box 1), the Bank will seek to improve rural employment programs.

43. *Health.* The Government has launched a major effort to redesign the financing and delivery of health care. As part of this effort, the Basic Health II project approved in FY96 is supporting measures to improve the coverage and quality of health services, particularly in the eleven poorest states, and to decentralize responsibilities to states to improve service delivery. The new social security law that takes effect in 1997 includes, in addition to pension system reform (para. 28), important changes in the financing of health insurance for private workers. A priority is to ensure that the new structure that results from this reform is efficient and financially sustainable. Proposed Bank health sector ESW and lending will assist in this task through analysis of alternative modes of health financing and delivery, demonstration projects, and support to related institutional reform.

44. *Education.* With a national primary school enrollment rate of 98 percent, the key issue is to raise the quality and efficiency of basic education, particularly in the poorest states which still have high levels of drop-out and repetition and low levels of cognitive achievement and absorption in secondary education. Through the ongoing Primary Education project and a proposed basic education project, the Bank will assist in improving the quality of school entrants through expansion in pre-school education targeted toward the poorest states, upgrading primary education through investments in cost-effective inputs (teaching materials, in-service teacher training), and expanding access to low-cost lower secondary education in under-served rural areas (e.g., through TV).

45. ***Unleashing the Productive Potential of Poor Regions.*** The incidence of poverty is highest in the southern states (65 percent compared with a national average of 34 percent in 1992), and has been rising. While these states account for about 15 percent of Mexico's population, they contain well over half of those classified as extremely poor. The poverty rate in their indigenous communities is alarmingly high at around 80 percent. Despite relatively high levels of public expenditures in recent years, deficiencies in the design and implementation of government programs, including limited local and private

sector participation, have led to disappointing results on the ground, failing to make these states fuller participants in national economic growth.

46. The *Southern States Initiative (SSI)* aims at better tapping the productive potential—in agriculture, forestry, industry—of the two poorest southern states of Chiapas and Oaxaca through an innovative multi-sectoral approach that emphasizes increased private sector and community participation and more decentralized government decision-making. The SSI, being prepared in close collaboration with the federal and state governments, community and private sector representatives, and IDB, will introduce a greater regional emphasis in Bank Group operations in Mexico, responding to the high regional concentration of poverty.

47. Based on ongoing analytical work, the SSI envisages a two-pronged Bank Group assistance strategy. The first priority is to restructure the existing Bank portfolio in these states (11 projects) to make it more responsive to local development needs. Second, selective new Bank Group interventions will be identified to help mobilize private investment in productive activities. The Bank would provide financing for key infrastructure and technical assistance to state and local governments to build capacities for better service delivery, improve the regulatory and incentive regime for business, and establish institutional mechanisms for consultation with the private sector. IFC would provide financing and technical assistance to enhance SME and microenterprise access to finance (e.g., through the Fondo Chiapas, a venture capital fund) and possible direct investment in identified projects. The Bank and IFC together, in partnership with the Government, will organize a task force including representatives of local and international business community and civil society to develop specific ideas for promoting private productive activities in these states, including attracting foreign investment.

Modernization of the State

48. Second-generation, institutional reforms will feature more prominently in Bank operations. The present Administration's strong commitment to these reforms expands opportunities for Bank-country partnership. Besides the institution-building components in individual projects, as indicated above, the Bank will support broader, systemic institutional reform associated with a changing role of government in development.

49. ***Strengthening the Institutional Underpinnings of Markets.*** With the liberalization of markets, the government's role shifts from the exercise of direct controls to strengthening the legal and institutional framework underlying markets to ensure they function efficiently and fairly in supporting private enterprise. Much of the Bank Group's assistance to the financial sector will be aimed at beefing up financial and capital market infrastructure (prudential regulation and supervision, accounting and reporting standards, financial and commercial laws), as noted above. In addition, the Bank will support, mainly through non-lending services, government initiatives in modernizing the judicial system.

50. ***Modernizing Public Administration.*** Besides providing an efficient market setting for private enterprise, the apparatus of the state needs to be modernized to improve the delivery of services that, even with an increased private role in the economy, will remain in the public domain, e.g., basic social and infrastructure services. The Bank will help in this effort, mainly through ESW and IDF-supported technical assistance, on two important fronts, building on ongoing work. First, we will support the modernization of the federal budget system, to improve links between planning and budgeting and upgrade financial and performance management. Second, we will support ongoing government initiatives to decentralize responsibilities for local services to state and municipal administrations. The Bank is currently working on these initiatives with sector ministries, particularly in health and education. Planned analytical work on intergovernmental fiscal relations responds to the need to ensure that decentralization initiatives in individual sectors take place within a sound, coherent overall framework for fiscal decentralization. Key issues are: making federal transfers more efficient and equitable; mobilizing local revenues to reduce heavy state and municipal dependence on the federal budget; and strengthening fiscal accountability. This will be complemented by technical assistance to strengthen state and municipal capacities for fiscal management.

Portfolio Management

51. Bank portfolio performance, which had generally been good, has been adversely affected since the 1994 crisis by fiscal constraints, high domestic interest rates that have reduced demand for funds onlent to states and municipalities, and an acceleration of fiscal and administrative decentralization. Problem and "at risk" projects have increased and disbursements on the investment portfolio have declined (see Portfolio Matrix, Annex 2). To help restructure the portfolio to reflect new, post-crisis priorities, the Mexican authorities canceled the $650 million of the Bank's portfolio anticipated in the previous CAS, plus additional amounts of about $210 million, for a total of around $860 million. The authorities may cancel additional as yet undetermined amounts during FY97-99. We will accept the project implementation consequences of such prior and future cancellations in the interest of responsive portfolio management if such cancellations appear justified under individual project circumstances.

52. The reorganization and decentralization of the Bank's Mexico Department will facilitate a closer, more active dialogue with the client and a dynamic portfolio management strategy where operations are viewed as instruments that may be adjusted during implementation to improve effectiveness. This more flexible strategy is essential to better portfolio management in the present Mexican context of change in priorities and institutional setting. The Bank strategy to deal with problem projects as well as more generic portfolio management issues is outlined below.

53. *Decentralization.* The Government's new emphasis on decentralization has resulted in a shift of project implementation responsibilities. The affected projects will be restructured and the roles of line ministries, state and municipal governments, and development banks in the portfolio (present and future) will be reassessed. As

procurement and disbursement are being transferred to state and municipal governments, training will need to be provided to help them assume these functions effectively.

54. *Budget Process.* The attractiveness of Bank funding to implementing agencies is reduced by the requirement in the Mexican budget system that it be included within each agency's budget ceiling, thus not providing any "additionality" to the recipient. While this procedure is fiscally sound, agencies are likely to prefer the use of other, unconditional budget funds in order to avoid the burdens associated with the Bank procurement, disbursement and auditing processes. This incentive problem will be addressed in two ways: by ensuring that Bank involvement brings real value-added to the client, through quality inputs, and responds to the client's priorities; and by building greater flexibility in Bank operations through simplifying projects and conditionality and showing greater responsiveness to restructuring ongoing projects to reflect changing client priorities. Other budget process issues, e.g., late release of budgeted funds, will be addressed as part of the broader dialogue on modernization of the budget system (para. 50).

55. *Resettlement and Participation.* As the Government does not have an overall agreed approach to resettlement and participation (of NGOs, civil society), the Bank has had difficulty with some ministries on projects involving resettlement or where participation issues have been important. To reach a common understanding on these issues, the Bank and Government have agreed to convene a workshop to discuss the Bank's operational directives and guidelines as well as the experience of other countries. The Bank will continue to endeavor, as much as possible, to involve stakeholders outside the Government in project design and implementation.

56. *Procurement and Auditing.* A training program aimed at improving procurement skills of staff at executing agencies, especially at state and municipal levels, will be discussed with the Government. To improve the timeliness and quality of audits, and in anticipation of the need for states to implement externally funded projects in the near future, we will: broaden the mandate of the regional audit staff to develop financial management and audit strategies with our clients; strengthen capacity in the Mexico office to follow up on disbursements and audits and provide feedback to executing agencies; and ensure that ARCS is sufficiently updated to be a useful instrument to team leaders.

57. *Development Impact and Benchmarks.* Performance benchmarks agreed within the CAS framework (Table 3) will be used to monitor the impact on the ground. Intermediate targets for FY98 on portfolio implementation will be: problem projects below 10 percent (23 percent in FY96); average duration as problem projects before restructuring or closing less than 3 months; and average time from Board approval to effectiveness less than 3 month.

58. The 1994 crisis also affected the IFC portfolio; however, as the long-term fundamentals of the companies represented in the IFC portfolio remain strong, the impact is viewed as temporary and reversible as the economy recovers. IFC's portfolio performance in Mexico has in the past been good. Mexico has one of the lowest

cancellation and droppage ratios in the Corporation. The loan and equity returns have been moderately above IFC's average and interest collection has been 100 percent (see Annex 5 for details). The strengthening of IFC's field office will be used to bolster expertise transfer during the implementation phase of projects.

VI. Instruments of Partnership

59. As outlined above, the proposed country assistance program will deploy the full range of Bank Group instruments—Bank lending and non-lending services, guarantees, portfolio management, IFC's investment and advisory activities. Within this range, there will be some shifts in the mix of instruments in order to tailor the Bank Group program closely to the changing development agenda and client needs.

60. The role of *non-lending services* in the Bank's country program will be enhanced, responding to client demand for more policy analysis and advice. Increased emphasis will be placed on nonformal economic and sector work (ESW) that is demand driven and responds quickly to policymakers' specific analytical needs, such as policy notes and working papers. Stepped-up macroeconomic monitoring (para. 25) would contribute to the dialogue on macro policy and contingency planning. Formal ESW will be directed at filling major knowledge gaps in important areas of the country assistance program—productivity, financial and capital market development, effectiveness of poverty programs, decentralization (Annex 3). The impact of ESW will be enhanced through closer interaction with policymakers and wider dissemination (seminars, workshops). The relocation of the Bank's Mexico Department to the field will help with these objectives. The Bank does face constraints in Mexico in broadening participation and dissemination to stakeholders outside the core Government agencies, but we will continue to exert efforts in that direction. For example, in the ongoing work on the Southern States Initiative, the Bank has been able to broaden participation to include local governments and civil society. IFC also is stepping up its advisory services (especially in capital market development).

61. Delivering an expanded program of non-lending services that are of sufficiently high quality to be of value in a country like Mexico will require strengthening the Bank's country economic team. It will also require tapping more effectively resources in the Bank's research complex as well as building closer partnerships with outside institutions involved in analytical work on Mexico (including those in Mexico). These partnerships will be strengthened both through regular ESW and technical assistance operations. In dissemination and training activities, we will make greater use of the increased services being offered by the EDI.

62. Within the Bank's *lending* program, there will be a shift away from traditional projects toward sector investment loans—in finance, infrastructure, social services—that address broader issues of sector policy and institutional framework and expenditure priorities (Annex 3). The reason for this shift is threefold. First, with an expanding private sector role in the provision of public services, especially in infrastructure, an increasingly important focus of Bank operations will be to support the establishment of a policy and institutional framework conducive to private participation. Second, given the Mexican

budget process, and the limited "additionality" of Bank funds (para. 54), sectoral programs provide a better means to influencing expenditure priorities than individual projects. Third, in coming years Mexico will be implementing major public institutional reforms such as decentralization that, because of their breadth, are better supported through sector operations. The increased emphasis on ESW will support the proposed shift to sector-based operations, and will be reinforced by the analytical work carried out directly in preparing these operations. Both together would contribute to a substantial enhancement of our country policy dialogue.

63. Focusing the lending program on fewer, well-chosen operations in key sectors of the country assistance strategy, and improved efficiency in portfolio management, would release more budgetary resources for non-lending services. Over FY97-99, about 37 percent of the Department's operations budget will be allocated to these services, compared with 21 percent over the preceding three years (Annex 1).

64. Increased private investment in infrastructure will be supported also through a more proactive approach to the use of Bank *guarantees* in mobilizing private financing (para. 35), along with IFC's syndicated loan mobilization program. The Bank has made an indicative provision for guarantees in our FY97-99 country assistance program of up to 10 percent of the proposed total Bank lending. The gas, power and water sectors have been identified as the most promising initial candidates for the use of guarantees.

VII. Size of Bank Group Program, Country Risk and Creditworthiness

65. ***Base Case***. The Bank lending program approved under FY94 and FY95 CASs was for annual commitments of up to $1.5 billion (excluding the FY95 crisis year for which commitments of up to $2.5 billion were approved). The FY97 CAS proposes the same average level of baseline lending over the next three years, but it also proposes that the shortfall of close to $1 billion in FY96 (due to carryover of the preparation of some projects into FY97) be reprogrammed into the next three-year program. That would give total commitments of up to $5.5 billion over FY97-99. The proposed lending program presupposes that the policy framework remains sound, the major elements of the base case economic scenario are realized, and efforts to improve portfolio quality are sustained.

66. Given the high debt service payments Mexico faces during the next three years, when the bulk of the emergency financial assistance received in 1995 falls due for repayment, it is important for Mexico that the Bank maintain its disbursements at a high level. Of the proposed total commitments during FY97-99, about $1.25 billion could be in adjustment lending—to support financial system and social security reform. There are both balance of payments and fiscal grounds for adjustment lending during this period. It is envisaged that adjustment lending will no longer be necessary beyond this period.

67. ***Alternative Lending Scenarios***. Given exposure limitations, higher Bank lending than in the base case is not feasible even if Mexico's performance turns out to be better than assumed in the base case. This is not likely to be a constraint on Mexico because, in

such a scenario, Mexico would enjoy improved access to world capital markets. Indeed, in these circumstances, Bank lending could decline relative to the base case in outer years.

68. The Bank's lending response to a downside economic scenario would depend on the causes of the deterioration in economic performance (Table 4). If the main cause is slippages in policy, lending would be lower. For example, in the downside scenario analyzed in Section IV, where follow-up on the reform agenda in the financial sector is slow and piecemeal, lending could fall to around two-thirds of the base-case level, perhaps even lower. In the extreme case where policy slippages were grave enough to reverse progress in restoring macroeconomic stability and call into question the country's overall creditworthiness, a prospect considered unlikely, lending could be limited only to critical programs in poverty reduction and human resource development. Such a scenario could result, for example, from a major loss of fiscal discipline and an associated rapid build-up of public debt or a serious erosion of external competitiveness through currency overvaluation. Lower lending could also result if there is insufficient progress on improving portfolio quality. The foregoing suggests three main triggers for lower lending: slippages in macroeconomic management (specific macroeconomic policy targets to form part of a continuing IMF program); failure to press ahead resolutely with financial sector reforms; and lack of progress in addressing key constraints in portfolio management.

69. If, in contrast, the deterioration in economic performance results mainly from an exogenous shock, and the Government's policy response is adequate, a temporary rise in Bank lending may be necessary. If the shock causes an external financial crisis, which opens a large balance of payments financing gap, the additional financing needed would come mainly within the framework of an IMF program. Resources available to respond to such financial emergencies are being increased through the enlargement of the GAB. The Bank's role as a source of additional fast-disbursing financing in this situation would be limited, focused on cushioning the impact on the poor, such as the PROSSE loan made during the recent crisis to protect critical social programs (Box 1). The amounts involved would be relatively small and should not alter significantly the projected path of Bank exposure to Mexico. This is the only possibility we envisage where Bank lending could be somewhat higher than in the base case. Canceling undisbursed amounts of previous loans that may not remain a priority in a crisis to create room for more quick-disbursing lending, if necessary, would also be an option, as was done in 1995.

Table 4: Alternative Bank Lending Scenarios

Cause of deviation from base case →	Negative shocks		Policy slippages
Bank lending response →	Limited, temporarily higher lending, if policy response adequate	Lower lending, if policy response inadequate	Lower lending

Note: Higher and lower lending is defined relative to the base case.

70. ***Country Risk and Creditworthiness***. With an export-led revival of growth and continued progress on the adjustment program, the base case scenario envisages Mexico's

creditworthiness indicators to recover in coming years from the impact of the recent crisis. This outlook is sensitive to internal and external risks—banking system, adverse developments in export and capital markets. However, in the most likely alternative scenarios that can be envisaged based on these risks, Mexico's economic situation, though weakening relative to the base case, is not expected to deteriorate to a point where Mexico is unable to meet its debt service obligations (see Section IV). A larger shock causing a more serious financial crisis cannot of course be ruled out, such as a political shock triggering a major capital outflow. But Mexico is reducing its vulnerability to such risks. It is strengthening its reserve position and improving the maturity profile of its debt. Its current policies—a floating exchange rate, more responsive monetary management, tighter fiscal discipline—position it better to deal with capital market volatility. The present Administration's political and social reform agenda should contribute to making the political and social fabric more resilient. And, as noted above, provided Mexico's economic policies remain on track, it should be able to obtain additional balance of payments support if that became necessary in the event of a major shock.

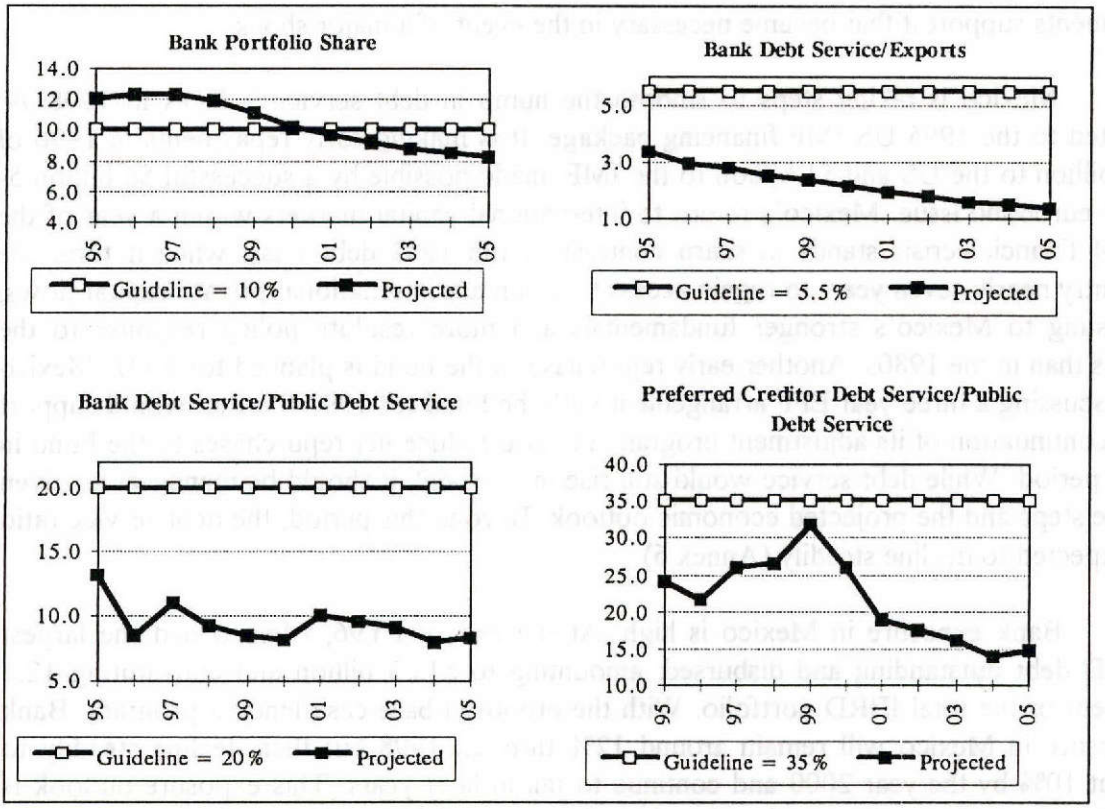
71. Mexico is taking steps to smooth the hump in debt service it faces in 1998-99, related to the 1995 US-IMF financing package. It is making early repayments in 1996 of $7 billion to the US and $1 billion to the IMF, made possible by a successful $6 billion 5-year eurobond issue. Mexico's return to international capital markets within a year of the 1994 financial crisis stands in sharp contrast to the 1982 debt crisis when it took the country nearly seven years to regain access to voluntary international private capital flows, attesting to Mexico's stronger fundamentals and more resolute policy response to the crisis than in the 1980s. Another early repurchase to the Fund is planned for 1997. Mexico is discussing a three-year EFF arrangement with the Fund for 1997-99, that would support the continuation of its adjustment program and also reduce net repurchases to the Fund in that period. While debt service would still rise in 1998-99, it should be manageable, given these steps and the projected economic outlook. Beyond this period, the debt service ratio is expected to decline steadily (Annex 6).

72. Bank exposure in Mexico is high. At the end of FY96, Mexico had the largest IBRD debt outstanding and disbursed, amounting to $13.3 billion and constituting 12.1 percent of the total IBRD portfolio. With the proposed base case lending program, Bank exposure in Mexico will remain around 12% through 1998 but then decline steadily to about 10% by the year 2000 and continue to fall in later years. This exposure outlook is similar to what was discussed and endorsed as part of FY95 CAS. While the proposed lending program would keep Bank exposure above the 10% guideline for a few years, the proposed lending is necessary to support adjustment and reforms that would allow an orderly reduction in the exposure. Bank exposure is expected to remain within the other exposure guidelines (Chart 2).

73. The risks to the Bank from the Mexico program are not only financial; the Bank's reputational capital also is at stake. Mexico is a large and important client country trying to emerge from a major financial crisis that continues to be the focus of much international attention. The Bank is, and is seen to be, closely involved in supporting Government

efforts in crisis management and reform in some major policy areas, a partnership that will become closer with the placement of the Bank's Mexico Department in the field. A key, and visible, area of Bank support is the rehabilitation of a financial system shaken by a severe banking crisis. A tougher, longer-term challenge involving close Bank engagement is the reduction of Mexico's high poverty and income inequality and acute regional disparities in development. The proposed Southern States Initiative constitutes a bold, innovative move to face this challenge head-on, in a setting that is socially and politically a difficult one. Potential rewards in these areas of Bank assistance are high, but so are risks. This CAS has argued that these risks are well worth taking. But both the financial and reputational stakes for the Bank make it imperative that every effort is made to ensure the job is well done.

Chart 2: Bank Exposure Ratios



74. ***IFC Investment Program.*** In response to the present widespread corporate financial distress and the emerging private sector financing needs as the economy recovers, IFC plans to increase its investment in Mexico appreciably in the next three years. A total of about $1 billion in investments is planned over FY97-99. In addition, IFC expects to mobilize about $1.2 billion through related syndications. At the end of 1995, IFC's Mexico portfolio amounted to about $650 million and represented 7.6 and 6.6 percent of total investments disbursed and held, respectively. These exposure levels make IFC's Mexico portfolio the fourth largest in the Corporation, but allow head room for an increase in investment. Planned IFC investments are an integral part of overall Bank

Group assistance program in support of private sector development, as outlined above. The bulk of the planned IFC investments in FY97-99 will be in financial/capital market development and manufacturing (about 30 percent each) and infrastructure (20 percent), with the balance in petrochemicals and agribusiness (Annex 5). The sectoral composition of planned IFC investments will reflect two important strategic thrusts: an increased focus on the promotion of SMEs within manufacturing; and support to private investment in newly opened infrastructure sectors. Another strategic emphasis will be to enhance the catalytic effect of IFC investments.

VIII. Collaboration with Other Organizations

75. Mexico's current stand-by arrangement with the IMF is on track. It has been extended by six months, to February 1997, to provide time for discussion of a three-year extended arrangement (EFF) that would succeed the stand-by and provide continued Fund support to and monitoring of Mexico's adjustment program (para. 69). Bank-Fund collaboration will remain active in macroeconomic management and will intensify in structural reform (para. 25). The EFF program is likely to incorporate several areas of structural reform—social security, taxation, financial sector reform, privatization, intergovernmental fiscal relations, reform of subsidy programs—where close Fund-Bank collaboration will be essential.

76. Collaboration with the IDB has increased in the past two years. The Bank's response to the Mexican crisis was closely coordinated with the IDB. In the period ahead, major areas of collaboration will include the financial system, social security reform, and the Southern States Initiative—all priority areas in our CAS. Our lending program includes several parallel loans. Over the next three years, IDB commitments are expected to average about $1.2 billion a year. Besides lending operations, collaboration is increasing in non-lending services. The present Administration's emphasis on institutional reform is opening new areas for collaboration, e.g., in decentralization. Collaboration in the field will intensify with the relocation of our Mexico Department to Mexico City. We have consulted with the IDB at several stages of the preparation of this CAS.

IX. CAS Priorities and Success Criteria

77. Like the challenge of development itself, the policy agenda discussed in the preceding sections is multi-faceted. The proposed country assistance strategy—defined in terms of the three themes of growth with stability, social development, and modernization of the state—will assist the Government in several key areas of this agenda. Within this strategic framework, the following will constitute the core priorities of our program over the next three years:

- *Growth with Stability*: (i) supporting sound macroeconomic management through enhanced monitoring and closer dialogue, especially on structural and micro underpinnings of macro policy; and (ii) ensuring sound financial and capital market

development, particularly restoring banking system stability and supporting comprehensive pension system reform.

- *Social Development*: (i) improving the efficiency and quality of social sector spending, including the targeting of safety nets and efficiency and quality of basic health and education; and (ii) making a dent in regional concentrations of poverty through the planned Southern States Initiative.

- *Modernization of the State*: (i) improving the regulatory, legal and judicial framework to facilitate private enterprise, foster competition, and provide a level playing field; and (ii) supporting an orderly and efficient process of fiscal and administrative decentralization.

78. Performance benchmarks we will use to evaluate progress in these priority (and other) areas are set out in the CAS Matrix (Table 3). The critical test of the success of the proposed country assistance strategy will be its effectiveness in reducing poverty, the objective that overarches the Bank Group program.

X. Agenda for Board Consideration

79. The Board may wish to comment on the following topics:

- Assisting Mexico recover from the financial crisis remains a priority, but Bank Group support increasingly should focus on the longer-term development agenda.

- Achieving better results on the ground in reducing Mexico's high poverty, both in its national and regional dimensions, is imperative and the CAS must treat that as its central challenge.

- Second generation, institutional reforms today are at the forefront of Mexico's development agenda and crucial to the effectiveness of the Bank Group portfolio.

- Evolving development agenda and client needs call for enhancing the role of non-lending services in the Bank Group program.

- There will be a strategic shift in the IFC program toward the promotion of small and medium-scale enterprises and support to private investment in newly opened infrastructure sectors.

ANNEXES

Annex 1: Mexico Country Assistance Strategy
(a) Bank Budget Matrix (FY97-99)
(US$'000)

CAS Objective	FY 97				FY 97	FY 97-99
	Lending & Supervision	Non-Lending	Total	% of Total	Trust Funds (disb. in FY97)	% of Total
I. Growth with Stability			**7,922**	**69.6**		60.0
A. Maintain Macro-Stability		434	434	3.8		
B. Strengthen Fundamentals of Growth						
(i) Mobilize Savings						
Pension Reform	440	28	468	4.1	300	
Financial System Development	753	354	1,107	9.7	986	
(ii) Enhance Productivity						
PSD	864	300	1,164	10.2		
Infrastructure (incl. housing)	1,183	150	1,333	11.7	254	
Labor Markets		77	97	10.4		
Ag/Rural Development	1,483	250	1,733	15.2	72	
C. Foster Sustainability of Growth						
Environmental Management	1,168	418	1,586	13.9	2,217	
II. Social Development			**1,867**	**16.4**		30.0
A. Better Target and Improve Basic Services						
Safety Net/Nutrition	161	167	328	2.9	200	
Health	186	228	414	3.6		
Education	581	250	831	7.3		
B. Expand Income-Generating Opportunities		294	294	2.6	500	
III. Modernization of the State			**1,591**	**14.0**		10.0
A. Strengthen Underpinnings of Markets	422	200	622	5.5		
B. Modernize Public Administration	422	547	969	8.5		
Sub-Total	7,663	3,717	11,380	100.0	4,529	
Other		700				
Overheads	1,020					
TOTAL BUDGET	**13,100**					
Non-lending as % of Total (excl. overheads)		37				40.0

Note: Although the lending and non-lending program is allocated above against categories as discussed in the CAS, there are important interrelationships between these categories. Therefore, resources shown against one will in many cases also impact on the others.

Mexico: Bank Budget Allocation by Activity FY 97-99
(Direct Costs Only)

	FY 95		FY 96		FY 97	
	US $ m	%	US $ m	%	US $ m	%
Lending	2,667.8	48	2,266.6	38	1,996.5	31
ESW	1,123.8	20	1,023.4	17	1,990.5	31
Supervision	1,692.6	31	2,439.4	41	2,043.9	32
Other	64.7	1	245.1	4	338.6	6
TOTAL	**5,548.9**	**100**	**5,974.5**	**100**	**6,369.5**	**100**

(b) MEXICO: IFC Operational Budget[1/]

	FY95		FY96		FY97		FY98	
	Staff Years	Costs	Staff Years	Costs	Staff Years	Costs	Staff Years	Costs
Financial Sector	1.3	0.4	1.5	0.3	2.0	0.4	4.5	1.0
Manufacturing/Agribusiness	5.4	0.9	5.8	1.2	5.5	1.5	4.5	1.0
Infrastructure	1.8	0.3	2.4	0.4	4.0	0.8	4.0	1.0
Petrochemicals	1.1	0.2	1.6	0.3	1.0	0.2	3.0	0.6
Oil, Gas, Mining	0.8	0.2	0.3	0.1	1.0	0.3	1.0	0.3
Engineering, Legal, Others	4.8	1.0	4.3	0.9	5.0	1.0	5.0	1.0
Total	15.2	2.9	15.9	3.1	18.5	4.2	22.0	4.9

1/ Excludes Regional and Corporate Overheads, in $ million, inflation adjusted.

IFC's budgetary resources for Mexico have been modest with about 16 manyears and US$3.0 million for all operational departments plus legal and engineering support in FY96. An increase to about 19 staff years in FY97 is planned to support the entry into new sectors (infrastructure in particular) and the greatly enhanced advisory component (capital markets in particular).

The IFC Mexico budget may need adjustment in size and composition, since infrastructure and petrochemical projects depend partly on the pace of Government progress on privatization. Financial sector activity depends partly on Government actions as well. The infrastructure program could potentially require up to twice as much resources.

Annex 2: Mexico Country Assistance Strategy
Bank Portfolio Matrix

In the medium-longer term, we expect the Mexico portfolio to resume its status as one of the strongest in Bank.

- As shown in the table below, a higher number of projects at risk in FY95-96 and lower disbursements in FY96 resulted from the crisis, reflecting Mexican budget constraints that have reduced counterpart funding in Bank projects and high domestic interest rates that have reduced demand for Bank funds onlent to state and municipal entities.

◆ *Risks/Rewards and the Bank's FY97-99 CAS.* The Bank's strategy for the next three years reflects a transition period as Mexico continues to deal with the impact of the crisis yet increasingly focuses on the longer term goals of reviving growth and reducing poverty. Overall, the proposed portfolio represents a balanced mix of risks and rewards. Investments in the financial sector, which remains fragile, carry a relatively high risk, but are a priority and promise a potentially high return in terms of contribution to restoration of financial stability and growth. The major risk in infrastructure is the Government's fulfillment of the ongoing privatizations and its subsequent ability to attract private participation in the provision of infrastructure services. Additional risks for infrastructure, environment and public sector operations, including an initiative in the Southern States, arise from the decentralization, resettlement and participation issues that are involved. Yet these operations are important to the long term viability of the development program. Human resource operations are concentrated in FY98-99 and reflect a lower risk profile.

◆ *Portfolio Management.* The Mexico Pilot with delegation of authority and increased field presence will allow the Bank to deal proactively in addressing the following issues:

- In response to the Government's decentralization policy, affected projects will be restructured. The roles of line ministries, state and municipal governments, and the development banks will be reassessed.
- A broad-based strategy will be adopted to promote sustainable development in the Southern States, in which the private sector and civil society will play a prominent role. The capacity and transparency of public sector management will also be strengthened.
- Environmental issues will be highlighted in the policy dialogue, and ongoing projects will be restructured to reflect new conditions.
- Problems predating the crisis will also need to be addressed, in particular the budgeting process affecting the Bank portfolio.
- Major implementation targets for end-FY98 include: % of problem projects < 10%, length of stay as problem project before restructuring or closing 3 months, and average time Board to effectiveness 3 months.

Portfolio Performance	FY93	FY94	FY95	FY96
Volume of Projects Under Implementation (US $ M) (end of year, disbursed plus undisbursed)	8,097	8,668	9,489	7,296
Number of Projects Under Implementation	45	43	41	35
Percent of problem projects (rated U or HU for past year)				
Development objectives	3	7	7	6
Overall status/Implementation Progress	5	7	17	23
Canceled during FY (US$M)	57.3	8.2	29.9	644
Disbursements (US $M)	1201	997	1,113	1,473 (o/w 675 investment)
Disbursement ratio (%) (investment projects only)	31.3	22.7	26.3	21.7
Completed projects rated unsatisfactory by OED	5	4	3	NA

Projects at Risk			Proposed Projects FY 97-99		Risk/Reward (Low/Med/High)
Problem Projects as of 6/30/96	US$M	Action	Growth with Stability	FY	
Envir./Nat. Resources	24	✓	*Pension System Reform*		
Northern Border Environment	208	✓	Contractual Savings I	97	Low/High
Medium Cities Transport	200	✓	Contractual Savings II	98	MediumHigh
Solid Waste II	60	✓	Contractual Savings III	99	Medium/High
Agricultural Technology	90	✓	*Finance/Cap. Markets Development*		
Urban Transport I	91	✓	Financial Sector Restructuring II	97	High/High
Decentralization II	500	✓	*Rural Productivity*		
Sub-Total Problem Projects	**1,173**		Rural Financial Markets TA	97	Low/High
			Rural Financial Markets II	99	Medium/High
% of Active Committed Portfolio	13		Agricultural Productivity	99	Medium/High
% of Projects	23		*Infrastructure*		
			Housing Sector III	97	Medium/High
Potential Problem Projects			Federal Roads	97	Medium/Medium
Transport Air Pollution	220	✓	Transmission & Distribution.	97	Medium/Medium
Primary Education II	372	✓	Infrastructure Guarantees	98,99	Medium/High
Sub-Total Potential Problem Projects	**592**		Water & Sanitation III	99	Medium/High
			Environment/Natural Resources		
Total Projects at Risk	**1,765**		Environmental TA II	98	Low/High
			Pollution Control	98	High/High
% of Active Committed Portfolio	24		Natural Resources Management	98	Medium/High
% of Projects	30		*Sub-total as % of Total Lending Program 65*		
Bankwide Projects at Risk (as of 4/5/96):			Social Development		
% of Active Committed Portfolio	30		Primary Education III	98	Low/High
% of Projects	33		Nutrition	98	High/High
			Health Sector	98	Medium/High
			Southern States Initiative	98	High/High
			Sub-total as % of Total Lending Program 25		
			Modernization of the State		
			PSD Competitiveness TA	98	Low/High
			State & Municipal Management TA	98	Medium/High
			Financial Infrastructure	99	Medium/High
			Science & Technology	99	Medium/Medium
			Sub-total as % of Total Lending Program 10		
			Total Lending Program $5.5 billion		
			Note: The lending program is allocated above a gainst the CAS thematic categories according to their predominant impact. It must be noted, however, that the impact of most of these projects cuts across these categories. For example, most projects listed under "growth with stability" and "social development" have institutional components that contribute to "modernization of the state."		

Projects at Risk include (i) projects categorized as "problem" projects and (ii) projects categorized as "potential" problem projects. The latter are defined as projects with satisfactory IP and DO ratings but which suffer from two or more of the following problems (see Prem Garg, EXCQA, Portfolio Improvement Program, Memo of April 10, 1996):

1. Counterpart Funding Constraints (rating 3 or 4)
2. Slow Disbursements (disbursement level < half of the original or revised forecast)
3. Effectiveness Delays (> 12 months after Board approval)
4. Financial Performance Problems (rating of 3 or 4)
5. Non-Compliance with Covenants (rating of 3 or 4)
6. Project Management Problems (rating of 3 or 4)
7. Extended Problem Status (> 2 consecutive years)
8. Procurement Problems (rating of 3 or 4)
9. Risky Countries (> 50% unsatisfactory commitments for operations closed during past 5 years) and no major change in economic management

10. Risky Instruments (>33% unsatisfactory commitments for operations closed during past 5 years)

CAS Decision: Balancing Risks and Rewards



Luis Muñoz
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Annex 3: Bank Lending and Non-Lending Program, FY 97-99

Lending/Guarantees		Non-Lending
FY97		
Lending Contractual Savings I Housing Sector III Federal Roads Transmission & Distribution Financial Sector Restructuring II	Technical Assistance Rural Financial Markets TA	CEM: Savings CEM: Restructuring and Productivity Fiscal Management/Decentralization Pre-School Education Review Training Assessment Financing Health Services Poverty Assessment Rural Poverty Industrial Pollution Prevention Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector Southern States Initiative Federal Budget Process Reform Informal Labor Markets Private Capital Inflows & Financial Integration Infrastructure Policy Notes Fiscal Costs of Health Insurance Reform PROCAMPO (Agricultural Policy) PROCEDE (Agricultural Policy) Gender and the Rural Economy
FY98		
Lending Contractual Savings II Southern States Initiative Nutrition Primary Education III Health Sector Reform Natural Resources Management Guarantees Infrastructure	Technical Assistance Environment PSD Competitiveness State & Municipal Management	CEM: Public Credit Programs Industrial Policy Agricultural Supply Response Land Markets in Rural Mexico Environmental Priorities and Decentralization Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector/Capital Markets External Debt/Asset Liability Management Infrastructure Policy Notes Southern States Initiative Follow-up Policy Notes on Poverty Studies PRODUCE (Agricultural Policy) Maize and Tortilla Policy Regulatory Issues in Water Sector
FY99		
Lending Contractual Savings III Water & Sanitation III Science and Technology Financial Infrastructure Pollution Control Rural Financial Markets II Agricultural Productivity Guarantees Infrastructure		CEM: Structural Reform and Poverty Alleviation Social Services for Marginalized Groups Education Decentralization Regulatory Issues in Rural Markets Ground Water Study Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector/Capital Markets Corporate Legal Framework/Judicial Reform Infrastructure Policy Notes Science & Technology (Others to be Identified)

Note: More nonlending tasks, especially nonformal tasks, will be added for FY98 and FY99. The above list does not include substantial analytical work supported by technical assistance loans. Two such TA loans are ongoing (FTAL, PTAL). Three TA loans (PSD Competitiveness; State and Municipal Management; and Environmental Decentralization) are being prepared, as shown above.

Mexico - Bank Fact Sheet, FY 1994-1999

Category	Past			Current	Planned[a]	
	FY94	FY95	FY96	FY97	FY98	FY99
Commitments (US$m)	1530.0	2387.4	526.5	1930.0	2170.0	1400.0
Sector (%)[b]						
Agriculture	13.1	3.6	35.4	1.6	2.8	32.1
Education	26.9	11.1	0.0	0.0	12.9	0.0
Elec.power,oth.engy.	0.0	0.0	0.0	20.7	4.6	0.0
Environment	24.1	0.0	0.0	0.0	2.3	21.4
Finance	0.0	43.5	0.0	41.5	11.5	51.7
Multi Sector	0.0	0.0	0.0	0.0	18.4	0.0
Pop/health/nutrition	0.0	0.0	58.9	0.0	30.0	0.0
Public Sector Mgmt	0.0	20.9	5.7	13.0	3.7	32.1
Social Sector	0.0	20.9	0.0	0.0	0.0	0.0
Transportation	0.0	0.0	0.0	18.1	4.6	0.0
Urban Development	13.1	0.0	0.0	18.1	4.6	0.0
Water Supply & Sanit	22.9	0.0	0.0	0.0	4.6	14.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Lending instrument (%)						
Adjustment loans[c]	0.0	41.9	0.0	41.4	11.5	0.0
Specific investment loans and others	100.0	58.1	100.0	58.6	88.5	100.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Disbursements (US$m)						
Adjustment loans[c]	197.0	0.0	500.0	1251.0	500.0	200.0
Specific investment loans and others	800.0	1112.9	973.2	1216.0	940.0	901.0
Repayments (US$m)	1007.1	1222.9	1461.4	1494.0	1533.0	1624.0
Interest (US$m)	907.4	959.0	951.1	1036.0	1038.0	1012.0

a. Ranges that reflect the base-case (i.e., most likely) scenario. For IDA countries, planned commitments are not presented by FY but as a three-year-total range; the figures are shown in brackets. A footnote indicates if the pattern of IDA lending has unusual characteristics (e.g., a high degree of frontloading, backloading, or lumpiness). For blend countries, planned IBRD and IDA commitments are presented for each year as a combined total.

b. For future lending, rounded to nearest 0 to 5%. To convey the thrust of country strategy more clearly, staff may aggregate sectors.

c. Structural adjustment loans, sector adjustment loans, and debt service reduction loans.

Note:

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

Annex 5: IFC Portfolio and Investment Program

Portfolio Status. As of June 30, 1996, IFC's Mexico portfolio involved 40 clients and stood at $652 million, of which $582 million (89%) related to loans and about $70 million (11%) to equity participation. Undisbursed amounts totaled $59 million. From a country exposure standpoint, IFC's Mexican portfolio is the fourth largest of the corporation after being the largest at the beginning of the 1990's. At year-end 1995, it amounted to 7.6% and 6.6% of total investments disbursed and held, respectively, by the Corporation worldwide. Sector-wise, IFC's outstanding investments are largest in general manufacturing (56%), chemicals/petrochemicals (17%), capital markets (15%), infrastructure (8%), and mining (4%).

Notwithstanding the difficult economic environment prevailing in Mexico, none of IFC's investee companies is in default and the collection rate on the loan portfolio remains firm at 100%. The financial yield and risk-adjusted financial yield[1] on the Mexican loan portfolio amounted to 4.2% and 5.1%, respectively, in FY96 compared with 3.8% and 3.2% for IFC as a whole.

Largely due to the devaluation of the peso, unrealized capital gains on the equity portfolio decreased sharply from a pre-crisis level of about $120 million to $68 million in August 1996. As the long-term fundamentals of the companies represented in IFC's equity holdings remain sound, this downturn may be viewed as temporary and reversible as the economy recovers. Profitability-wise, the equity portfolio ended FY96 with a return on average capital employed of 1.7% compared with 8.1% for the IFC's equity portfolio as a whole. This low performance resulted primarily form IFC's decision to hold on to its unrealized capital gains until fuller recovery of the local stock market. Over the FY92/FY96 period the average equity return in Mexico was 16.6% vs 13.0% for IFC as a whole.

Recent and Planned Investment Program. During FY96, IFC's Mexican activities included the processing of 10 transactions for which funds totaling $733 million were mobilized for the private sector.[2] Of this total, IFC's own-account approvals amount of $243 million of which $194 million related to loan operations, $38 million to equity and quasi-equity participations, and $11.1 million to interest and currency swaps.

Taking into account the emerging needs of the private sector and the development agenda proposed in this CAS, IFC intends to significantly increase its investment activities and portfolio exposure in Mexico in the coming years. Reflecting the sizable long-term financing needs of the private sector, IFC anticipates that through FY99 its activities could

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[1] Income contractually due, dividends, capital gains and financial service fees, minus borrowing costs, if applicable.

[2] In FY95, IFC's investment activities included 9 operations for which financial support of $189 million was extended, including $75 million for IFC's own account.

increase from 10 to 14 per year while gross approvals could reach $700 million and above, including $300-350 for IFC's own account. Such a program would result in the processing of 40-44 projects involving gross commitments of $2.2 billion through FY99, of which about $1 billion would be for IFC's own account. Sector-wise, over 50% of the program would go to financial market development and general manufacturing, and the balance to infrastructure, petrochemicals and agribusiness. The share of infrastructure could increase substantially with a comprehensive and fast privatization program in this sector.

Mexico: IFC Investment Activities

Category	Actual		Planned[a/]		
	FY95	FY96	FY97	FY98	FY99
IFC Net Approvals (US$m)	75	243	300	350	350
Sector (%)					
Financial Sector	14	42	30	30	25
Manufacturing	51	40	30	30	25
Agribusiness	0	0	5	5	10
Infrastructure	2	0	15	20	20
Petrochemicals	0	16	15	15	15
Oil/Gas/Mining	33	2	5	0	5
Total	*100*	*100*	*100*	*100*	*100*
Investment Instrument (%)					
Loans	84	84	85	85	85
Equity	16	16	15	15	15
Total	*100*	*100*	*100*	*100*	*100*

Notes
a/ *Includes quasi-equity types of both loan and equity instruments.*

The non-financing program is going to increase with additional resources devoted to joint advisory work with the Bank, in particular in the financial and infrastructure sectors.

Mexico - Key Economic Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
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	100.0	100.0	100.0	100.0
Agriculture[a]	9.1	8.9	8.4	8.2	8.0	8.2	..	..	..	..	..	..
Industry[a]	30.3	29.6	29.1	28.2	28.1	27.8	..	..	..	..	..	..
Services[a]	60.6	61.4	62.5	63.6	64.0	64.0	..	..	..	..	..	..
Total Consumption	78.3	79.7	81.0	81.0	81.6	77.7	78.7	78.0	77.3	76.7	76.3	75.1
Gross domestic investment	22.8	23.4	24.4	23.2	23.5	19.4	19.2	20.6	21.9	23.7	24.2	26.3
Government investment	4.8	4.5	4.1	4.1	4.2	4.1	3.8	4.1	4.3	4.6	4.6	4.8
Private investment	13.6	14.7	16.3	15.9	16.1	12.3	12.0	13.2	14.3	15.8	16.1	17.6
Increase in stocks	4.5	4.2	3.9	3.2	3.1	3.1	3.3	3.3	3.3	3.3	3.4	3.9
Exports (GNFS)[b]	15.6	13.6	12.4	12.2	12.7	24.0	26.2	27.8	29.2	30.1	30.7	31.3
Imports (GNFS)	16.7	16.8	17.9	16.4	17.8	21.2	24.1	26.5	28.4	30.5	31.1	32.7
Gross domestic savings	21.7	20.3	19.0	19.0	18.4	22.3	21.3	22.0	22.7	23.3	23.7	24.9
Gross national savings[c]	19.8	18.4	17.0	16.9	16.0	18.7	17.9	19.0	20.0	21.6	22.1	24.3
Memorandum items												
Gross domestic product (US$ million at current prices)	247,057	290,529	334,356	367,581	377,112	250,038	289,920	305,128	324,538	348,739	376,597	556,562
Gross national product per capita (US$, Atlas method)	2,450	2,981	3,490	3,810	4,090	3,320	2,964	2,897	3,223	3,445	3,658	5,100
Real annual growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	4.4%	3.6%	2.9%	0.7%	3.5%	-6.9%	3.0%	3.5%	4.0%	5.0%	5.0%	5.3%
Gross Domestic Income	5.6%	3.2%	3.2%	0.8%	3.4%	-11.1%	2.3%	3.1%	3.6%	4.7%	4.8%	5.1%
Total consumption	5.5%	4.8%	3.7%	0.4%	3.5%	-11.7%	0.4%	0.8%	2.1%	3.4%	4.0%	4.5%
Private consumption	6.1%	4.9%	3.9%	0.2%	3.7%	-12.9%	1.0%	1.2%	2.3%	3.5%	4.0%	4.5%
Real annual per capita growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	0.5%	1.6%	0.9%	-1.2%	1.6%	-8.6%	1.1%	1.7%	2.2%	3.3%	3.4%	3.7%

(Continued)

Mexico - Key Economic Indicators
(Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Balance of Payments (US$m)												
Exports (GNFS)[b]	38,411	39,695	41,451	44,872	50,717	63,532	76,070	84,948	94,695	105,119	115,434	174,227
Merchandise FOB	30,390	30,905	32,259	35,453	40,416	53,362	65,047	72,923	81,138	89,896	98,781	148,078
Imports (GNFS)[b]	41,215	48,725	59,681	60,473	71,136	55,203	69,937	80,734	92,258	106,427	117,253	182,047
Merchandise FOB	31,272	38,184	48,193	48,924	58,880	46,274	57,816	67,574	77,065	89,197	98,405	152,521
Resource balance	-2,804	-9,030	-18,230	-15,601	-20,419	8,329	6,133	4,214	2,437	-1,308	-1,819	-7,819
Net current transfers (including official current transfers)	3,978	2,745	3,386	3,640	4,011	3,965	4,101	4,354	4,520	4,525	4,803	10,601
Current account balance (after official capital grants)	-7,451	-14,892	-24,438	-23,399	-29,419	-655	-3,563	-4,967	-6,276	-7,163	-7,735	-11,254
Net private foreign direct investment	2,633	4,761	4,393	4,389	10,973	6,964	5,800	6,000	6,400	7,100	9,600	9,700
Long-term loans (net)	9,224	4,171	51	3,227	4,271	7,817	354	1,836	363	1,749	78	-1,802
Official	4,181	1,392	620	20	-624	10,341	-7,113	-385	-2,718	-3,343	-1,088	-123
Private	5,043	2,779	-569	3,207	4,895	-2,524	7,467	2,221	3,080	5,092	1,166	-1,680
Other capital (net, including errors and omissions)	-1,175	14,099	21,168	21,724	-4,216	-3,275	-1,991	1,308	1,155	1,570	3,813	6,622
Change in reserves[d]	-3,231	-8,139	-1,174	-5,941	18,391	-10,851	-600	-4,177	-1,642	-3,256	-5,756	-3,266
Memorandum items												
Resource balance (% of GDP at current market prices)	-1.1%	-3.1%	-5.5%	-4.2%	-5.4%	3.3%	2.1%	1.4%	0.8%	-0.4%	-0.5%	-1.4%
Current account balance (% of GDP at current market prices)	-3.0%	-5.1%	-7.3%	-6.4%	-7.8%	-0.3%	-1.2%	-1.6%	-1.9%	-2.1%	-2.1%	-2.0%
Reserves in months of imports of goods	3.8	5.6	4.7	6.2	1.3	4.4	3.2	3.1	2.7	2.4	2.5	3.6

(Continued)

Mexico - Key Economic Indicators
(Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Public finance (as % of GDP at current market prices)[e]												
Current revenues	27.0	25.8	26.1	25.4	25.6	26.9	25.4	25.5	25.7	26.0	26.2	26.6
Current expenditures	26.3	22.5	20.6	21.8	21.8	23.1	22.6	22.8	22.5	22.4	22.2	21.6
Current account surplus (+) or deficit (-)	0.7	3.3	5.5	3.6	3.8	3.8	2.8	2.7	3.2	3.6	4.0	5.0
Capital expenditure	3.8	3.9	4.0	3.3	4.2	3.7	3.5	3.7	3.8	3.9	4.2	4.9
Overall Balance	-3.1	-0.6	1.5	0.3	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3	0.1
Monetary indicators												
M2/GDP (at current market prices)	26.3	30.7	31.3	32.0	34.9	38.5	..	..	..	..	..	..
Growth of M2 (%)	46.2	47.1	20.3	13.4	21.3	38.7	..	..	..	..	..	..
Private sector credit growth / total credit growth (%)	83.7	105.2	161.5	193.3	139.9	43.1	..	..	..	..	..	..
Price indices(1980 =100)												
Merchandise export price index	87.3	82.3	84.9	86.4	95.8	110.6	112.1	115.1	118.7	122.1	125.1	139.8
Merchandise import price index	134.4	135.6	137.1	138.5	141.7	153.5	151.0	154.7	158.9	162.8	166.7	188.2
Merchandise terms of trade index	65.0	60.7	61.9	62.4	67.6	72.0	74.2	74.4	74.7	75.0	75.0	74.3
Real exchange rate (US$/LCU)[f]	128.8	117.5	107.4	101.5	105.3	152.8	135.0	135.0	135.0	135.0	135.0	135.0
Consumer price index (% growth rate) (period average)	26.7%	22.7%	15.5%	9.8%	7.1%	34.9%	39.0%	19.8%	10.8%	8.0%	6.0%	5.0%
Consumer price index (% growth rate) (end-of-period)	29.9%	18.8%	11.9%	8.0%	7.0%	51.3%	27.0%	12.5%	9.0%	7.0%	5.0%	5.0%
GDP deflator (% growth rate)	29.8%	21.8%	14.7%	9.9%	7.4%	35.4%	33.8%	17.8%	9.8%	7.2%	5.6%	4.9%

a. GDP components are at market prices.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated non-financial public sector.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Mexico - Key Exposure Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Total debt outstanding and disbursed (TDO) (US$m)[a]	104,439	114,065	112,227	127,436	136,125	161,096	159,048	159,731	160,730	161,155	159,889	173,482
Net disbursements (US$m)[a]	17,637	10,117	2,162	4,798	7,475	16,466	-6,295	-2,629	-2,581	-3,107	-4,463	-410
Total debt service (TDS) (US$m)[a]	11,316	13,545	20,822	21,931	19,938	29,206	39,280	34,481	41,118	45,909	47,374	50,296
Debt and debt service indicators (%)												
TDO/XGS[b]	25.9	249.5	238.6	254.7	239.9	229.7	191.4	173.4	157.2	142.8	129.5	91.4
TDO/GDP	42.3	39.3	33.6	34.7	36.1	64.4	54.9	52.3	49.5	46.2	42.5	31.2
TDS/(XGS + current transfers)	26.7	31.9	46.4	45.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4	27.2
IBRD exposure indicators (%)												
IBRD DS/public DS	16.2	16.6	11.2	15.5	15.1	13.2	8.4	11.0	9.1	8.2	7.8	8.3
Preferred creditor DS/public DS	39.3	36.5	22.9	33.3	31.1	24.1	21.5	25.9	26.2	31.0	24.9	14.6
IBRD DS/XGS	3.6	4.0	4.0	3.8	3.5	3.4	3.0	2.8	2.5	2.4	2.2	1.4
Share of IBRD portfolio	11.4	11.7	12.1	11.9	11.8	12.0	12.3	12.4	11.9	11.1	10.2	8.2
IFC (US$m)												
Loans	119	69	67	53	133	63	194	310	340	375	400	420
Equity and quasi-equity[c]	20	60	64	36	21	12	38	75	85	90	100	105
MIGA												
MIGA guarantees (US$m)	0	0	0	0	0	0	0	0	0	0	0	0

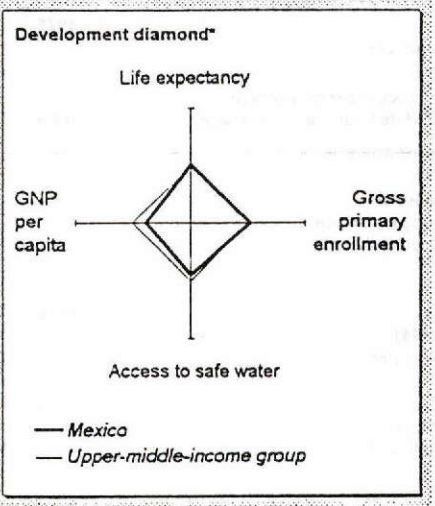
a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

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

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

Mexico at a glance

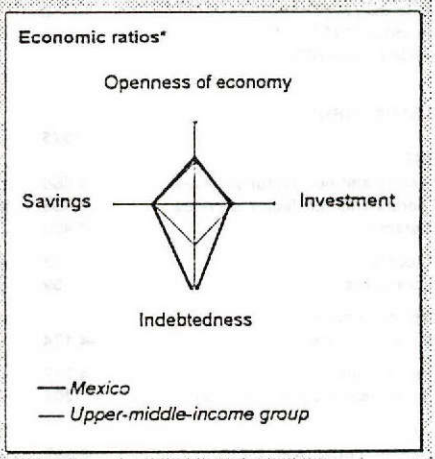
POVERTY and SOCIAL	Mexico	Latin America & Carib.	Upper-middle-income
Population mid-1995 *(millions)*	91.8	481	442
GNP per capita 1995 *(US$)*	3,320	3,320	4,300
GNP 1995 *(billions US$)*	304.9	1,597	1,901
Average annual growth, 1990-95			
Population *(%)*	1.9	1.8	1.7
Labor force *(%)*	2.9	2.4	2.1
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	34	..	..
Urban population *(% of total population)*	75	74	74
Life expectancy at birth *(years)*	70	68	69
Infant mortality *(per 1,000 live births)*	35	41	36
Child malnutrition *(% of children under 5)*	11	..	..
Access to safe water *(% of population)*	78	80	86
Illiteracy *(% of population age 15+)*	13	14	13
Gross primary enrollment *(% of school-age population)*	112	110	107
Male	114	..	..
Female	110	..	..



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

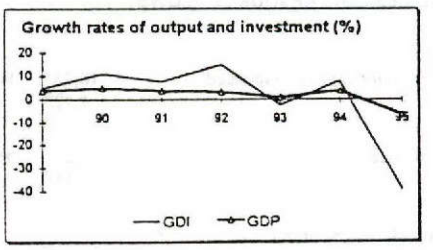
	1975	1985	1994	1995
GDP *(billions US$)*	94.4	183.6	377.1	250.0
Gross domestic investment/GDP	22.3	20.8	23.5	19.4
Exports of goods and non-factor services/GDP	5.7	15.5	12.7	24.0
Gross domestic savings/GDP	19.0	25.9	18.4	22.3
Gross national savings/GDP	17.1	22.1	16.0	18.7
Current account balance/GDP	-4.4	0.4	-7.8	-0.3
Interest payments/GDP	1.2	5.1	2.4	3.9
Total debt/GDP	19.3	52.8	36.1	64.4
Total debt service/(exports + current transfers)		52.4	36.4	43.3
Present value of debt/GDP	..	..	32.7	..
Present value of debt/exports	..	..	219.4	..

	1975-84	1985-95	1994	1995	1996-99
(average annual growth)					
GDP	5.1	2.0	3.5	-6.9	3.9
GNP per capita	2.0	0.3	1.2	-10.8	..
Exports of goods and nfs	12.5	5.2	7.3	28.4	10.3

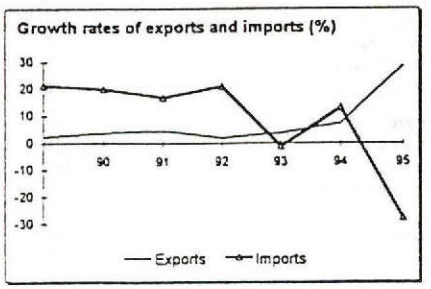


STRUCTURE of the ECONOMY

	1975	1985	1994	1995
(% of GDP)				
Agriculture	10.8	9.1	8.0	8.2
Industry	29.9	33.5	28.1	27.8
Manufacturing	21.9	23.5	19.7	19.8
Services	59.4	57.4	64.0	64.1
Private consumption	71.6	64.8	70.0	67.3
General government consumption	9.3	9.3	11.6	10.4
Imports of goods and non-factor services	9.0	10.4	17.8	21.2



	1975-84	1985-95	1994	1995
(average annual growth)				
Agriculture	3.2	0.3	4.2	-3.8
Industry	5.2	2.4	4.1	-8.0
Manufacturing	4.4	2.8	3.6	-6.4
Services	5.3	2.0	3.4	-6.7
Private consumption	4.1	3.8	3.7	-12.9
General government consumption	6.6	1.2	2.5	-4.1
Gross domestic investment	2.4	3.7	7.8	-39.5
Imports of goods and non-factor services	2.8	13.3	12.9	-27.6
Gross national product	4.5	2.2	3.1	-8.7

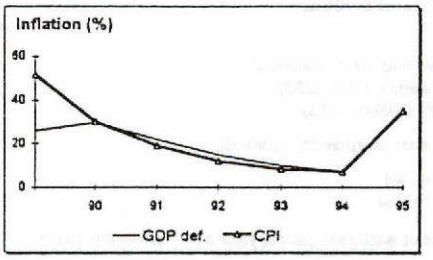


* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Mexico

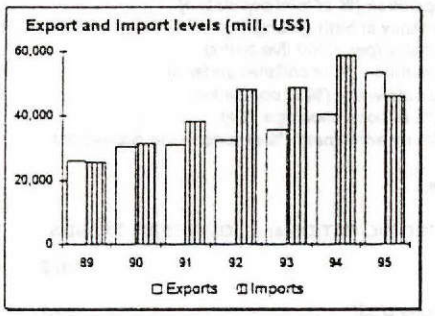
PRICES and GOVERNMENT FINANCE

	1975	1985	1994	1995
Domestic prices				
(% change)				
Consumer prices (period average)	..	57.7	7.1	34.9
Implicit GDP deflator (period average)	15.5	56.2	7.4	35.4
Government finance				
(% of GDP)				
Current revenue	..	31.5	25.6	26.9
Current budget balance	..	-1.6	3.8	3.8
Overall surplus/deficit	..	-6.2	-0.4	0.1



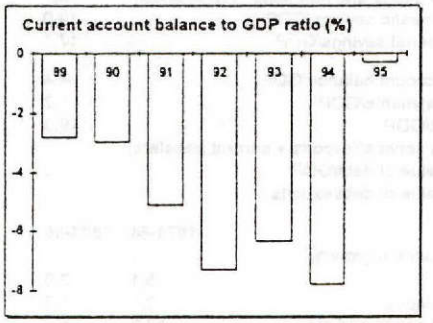
TRADE

	1975	1985	1994	1995
(millions US$)				
Total exports (fob)	..	22,931	40,416	53,362
Fuel	..	14,767	7,445	8,422
n.a.	..	..	..	..
Manufactures	..	6,245	29,936	40,379
Total imports (cif)	..	14,533	58,880	46,274
Food	..	1,082	9,510	5,335
Fuel and energy	..	..	..	..
Capital goods	..	3,165	13,322	8,697
Export price index *(1987=100)*	..	125	110	122
Import price index *(1987=100)*	..	99	119	123
Terms of trade *(1987=100)*	..	127	93	99



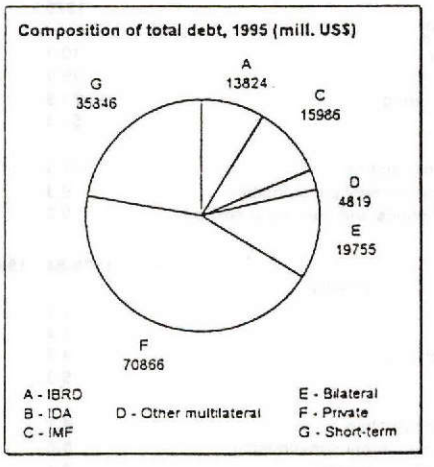
BALANCE of PAYMENTS

	1975	1985	1994	1995
(millions US$)				
Exports of goods and non-factor services	6,066	27,726	50,717	63,532
Imports of goods and non-factor services	8,466	19,915	71,136	55,203
Resource balance	-2,400	7,811	-20,419	8,329
Net factor income	-1,783	-8,996	-13,012	-12,948
Net current transfers	59	1,986	4,011	3,965
Current account balance, before official transfers	-4,124	801	-29,419	-655
Financing items (net)	4,327	-3,222	11,028	11,505
Changes in net reserves (- = increase)	-204	2,421	18,391	-10,850
Memo:				
Reserves including gold *(mill. US$)*	1,897	4,997	6,300	16,870
Conversion rate *(local/US$, period average)*	1.25E-02	0.3	3.4	6.4



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1994	1995
(millions US$)				
Total debt outstanding and disbursed	18,231	96,867	136,125	161,096
IBRD	1,123	4,034	13,038	13,824
IDA	0	0	0	0
Total debt service	2,613	15,293	19,938	29,206
IBRD	116	597	1,990	2,375
IDA	0	0	0	0
Composition of net resource flows				
Official grants	8	78	47	..
Official creditors	381	809	-623	10,341
Private creditors	3,365	-831	4,985	-2,424
Foreign direct investment	609	491	10,973	6,964
Portfolio equity	0	0	4,088	519
World Bank program				
Commitments	310	928	2,815	1,877
Disbursements	188	840	943	1,733
Principal repayments	39	335	1,065	1,411
Net flows	150	505	-123	322
Interest payments	78	262	924	964
Net transfers	72	243	-1,046	-642



Private Sector
Strategy

Attachment 1

MEXICO
COUNTRY ASSISTANCE STRATEGY

PRIVATE SECTOR STRATEGY

I. INTRODUCTION

1. This Private Sector Strategy Paper (PSS) addresses selected issues that are relevant to Mexico's private sector development, as an important input to the country's overall strategy to recover from the recent crisis, reduce poverty and achieve sustained growth. The PSS is a supporting document of the Country Assistance Strategy (CAS), which attempts to provide a comprehensive assessment of the country's overall development needs and Bank Group assistance strategy.

2. Efforts to promote private sector development permeate virtually every Bank Group operation identified in the CAS. The PSS, however, focuses in more detail on five areas deemed important for private sector development at this stage: strengthening the banking sector, developing non-banking and capital markets, enhancing the competitiveness of Mexican corporations particularly in the SME sector, improving infrastructure and correcting regional development imbalances.[1] These areas reflect both the current priority needs of the Mexican private sector, as well as the proposed allocation of Bank Group resources for private sector development in Mexico over the FY97-99 period.

3. The PSS is organized in four sections: the next section describes the local private sector and presents an overview of the current business environment in Mexico. The third section summarizes Government actions to promote the private sector and the fourth section describes the Bank Group's strategy to assist the Government in removing the remaining constraints to private sector development.

II. THE PRIVATE BUSINESS ENVIRONMENT

General Profile

4. The macroeconomic reforms instituted by the Mexican authorities over the past decade have significantly elevated the role of the private sector. The sale of Government-owned enterprises and the re-privatization of the banking sector have played an important part, but most critical has been the opening of the economy to international competition.

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[1] These sectors do not preclude active participation in other important areas such as agribusiness and small scale mining.

5. Characterized by a fairly diversified productive base, the Mexican private sector presently accounts for 70% of GDP and 86% of total employment. Data on output trends and productivity growth suggests a duality within the Mexican private sector. A large traditional sector, comprising mainly small and medium sized firms, employs a large fraction of the labor force but accounts for a much smaller portion of output and exports. Productivity improvements in this sector have been slow and output growth sluggish. In contrast, the modern sector has experienced faster productivity growth, and stronger output and export performance.

6. **Growth Patterns**. The evolution of private sector activity in Mexico mirrors the evolution of GDP in general. GDP growth has been moderate overall since the liberalization efforts began and has varied significantly across sectors, as productive activities have adjusted with differing degrees of success to structural changes. As shown in Table 1, agricultural growth remained flat while industry and services each grew by about 3.0% p.a. Within manufacturing, some industries experienced slow or even negative growth (e.g. textiles, clothing, footwear, wood products, agro-industry) while export-oriented industries (e.g. automobile assemblies and autoparts, electrical and electronic goods, petrochemicals and steel) showed the most dynamic performance.

Table 1
MEXICO
Gross Domestic Product and Sectoral Growth Rates

	GDP Share (%)	GDP Average Growth Rate	
Sector	*1995*	*1985-94*	*1995*
Agriculture	7.6	0.5	-3.8
Industry	32.7	3.1	-8.0
Mining	3.7	1.2	-0.7
Manufacturing	22.6	2.4	-6.4
Construction	4.6	2.0	-22.0
Electricity, Gas & Water	1.8	4.5	3.1
Services	59.7	2.3	-6.7
Trade & Restaurants	23.3	2.2	-14.4
Trans., Warehouse & Comm	7..9	4.5	-1.9
Finance, Insurance & Fixed Assets	12.4	3.5	0.4
Community, Social & Personal Services	16.1	1.4	-2.4

Source: Calculations based on National Accounts series. INEGI

7. The recent economic recession has had strong repercussions on sectoral developments. Mexico's overall index of industrial production declined in 1995, as did agricultural output and services. Within the industrial sector, the construction industry experienced the most severe contraction as a result of a sharp decline in public infrastructure projects and private investment. Output of all major manufacturing sectors declined with the exception of basic metal industries which grew by 9%. Notwithstanding a flat growth performance within the mining sector as a whole, iron ore and other non-metallic metals experienced real growth rates between 13% and 15%, reflecting the positive role of direct and indirect exports in these mining activities.

8. The past decade also witnessed a significant shift in the nature and distribution of exports. As detailed in Table 2, manufactured exports have replaced oil as Mexico's main

source of export earnings. In addition to the dynamism of manufactured exports growth, this evolution also reflects a halving in world oil prices since 1982. Agricultural exports have remained constant at around 5-6% of the total, with rising sales of fresh fruit and vegetables offsetting declining revenues from traditional export crops such as cotton and coffee.

Table 2
MEXICO
Structural Changes in Mexican Exports
(percentages)

Year	Manufactured Exports/ Manufacturing GDP	Manufactured Exports/ Total Exports (excluding in-bond)	Petroleum Exports/Total Exports (excluding in-bond)
1982-83	10.5	17.5	74.5
1986-87	23.6	37.7 *	50.9 *
1994	32.0	68.9	21.2
1995	53.8	73.2	17.4
1985-87*			

Source: El Indicador Bursatil

9. The *peso* crisis has reinforced the above trends, as exports have taken up the slack in domestic demand. In US dollar terms, total merchandise exports increased by 31% in 1995, with manufacturing exports experiencing a 47% surge and the "*Maquiladora*" (in-bond) industry growing by 18%. This high export growth continued through the first half of 1996, facilitated by the sharp improvement in Mexico's price competitiveness and strong diversification into non-traditional exports.

10. **Recent Performance.** Following a major recession in 1995, the country's prospects for faster growth and lower inflation have improved in 1996. The disciplined fiscal and monetary policies required to stabilize the economy, however, have limited the credit available to the private sector. Uncertainties about the future performance of the Mexican economy also have led to a significant contraction of international credit and have forced companies to become more resourceful in their search for overseas funding. Medium to long-term external financing today for private entrepreneurs is largely limited to the securitization of export receivables. The foreign syndicated loan market remains largely closed, while the bond market is only starting to recover with limited issues involving a few premier companies. This situation has severely complicated the private sector's capacity to meet its investment needs.

11. The *peso* crisis has caused widespread corporate distress as Mexican enterprises have been hit within a relatively short time with high real interest rates and weak domestic demand. Unprecedented declines in output and difficulties experienced in passing raw material cost increases to customers have depressed operating profits. The domestic credit crunch and the closing of foreign credit markets have caused severe financing shortfalls and consequent liquidity difficulties as well. Resulting losses have further eroded already over-leveraged balance sheets.

12. Payment delays within the private sector have resulted in a "domino-effect" accumulation of receivables, while lower sales have caused an undesirable build-up of

inventories. Both have led to dramatic declines in liquid assets at a time when credit to finance current assets is not readily available. Even among companies that have managed to show positive net incomes, there are many examples of firms which cannot meet payments to suppliers and creditors alike and which continue to face inadequate liquid balances, depressed cash flows, and pressing debt service obligations. With the dramatic reduction in conventional domestic and foreign credit, lenders have become increasingly reluctant to refinance existing debt, leading many companies to bankruptcy. This widespread corporate problem has forced many companies to focus on continuing debt servicing and rollover issues rather than in addressing the operational and asset restructuring needs of their businesses. Private investment fell 34% in 1995, the most pronounced fall in the last 15 years.

13. The above operational strains have widened performance differentials within the private sector. Large productive concerns have weathered the crisis better than their smaller counterparts and companies that serve the domestic market have been more seriously affected than those which diversified into exports.[2] The small and medium scale enterprise sector (SME) has been particularly hard pressed. The non-tradable sector has been hurt the most due to the combined impact of a sharp decline in domestic demand, production cost increases, and limited access to international capital markets. On the brighter side, commodity and other basic import substitution industries have been helped as their foreign competitors have been effectively priced out of the market. The incipient recovery and decline of market interest rates observed in mid-1996, also are expected to improve the overall financial situation of both private corporations and banks.

14. The liberalization effort in Mexico has improved the environment for foreign investment. Foreign direct investment increased from $US2.6 billion in 1990 to US$11 billion by 1994. Even in the midst of the recession of 1995, foreign direct investment continued at US$7.0 billion. Foreign direct investment has introduced many modern technologies and management practices, particularly in manufacturing. Portfolio equity investment also increased significantly, rising from US$2.0 billion in 1990 to a peak of US$10.7 billion in 1993. The political and economic uncertainties associated with the financial crisis reduced net equity inflows to US$0.5 billion in 1995. Net bond placements showed a more exaggerated pattern with net redemption in 1995 of US$14.4 billion.

III. THE GOVERNMENT AND THE PRIVATE SECTOR

15. Over the last fifteen years, Mexico has pursued a long process of economic reforms directed at promoting private sector-led growth and shrinking the role of the state. As part of that agenda, the Mexican authorities have engaged in fiscal reforms

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2 Detailed information illustrating the impact of the above crisis on enterprise performance by size category is scarce. The available evidence, based on electricity sales as a proxy for industrial activity, suggests that micro, small and medium sized firms have been the hardest hit. Electricity sales to this particular group dropped by 20% in 1995 while they increased marginally by 1% among the largest Mexican corporates.

accompanied by trade liberalization. This effort was formalized in the NAFTA agreement which came into effect in January 1994. The competitive atmosphere was enhanced by liberalization of the law on foreign investment, which permits majority foreign ownership in certain sectors. The reprivatization of the commercial banks, elimination of credit controls, and reduction of the role of government development banks and trust funds were meant to allow the private sector a greater role in allocating resources. Tax reform, industrial deregulation, improved intellectual property rights, a privatization program in mining and steel, telecoms, roads and ports, and extensive agricultural reforms provide further evidence of Mexico's adjustment.

16. In addition to launching a comprehensive economic stabilization program, the Government has taken a number of actions over the past year to maintain public confidence in the banking system. The Laws of Credit Institutions, Brokerage Houses and Financial Groups were amended to permit greater foreign involvement and participation in the financial sector. The National Securities and National Banking Commissions were merged to strengthen bank supervision and ensure the application of uniform accounting and regulatory standards among financial institutions. Finally, a number of legal reforms were introduced to facilitate the securitization and sale of bank loan portfolios to third parties, lift banking secrecy to provide potential purchasers with detailed information on credit risk, and clamp down on the practice whereby banks lend money to themselves and to members of groups to which they belong.

17. The Government also launched various programs to contain the deterioration of banks loan portfolios and maintain adequate capitalization within the banking system. FOBAPROA, the banking support fund administered by the Banco de Mexico, intervened in ten banks and provided assistance to other banks through various support mechanisms. Reflecting the critical role which the banking sector must play in the economic recovery process, these support programs have thus far primarily addressed the risk of systemic bank failure. Now, increasing attention is being given by the Mexican authorities to establishing a base for recovery of the corporate sector. In recent months, the Government initiated programs to facilitate the restructuring of financially distressed enterprises on a case-by-case basis. The UCABE program, designed to resolve stalled debt negotiations, has targeted companies with roughly US$150-500 million of bank debt.[3] A second program would provide equity to distressed small-and medium-scale enterprises through NAFIN.

Constraints to Private Sector Development

18. While recent Government actions and initiatives will contribute to the ongoing economic recovery process, additional reforms are needed to induce a broad-based modernization of the economy and private sector. Key areas that need to be addressed immediately are banking and corporate restructuring. Over the longer term, major constraints include: infrastructure bottlenecks, underdeveloped capital markets, regional

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3 UCABE's financial instruments include: (a) a debt swap mechanism that allows a debtor to obtain a 22.5 percent reduction in the amount owed, without causing a corresponding 22.5 percent book loss to the creditor; (b) and debt swap alternatives to enable banks to swap exposures among themselves on a one-for-one basis.

imbalances, continuing regulatory barriers to trade and investment particularly at state and municipal levels, low skill levels, and inadequacies of the commercial legal framework and judicial system that especially disadvantage SMEs and contribute to a concentrated industrial structure.

19. In those key areas where the Bank Group plans to collaborate in assisting the Government, the following Government actions are required:

- **Banking.** Some liquidation and consolidation of Mexico's banking system may be necessary. While every effort to resist bank failure is appropriate, ultimately the health of the overall system will call for some adjustment to avoid contaminating potentially salvageable banks. The basis for this adjustment ideally should be market-based, i.e., voluntarily sought by shareholders and creditors. The authorities need to both (a) place a cap on the financial relief provided and (b) establish a termination date on the period of forbearance with respect to failure to honor contractual obligations. Problems of "willingness to pay" need to be eliminated so that "ability to pay" can be effectively addressed.

- **Corporate Restructuring.** Mechanisms need to be put in place to enable the timely and impartial enforcement of contracts. This is a *sine qua non*. Otherwise, perverse market expectations will thwart the best efforts of the authorities in other areas. A specific set of actions in this regard would include improvement of title registry and recordation, measures to enable the perfection of security interest, the strengthening of bankruptcy provisions and the strengthening of legal and administrative procedures regarding asset foreclosures. In addition, special financing facilities need to be established, aimed at financing the transfer of assets from distressed enterprises and financial institutions. Once borrowers are convinced that the authorities are not likely to encourage contractual leniency after the current relief has been exhausted, such facilities will help them realize at least partial value for distressed assets—an outcome that has been unavailable to date.

- **Capital Markets.** Actions are needed to strengthen and diversify Mexico's capital markets in order for them to contribute over the longer-term to improved stability and efficiency in the process of resource allocation

- **Infrastructure**. The legal and regulatory framework for private provision of power, and water and sanitation needs to be improved. While much privatization has taken place in these sectors, the largest enterprises have not been fully privatized. Also, stalled petrochemical privatizations need to move ahead. These sectors provide the most important infrastructure services for private sector activity, and if they are not reformed, will stymie private sector growth.

- **Regional Development**. Mexico's uneven regional development remains a severe obstacle to sustained and balanced growth. Government initiatives are needed to reduce poverty in these areas by accelerating private sector led growth and improving the delivery and management of basic social services.

IV. THE BANK GROUP STRATEGY

Strategic Framework

20. Since the devaluation of the *peso*, the Bank Group's assistance to the Mexican private sector has been of a crisis-response nature where efforts have been primarily aimed at containing the financial crisis and stabilizing the environment for corporate development. As Mexico is likely to remain in a difficult state of transition for much of the next three years, the Bank Group's private sector strategy will continue to focus on the immediate priorities of the Mexican private sector. At the same time, however, the Bank Group will begin to focus on those areas that need to be strengthened to ensure sustained private sector growth in the medium to long-term.

21. Given its critical importance to the economic recovery process, the *financial sector* will continue to account for a significant part of the Bank Group's economic and sector work program, investment and lending activities, and policy dialogue with the Mexican authorities. While the *banking sector* will remain the top immediate priority, the Bank Group's support will increasingly shift to strengthening the regulatory and institutional framework needed to ensure the future development of the banking system and diversify further the range of financial institutions and financial products. Beyond the financial sector, high priority will also be assigned to assist the *corporate sector in restructuring* its troubled enterprises, in particular SMEs.

22. Medium to long term issues to which the Bank Group will assign high priority relate to the general constraints to private sector development predating the crisis, particularly *infrastructure* deficiencies and excessive *regional concentration* of productive activities. While infrastructure development will remain a key area of Bank Group involvement, the focus of support will shift to promoting increased and more efficient private participation. Activities to achieve more balanced regional development will feature a new Southern States Initiative which aims to foster growth and poverty reduction in the poorest two states through an enhanced role of the private sector.

23. The above strategic areas for Bank Group intervention are key to sustained growth, employment generation, and poverty alleviation. The rationale behind their selection and details of the Bank Group's strategy to be pursued for each through FY99 are presented in the subsequent sections. Matrices relating to each strategic area and providing summary information on the objectives, actions, benchmarks, and instruments which will be part of the proposed Bank Group's agenda are included at the end of each section.[4]

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[4] IFC's involvement in each individual transaction will need to be tested against IFC's project selection criteria as described in Annex 1.

1. The Banking Sector

24. The *peso* devaluation of December 1994 has had both immediate and long-term adverse effects on the capacity of the system[5] to respond to the needs of the private sector. The Government has currently intervened in 10 banks and the 12 largest banks still in private hands are struggling to meet adequate capital adequacy levels.

25. The systemic weaknesses from which the banking sector currently suffers were already evident when the banks were privatized in 1991-92. The new bankers inherited unprepared personnel and weak internal systems and controls, particularly in the area of credit analysis. In some cases, banks were sold to controlling shareholders lacking lending experience and access to technical expertise. Moreover, the new owners were under considerable pressure to record high earnings, having paid multiples of between three and four times book value for their ownership interests. In the rush to compete for market share, lending exploded to levels many times the economy's growth rate, with much of the credit expansion in consumer lending. Consumer lending was already growing in the three years proceeding privatization. Not surprisingly, portfolio quality suffered, becoming particularly evident toward the end of 1994.

26. The *peso* devaluation accentuated the above portfolio trends and weaknesses of the banking system. Mexico's commercial banks posted a net loss of N$37.9 billion (US$6.0 billion equivalent) in 1995 and of N$16.3 billion (US$2.0 billion equivalent) through March 1996. Past due loans increased by 74.4% from N$57 billion to N$98.7 billion in 1995. Available data also reveal that during the first half of 1996 the commercial banks' loan portfolio deteriorated further with the ratio of past due loans to gross loans reaching an estimated 15% as compared to 7.3% at year-end 1994, and 14% at year-end 1995 (excluding FOBAPROA purchases).

TABLE 3
Mexico
Structure of Commercial Banking System
(N$ million as of end-March 1996)

Bank Groups	Number of Banks	Assets	Gross Loans	Direct Funding	Equity	Net Profit or Losses
Intervened Banks	8	136,897	142,318	98,795	-40,127	-13,975
Privatized Banks	12	886,189	553,388	506,934	54,767	-2,995
New Local Banks	15	36,062	18,742	14,335	6,421	293
Subs. of Foreign Banks	16	41,524	6,981	9,859	5,249	326
Banking System	51	1,100,672	720,429	629,923	26,310	-16,351

5 Fifty-four institutions comprise the Mexican commercial banking sector. Twenty are established banks (18 of which were privatized in 1991/2). The remaining banks in the system operate under charters issued since 1993. The Mexican banking system is characterized by extreme concentration and little foreign participation. Three large banks -Banamex, Bancomer and Serfin- represent about 46% of total system assets, the seventeen other established banks represent about 48% of the system and the newly chartered banks, 6%.

27. Since early 1995 the Government has tightened banking supervision and provided financial support to the banking system. While these actions contributed to an improvement in the banks' capitalization, the deterioration in their loan portfolios—as stated earlier—has not yet been firmly contained. Further actions need to be taken in the following areas:

- *Accounting and Reporting Practices.* There remains a lack of unbiased, transparent and timely financial reporting. Accounting and loan classification practices continue to overstate profitability and obscure the true condition of banks. The practice of "quick-fix" restructuring to eliminate arrears and avoid reclassifying troubled loans of major debtors also results in overstatement of loan quality and inadequate provisioning. Finally, Mexican GAAP encourages the overstatement of profits and thus capital adequacy calculations[6].

- *Legal and Regulatory Framework.* Laws governing commercial transactions are no longer adequate to meet the complex requirements of a global economy. The Bankruptcy Law, in particular, needs improvement. It has proven to be an ineffective instrument for managing orderly workouts or liquidation of troubled companies. Its complicated procedural requirements, together with certain of its substantive provisions, have impeded the ability of lenders to force debtors into bankruptcy and have contributed to delay enterprise restructuring agreements and the disposition of impaired banking assets needed for a comprehensive rehabilitation of the banking system. Additionally, the Law on Negotiable Instruments and Credit Transactions limits the financing options available to companies through banks and non-bank intermediaries, and thus prevents private sector entities from entering into mutually beneficial contracts.

- *Liability Protection.* Through FOBAPROA, the Government currently provides an implicit guarantee of all unsubordinated bank liabilities. As part of the rehabilitation of the Mexican banking system, such coverage should be limited to retail deposits below a certain threshold so as to encourage banking efficiency by subjecting banks to greater scrutiny from inter-bank lenders, rating agencies, large depositors and bond investors.

- *Regulation and Supervision.* Prudential regulatory norms and supervisory capacity are still inadequate. Although the authorities have introduced capital adequacy criteria more in line with BIS (Basle Accord) requirements, the inadequacies in accounting and reporting standards weaken the positive impact that capital adequacy criteria were designed to achieve.

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6 As part of the banking reform package supported by the ongoing IBRD's Financial Sector Restructuring Loan, the authorities will require banks to switch to international accounting standards starting with their year-end 1996 financial statements. However, private sector analysts believe it may take as long as a year thereafter before individual bank accounting systems fully implement the new system.

- *Financial Infrastructure Services.* The poor quality and lack of para-financial services constrain the modernization of the financial system. Improvements in this area would provide both regulators and financial sector participants with objective information necessary for sound evaluation of loans, borrowers and financial institutions.

28. **Bank Group Strategy - Banking Sector.** Through its Financial Sector Technical Assistance Loan (FTAL), the Bank Group has thus far contributed to the introduction of important improvements in regulation, supervision and institution building in the area of bank and non-bank intermediaries. Similarly, through the Financial Sector Restructuring Loan (FSRL), it has also addressed the most important short-term threats facing the banking system. Both of these efforts have encouraged reliance on market based solutions, greater incentives for market oversight of financial intermediaries, the introduction of new financial instruments, and the modernization of the legal/regulatory framework for lending.

29. To complement the above efforts, the Bank Group will, in the short-term, deepen its support of the banking sector with the objective of: (i) further improving accounting, reporting, and disclosure standards in the banking industry; (ii) bringing prudential regulations in line with international standards, and (iii) providing technical and financial assistance sufficient to assure the enactment of needed banking reforms. As part of that agenda, the Bank intends to process a second Financial Sector Restructuring Loan (FSRL II) in FY97. Through that new operation as well as a planned Financial Infrastructure Loan, it would build upon the progress achieved thus far in the banking system by assisting the economic authorities in:

- Operating an RTC type facility to divest bank assets held by the Government through FOBAPROA;
- Upgrading and modernizing public registries and credit bureaus;
- Updating the laws pertaining to credit and collateral, and undertaking needed reforms in bankruptcy laws and processes; and
- Improving the technical and supervisory capacity of regulators across the financial sector.

30. In addition to supporting the Bank's technical assistance and policy dialogue activities, IFC will seek to further expand its presence in the banking sector beyond the recent Banamex operation (FY96) through a combination of loans and equity investments. As part of this increased portfolio exposure, IFC would use commercial banks as vehicles through which to channel restructuring finance to the SME sector. The use of the country's strongest and largest banks will allow for wider distribution of IFC finance throughout the country, and IFC's equity participation should encourage foreign banks to

increase their investment in Mexico at this time. In addition to providing much needed financing, this instrument will aim to reinforce the use of strict financial discipline both in the banking and corporate sectors. Financial assistance will be completed by assigning a senior person to the field to actively transfer IFC's restructuring experience.

31. Over the medium-term, the Bank Group's assistance will aim to (i) bolster market discipline by reducing deposit insurance; (ii) broaden the use of international accounting standards; (iii) reduce arbitrage by closing loopholes within the financial regulatory framework; (iv) promote the development of private financial information gathering and reporting institutions; (v) deepen asset securitization through the establishment of private specialized financial institutions; and (vi) further develop micro and small enterprise lending.

MEXICO PRIVATE SECTOR STRATEGY: BANKING SECTOR DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Return of intervened banks and assets to private sector (Bank Resolution).	• Resolution (sale/merger/liquidation) of banks under government control, transfer of banks and assets to private management. • Adequately equip bank resolution agency (VVA) to manage and sell assets acquired by the government.	• Bring majority of currently intervened banks to point of resolution by year-end 1996; resolve remaining banks by end-July 1997. • Begin operations of VVA in July 1996; disposition of assets in accordance with annual targets over next five years.	• Technical assistance through financing of international experts, seconded staff of RTC-type entities (FTAL). • Banking System ESW. • FSRL I, II.	• Technical assistance and advisory role to help authorities strengthen banking framework and establish RTC-type institution.
Strengthen prudential regulations, accounting and disclosure framework (rules and regulations).	• Introduction of revised bank accounting for year-end 1996 statements based on international GAAP. • Limitations on qualification of subordinated convertible debt as Tier I capital. • Revised capitalization rules, including market risk. • Revised loan classification rules.	• Prudential regulations and capital rules more comparable with OECD countries. • Accounting rules for banks and other financial institutions consistent with international standards (US GAAP). • Evidence (based on visits to banks) that banks are applying new standards.	• Technical assistance through financing of international experts (FTAL). • Advisory role to assist authorities to conform to international (Basle) standards (FTAL). • FSRL I, II. • Financial Infrastructure Loan.	• Technical staff participation.
Strengthen banking supervision.	• Further improvement in the staff, systems, equipment and permanent training programs of the CNBV. • Continued annual on-site inspection of major banks, diagnostic audits and better analytical use of examination and audit results.	• Evidence (through monthly reviews by IBRD) of tighter CNBV control of banking activities, including application of penalties/sanctions.	• Technical assistance, including seconded examiners from OECD countries (FTAL).	• Technical staff participation.

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Encourage market-based discipline through limitation of FOBAPROA coverage of bank liabilities.	• Development of a timetable for removing implicit government guarantee for securities, interbank lines and eventually large deposits of banks.	• Announcement in 1996 of plans to phase out certain coverage.	• Advisory role. • FSRL I, II.	
		• Implementation of phase-out, beginning with interbank liabilities in 1997 and progress in accordance with agreed timetable.		
Modernize lending/securitization framework.	• Introduce changes in lending laws, particularly regarding secured transactions, title transfer and asset-backed securities.	• Evidence of greater reliance on loans secured by movable property, whole loan sales and asset-backed securities transactions taking place.	• Financing of domestic and international expertise (FTAL). • Financial Infrastructure Loan.	• Institution -building (equity finance) role for (a) banks at the Financial Group (FG) level, bank level and in other corporate entities of the FG within a multibanking context; (b) securitization institutions; (c) institution-building role at the regional level for microlending allowing IFC to "wholesale" its experience in this area; and (d) information generating institutions (e.g., rating agencies, financial publications, financial news and data networking ventures).
Reform the bankruptcy and work-out framework.	• Introduce laws and supporting regulations for bankruptcy, suspension of payments as well as voluntary work-outs.	• New legislation and rules drafted.	• Financing of domestic and international legal expertise (FTAL).	
Strengthen private commercial banks.	• Attract foreign equity financing for banks and the transfer of banking technology and systems. • Establish an RTC-type institution for the purchased loan portfolio and for insolvent banks. • Provide "financial work-out" expertise . • Rationalize prudential regulations across all activities spanned by financial groups and strengthen accounting and reporting requirements for financial groups, particularly the requirement to publish both consolidated and individual financial statements. • Accelerate measures to allow securitization of bank assets. • Mobilize resources for term finance and equity injections.	• Majority of commercial banks operating with improved capital adequacy and stronger financial and operating performance indicators. • Significant reduction in number and size of intervened banks. • Evidence of banks undertaking more secured lending and asset sales/ securitization.	• FTAL (ongoing). • FSRL I, II.	• Funds mobilization and catalytic roles regarding (a) credit lines to banks for restructuring finance (Banamex FY96 and Probursa FY97); (b) subordinated debt to banks to strengthen Tier II capital; (c) syndication of loans to banks (Banamex FY96); and (d) asset (loan) securitization (Banamex FY96). • Institution-building role (equity finance) for selected banks during the transition. • Technical assistance role for strengthening long-term financial system framework across all activities of financial groups. • Funds mobilization and catalytic roles for (a) lending to selected banks; and (b) securitization of bank assets.

2. Capital Markets and Specialized Financial Institutions

32. Mexico's financial markets have not yet attained the level of diversification and sophistication expected for such a large liberalized economy. Note from Table 4 below the extremely small share of total financial assets accounted for by specialized financial institutions in such areas as leasing, factoring, venture capital and insurance.

33. Given the nature and extent of existing capital market constraints, various tasks need to be addressed on a priority basis if local financial markets are to be developed and play a leading role in the ongoing recovery process. In addition to restoring the health of the banking sector and raising domestic savings, these tasks include: (i) securing an orderly transition to a funded pension system; (ii) strengthening the institutional framework for housing finance; (iii) rapidly expanding the financial services available to SMEs through such institutions as leasing and venture capital; and (iv) remedying the inefficiencies and lack of transparency of the equity and bond markets.

Table 4
MEXICO: Assets of Mexican Financial Institutions
(Millions of New Pesos and % of Total)

Type of Institution	Dec-93	%	Dec-94	%	Sep-95	%
Commercial Banks	556,678	50	799,880	47	872,554	52
Brokerage Firms	210,814	19	399,244	24	251,657	15
Development Banks (Gov't.)	195,424	17	336,488	20	409,727	24
Mutual Funds	80,481	7	61,234	4	61,611	4
Insurance	29,651	3	35,408	2	42,236	3
Others[1]	47,911	4	61,561	4	46,073	3
TOTAL	**1,120,959**	**100**	**1,693,815**	**100**	**1,683,857**	**100**

Source: CNBV
1/ "others" includes credit unions, factoring companies, leasing companies, warehousing companies, bonding companies and exchange houses.

34. ***Pension Reform and the Contractual Savings Industry.*** Without understating the other financial market constraints, the most pressing capital market issue involves the reform of the *Sistema de Ahorro para el Retiro* (SAR) into a privately-managed system. Indeed, with a current base of 10 million affiliates, such a reform could potentially create the single largest financial industry in Mexico within a decade. For a vibrant private sector-managed contractual savings industry to be established, the current reform program will have to address key issues pertaining to: (i) transition costs; (ii) fiscal implications; (iii) system coverage; (iv) fee structure; and (v) competition.

35. As it stands, further work is required to encourage efficiency, economies of scale and public confidence. Mexico also needs to replace the Pay-As-You-Go (PAYG) system for public employees. Furthermore, pension contribution rates must be raised preferably through the transfer of the current INFONAVIT contributions to the funded pension system. Competition and efficiency in asset management must be encouraged by offering greater choice to workers regarding investment assets, vehicles, and providers. Finally, greater specialization is required with respect to investment objectives with commensurate

flexibility regarding admissible investment options. Concurrently with this last task, Mexico should eventually dismantle the artificial segmentation between the management of mandated savings (managed by AFOREs) and voluntary savings (managed by insurers, mutual funds, banks, etc.).

36. ***Housing Finance.*** Due to the flows of real assets involved, housing finance also has the potential to significantly influence the development of domestic financial markets. However, the persistent lack and high cost of such finance has remained an important social concern in Mexico by putting home ownership beyond the reach of most people. The main problem here is that Mexico does not have a coherent national housing policy. To the extent that the housing framework is marked by inefficiencies, the introduction of new financial products and creation of greater asset liquidity are impeded. The state has attempted to provide both housing and housing finance through multiple institutions and programs as well as through the *ad hoc* diversion of specific taxes. This has resulted in enormous fiscal costs, significant institutional failures, and sharply segmented markets.

37. ***Other Non-bank Financial Services.*** Sources of medium and long term funding from non-bank financial intermediaries are very limited. Although during 1995, 54 companies in Mexico were engaged in *leasing* with the 10 largest companies accounting for 72% of the total leasing portfolio, lease financing has not developed much beyond the consumer automobile market. The *factoring* market is served by some 31 factoring companies of which the top 10 companies account for 73% of related assets. In the cases of both leasing and factoring, companies belonging to large financial groups account for a large share of the respective markets. Payment performance is deteriorating in these markets as with commercial bank lending, causing many of the independent companies to disappear. Furthermore, given that senior financial group management is currently concerned with strengthening banks under their ownership, this is likely to divert attention away from other financial services. This is particularly detrimental to SMEs given the important role that leasing and factoring have in this sector. (In leasing, security enforcement is relatively easy, whereas the enforcement of a lien in a traditional bank loan can take a long time.) A competitive *venture capital* industry has not developed in Mexico and venture capital companies of the larger groups have not worked well. Years of directed credit by the development banks seems to have undermined the private equity culture in Mexico.

38. ***Stock Market.*** Although it has always been a "thin" market and not an important source of new equity capital (company listings declined from over 200 in recent years to 184 today), the Mexican Bolsa had, prior to the 1994 devaluation, achieved international recognition as an important stock exchange among emerging market countries. The crisis, however, revealed a number of shortcomings in the legal and regulatory framework.. Despite an efficient, open "out-cry" trading system for most listed securities and the imminent move to T+1 clearing and settlement, trading systems remain inadequate in the second-tier market. Illiquidity is a problem for many issues as well, given that the average float of any issue traded on the Bolsa is about 30% of its market capitalization. Market capitalization is currently about one-third of GDP but this masks the thinness of the equity market, which represents only 5% of the volume of securities traded. Also, the stock

market is dominated by 33 brokerage firms, of which four account for 40% of total trading. About 40% of average daily trading is dominated by trading in the shares of 5 companies. These inadequacies significantly hinder the development of pension and mutual funds, the restructuring of enterprises and privatizations.

39. ***Bond Markets.*** Mexico's private bond markets—which had been attractive to international investors prior to the *peso* crisis—have since tumbled and virtually dried up. While the main reasons for this situation are to be found in inflation and interest rate uncertainties, they have also been compounded by structural problems, including the existence of multiple interest-rate bases (dollar, inflation linked, and nominal). Public debt management in the past was dominated by the pursuit of very short-term goals leading to large year-to-year fluctuations in interest rates. Also, the way public debt has been issued has not helped to create or maintain a full interest-rate spectrum, thereby hampering the development of private markets in interest-bearing securities. A private pension fund system would greatly enhance the development of the medium and long-term bond markets.

40. **Bank Group Strategy - Financial Institutions and Markets.** Building upon the advisory services it has thus far extended on ***pension reforms***, the Bank will encourage the formulation of an appropriate regulatory strategy. As it has done over the past year, IFC will continue to assist the Bank in remedying specific deficiencies of the regulatory framework. It will play also an institution-building role in private sector pension management companies and act as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable technical partners.

41. Regarding ***housing finance***, the Bank Group will focus its support on three broad areas. *First*, the Bank will assist the Mexican authorities in articulating long-term national housing priorities and policies. *Second*, the Bank will assist the Government in redefining the role of existing housing finance institutions. This assistance would extend to formulating and implementing plans for the restructuring, phasing out or privatization of existing public institutions. *Third*, the Bank would support this program with appropriate financial assistance, including selective provision of Bank guarantees to enhance the funding capability and functions of public housing finance institutions. To the extent that the concerned entities are restructured and reoriented within a private sector framework, IFC would play institution-building, technical assistance, and "honest-broker" roles in helping these institutions become established market-driven players in the secondary housing finance market.

42. The Bank Group's strategy for development of Mexico's ***equity markets*** will initially entail in-depth analysis of the causes of underutilized use of stock markets. Such assistance will also involve identifying necessary reforms to improve: (a) second-tier market trading systems; (b) company reporting and disclosure requirements; (c) institutional investor guidelines; and (d) the regulatory and technical requirements associated with derivatives markets, securities lending, short selling, margin accounts and minimum margin requirements. While the Bank will focus on the technical aspects of the regulatory environment, IFC will: (i) promote the development of more efficient non-bank financial service institutions, particularly in leasing and factoring, as well as a more efficient and effective over-the-counter (OTC) market; (ii) promote a strong venture capital and private equity industry; and (iii) provide equity underwriting facilities.

43. In ***debt markets***, the Bank will play a technical assistance role to help rationalize the structure of the public debt, remove interest-rate segmentation of debt securities markets and eliminate hindrances in the issuance of private debt securities and structured finance. IFC will support the development of orderly long-term credit markets through a two-pronged approach involving: (i) the selective use of bond underwriting facilities; and (ii) the promotion of markets for asset backed securities and the provision of equity finance, as well as technical assistance for asset securitization vehicles.

MEXICO PRIVATE SECTOR STRATEGY: FINANCIAL MARKETS DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Ensure retirement with dignity through improved competition and efficiency in pension fund management and lower government liability	• Replace PAYG system for public employees, transfer INFONAVIT contributions to AFORES, greater competition in mandated savings management between banks, mutual funds, insurers and AFORES, and greater accountability through independent directors, education, and performance comparison.	• Coverage of public employees; phaseout of INFONAVIT; entry of foreign managers, banks, mutual funds and insurance companies in retirement savings management; liberal investment guidelines to encourage long term risk-taking; modifications of certain minimum guarantee provisions.	• Contratural Savings Loans I, II, III.	• Policy advice including TA on regulations, investment management guidelines and corporate governance. • Institution-building through participation in AFORE.
Lower cost of and improved access to housing finance.	• Determine long term housing finance strategy, target population, cost and fiscal affordability. Derive a consistent role for public housing finance institutions (phaseout, privatization, expansion, etc.)	• Preparation of housing finance strategy, determination of affordable subsidy/resource transfer to the housing sector, action plan and implementation for FOVI, INFONAVIT, and other housing finance institutions.	• Housing Finance Loan. • Guarantee. • Policy Analysis.	• Policy advice. • Equity investment in mortgage insurance company. • Multi-line reinsurance corporation. • SOFOL (mortgage securitization).
Develop markets for mortgage- and asset-backed securities.	• Reform of registries and notaries, suasion by Central Bank for product standardization, sensible capital guidelines for ABS transactions, regulatory reforms to simplify vehicles, products, and transactions.	• Improved laws/regulations relating to notaries, registry, borrowers' consent, and issuance of typical ABS implemented across most states. Capital adequacy guidelines for ABS deals. Simpler and automatic approval of ABS issuance by banks and SOFOLs.	• Financial Infrastructure Loan. • Ongoing FTAL. • Policy Analysis.	• Policy advice. • Equity investment in asset securitization company.
Improve capacity to raise capital through stock markets, reduce cost of new capital, create exit mechanism for banks, government, and NAFIN.	• Increase number of listings; improve trading, liquidity, and self-regulation; targeted marketing to listable companies. Encourage listing of all large businesses (subsidiaries) rather than just the holding company. Rationalize investment guidelines of pension funds and insurance companies.	• Higher number of listings, market capitalization, and new equity offerings. Pension fund guidelines that encourage equity investment and liquidity.	• CEM on Savings.	

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Develop a long term domestic bond market and lower cost of capital.	• Develop a long term public debt issuance strategy. Homogenize government debt, extend yield curve, and create benchmark interest rate structure. Facilitate ABS/MBS markets. Allow institutional investors to develop bond markets.	• Adoption by market of uniform domestic interest rate benchmarks. Improved efficiency of bond markets in terms of new issuance, liquidity, maturity and interest rates.	• CEM on Savings	• Credit Lines for Board underwritings. • Asset backed securities.
Improve efficiency of and mobilization of savings by insurance companies and mutual funds.	• Permit them to manage mandated retirement savings. Greater harmonization/supervision of similar operations of mutual and pension funds. Increase number of independent directors. Greater foreign competition.		• CEM on Savings. • Ongoing FTAL. • Seminars, study tours.	• Policy advice. • Equity investment in domestic insurance firm, mutual fund company.
Improved financial market infrastructure.	• Improved bankruptcy code and process, adoption of GAAP standards, improvements in collateral law and registries, development of credit bureaus and rating services, technical upgrading of principal regulators.	• Implementation of legal and market reforms.	• TA and sector work to identify more specific measures. • FTAL (ongoing). • Financial Infrastructure Loan.	• Policy advice. • Equity investment in registry companies, rating agencies, credit bureaus.

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September 29, 1996 1:50 PM

3. Corporate Restructuring and Small and Medium Scale Industry

44. Extensive financial restructuring of the corporate sector represents a key determinant of economic recovery and future growth for the private sector in Mexico today. Financial restructuring is primarily required for the recapitalization of over-indebted companies which have become uncompetitive as a result of high financial expenses, and which are thus unable to raise new financing for adjustment and growth.

45. Mexico's *peso* crisis and ensuing recession also have created the need for important structural changes among Mexican corporates. Significant increases in the cost of imported and local inputs require the restructuring of installed capacity. Trade liberalization and increased international competition similarly require significant alterations in existing production facilities. While the devaluation of the *peso* has opened up new export markets, significant re-deployment of existing capacity must now take place to take advantage of new opportunities.

46. The need for operational and financial restructurings is particularly relevant in the SME sector. Even before the *peso* crisis, this sector lagged in modernization, product quality and production efficiencies. Lack of professional management in these largely family owned enterprises is a major problem. The crisis worsened the operating conditions across this sector, and in addition the banking system directed new credits towards the larger corporations.

47. Although critical for the success of the ongoing economic stabilization efforts, the corporate restructuring described above has not yet taken hold within the Mexican private sector. The main reasons are the illiquidity of the banking system, the associated unavailability of corporate credit and the inadequacy of Mexico's legal and regulatory framework. This has led to unprecedented "asset paralysis" within the private sector. While the Government has engaged in several debtor arrangements that have avoided a cascade of wholesale corporate defaults, the corporate expectations of further government sponsored assistance also have delayed negotiations between debtors and creditors.

48. **Bank Group Strategy - Corporate Restructuring.** Strengthening the competitiveness of the private sector forms the core of the Banks Group's strategic agenda in Mexico. This entails responding to both the immediate financial restructuring needs as well as to the systemic problems of low productivity growth, asset redeployment and technological obsolescence.

49. To achieve the above objectives, the Bank—in cooperation with IFC—will provide the Government with the technical support needed to remove the legal and regulatory obstacles to the corporate restructuring process. Through the ongoing ESW program and Financial Technical Assistance Loan (FTAL) it will seek to both reform the regulatory and legal framework for bankruptcy, liquidation and foreclosure, as well as develop the legal environment required to expedite infusion of capital and redeployment of assets. Additionally, through a new Financial Restructuring Loan (FSRL II), the Bank intends to support the development of financial infrastructure and enterprise restructuring. In the

medium term, the Bank is supporting the Government in promoting assistance through ESW work on industrial policy and a PSD Competitiveness project, involving promotion of quality standards at the enterprise level and a more client oriented R&D infrastructure.

50. Building upon its earlier financial restructuring experience in Mexico, IFC's strategy will focus on providing tailored assistance to individual Mexican corporates. While it is impossible to generalize about the specific components of each restructuring in which IFC will participate, each effort will seek to reduce unsustainable corporate debt and liquidity burdens while improving resource utilization. Incremental investments in fixed assets and inventories as well as organizational and technological changes would be implemented to improve cash flow and secure long-term viability. Long term debt and equity needs would be addressed to both recapitalize poorly structured balance sheets and to finance incremental investments in fixed and working capital.

51. Because small and medium enterprises have been the hardest hit by recent economic events, IFC will devote greater resources to identifying economically sound SMEs that need special support to weather the current crisis and prosper under NAFTA. Its efforts will center on a two-pronged approach involving both wholesale and direct assistance.

- *Wholesale Approach.* As part of its overall financial sector and capital market development activities, IFC will work with local financial intermediaries or will help establish specialized institutions capable of providing restructuring assistance to medium and smaller enterprises. On the equity side, it will support private equity/venture capital funds such as the imminent Mexican Partners Fund and the Fondo Chiapas, while on the lending side this will be achieved through credit lines for on-lending or the provision of leasing services such as the recently approved BANAMEX and PROBURSA operations. Leasing and factoring operations will also be supported as a means to broaden the availability of equipment and working capital finance for SMEs.

- *Direct Assistance.* IFC will increase its direct assistance to promising "second tier" companies that need restructuring, to improve their competitiveness and access long-term capital. IFC will favor those situations where financing needs cannot be met purely from local sources and where its presence is catalytic in persuading parties to agree to a successful restructuring package. In such direct transactions, emphasis will be placed on providing restructuring assistance to firms with whom IFC does not have existing investments.

- Although IFC's strategy will give priority to second tier companies, the special circumstances facing Mexico also dictate that it provide selective support to those larger companies which face unusual adjustment and investment financing constraints. Operations will be limited to those cases where IFC's support is essential to reaccess the international financial markets, or where innovative financial engineering or other forms of IFC value added and role are required to firm up project restructuring or project financing packages.

MEXICO PRIVATE SECTOR STRATEGY: CORPORATE RESTRUCTURING AND DEVELOPMENT FY 1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Promote debt workouts - return SMEs and other companies not covered by UCABE companies to a sound debt footing - at minimum government cost.	• Further develop the existing proposal for an RTC-type entity. Require it to farm out management of or auction off all loans and other assets in government hands to private sector. • Facilitate provisions of TA to enterprises in preparation of debt workout/reorganization plans.	• Non performing loan portfolio of Banking sector to be brought down to reasonable level after 3-5 years.	• Financial Infrastructure Loan.	• Direct financial and real restructuring support to individual companies. • Participation in SME venture capital funds. • Enterprise restructuring lines of credit involving local financial intermediaries..
Improve legal/regulatory framework for workouts and bankruptcy system.	• Focus on key legal/regulatory obstacles, such as asset-backed securities, secured transactions, etc. and related components of bankruptcy law .	• New legal frameworks with implementing regulations and institutional capacity to implement.	• FTAL (ongoing) • FSRL II.	• Participation in IBRD technical and advisory assistance.
Promote demand driven SME assistance.	• Backward linkage programs with larger firms to SME suppliers • Facilitate TA to enterprises to build financial management and general business skills.. • Improve technology level of enterprises through promotion of quality standards at enterprise level, in client-orientation of R&D infrastructure.	• More financial flows to SME sector, greater indirect participation in exports, more long-term subcontracting relations. • Number of enterprises with ISO-9000/14000 certification, productivity growth in technology intensive SME sectors.	• ESW on Industrial Policy • PSD Competitiveness • Additional support to CIMO (to support efficiency improvements in private companies). • Support of collective action (horizontal networking between enterprises).	• Participation in venture capital companies directed at SMEs. • Loan transactions with larger firms sponsoring financial/technical support programs to SME suppliers.. • SME credit lines to local financial intermediaries. • Equity and loan transactions involving individual larger SMEs.

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4. Infrastructure

52. Mexico has the weakest infrastructure of all countries in Latin America with similar income levels. Many of the observed infrastructure deficiencies could be overcome through innovations in regulation, competition, and private ownership, as in Argentina and Chile. The Mexican Government has until recently monopolized infrastructure and prevented private investment in a number of critical infrastructure services. This has compounded Mexico's infrastructure constraints especially since the *peso* crisis, as Mexico had to scale down pubic expenditure for infrastructure projects due to the overriding importance of maintaining fiscal discipline and correcting critical macroeconomic imbalances in the economy. Government ownership of infrastructure also has been a major reason underlying the weak development of the Mexican equity market.

Table 5
MEXICO
Infrastructure Comparators for Latin America

Country	Income (per capita) 1993 Dollars	Electric Power (kwh/person) 1992	Telephone Mainlines (per 1000 persons) 1992	Population with access to safe water 1991 (% of total)
Venezuela	$2,840	3,404	91	89
Brazil	$2,930	1,570	71	96
Chile	$3,170	1,646	94	86
Mexico	$3,610	1,381	80	78
Argentina	$7,220	1,670	123	64

Source: World Development Report (1995).

53. Having recently acknowledged its inability to meet all of Mexico's infrastructure needs, the Government is recognizing the importance of privately owned and managed infrastructure services. Reflecting a renewed commitment to accelerate the privatization of such services, the Government took a number of positive steps in that direction over the past year. A Privatization Commission was created and the Constitution was amended to allow for private and foreign investments in telecommunications, satellite communications, gas distribution and storage, ports and airports, and railways. Bids were issued and some 92 concessions were awarded involving the country's leading port facilities and ports, including VeraCruz, Acapulco and Altamira. Strategic decisions concerning market structure and regulations were also taken in the railway sector where 12 investor groups have since registered for concessions to be awarded later this year. The opening of Mexico's long-insulated natural gas market took a major step forward with the unveiling of 11 metropolitan centers—including the critical Mexico City market—to privately owned pipeline distribution. Privatization of telecommunications has proceeded well as witnessed by the eight concessions for long distance communications, and the 158 applications for paging services and paging channels approved by the Government since September 1995.

54. Notwithstanding the above achievements, the Government's intentions and direction remain unclear in the power, petrochemicals, water and sanitation sub-sectors, where privatization has fallen short of expectations. Besides a firm political commitment and the development of transparent legal and regulatory frameworks, a range of other issues—relating principally to market structures, concession design, public procurement

rules, government guarantees, and tariff policies—need to be urgently resolved if the pace of private investment in these infrastructure activities is to be accelerated and adequate levels of financing are to be mobilized. A summary of these particular sub-sectors follows:

- In ***power,*** private generation and co-generation have not yet taken place although reforms to allow for such privatization were introduced in 1992. Causes for this situation include a lack of political will to privatize CFE, the absence of incentives for private investments and, most importantly, difficulties encountered by prospective investors in reaching critical contractual arrangements with the National Electricity Commission;

- In ***water,*** despite the fact that Mexico remains critically short of basic water treatment and distribution systems, large scale privatization has been hampered by restrictive state regulations, inadequate water tariff structures, the generally poor financial condition of most municipalities and weak technical capacity of local water authorities;

- In ***petrochemicals,*** the privatization of Premix Petrochemicals—which had been announced in early 1995—has encountered serious opposition from the Mexican Congress and is presently stalled. Authorities originally involved in the sale of the targeted 10 chemical complexes have been overtaken by political pressures.

55. **Bank Group Strategy - Infrastructure.** The principal challenge for the Government in expanding private infrastructure services is to promote effective competition, especially in those sub-sectors that exhibit natural monopoly characteristics. Within this strategic framework, the Bank Group and the Government have come to share the common view that the greatest opportunity for improving the quality and efficiency of infrastructure services lies in increasing private sector participation within an appropriate regulatory environment and removing statutory restrictions on competition. There is also agreement that more efficient public investment and more effective operating modalities are required for those services which will not attract private financing (e.g. secondary roads, urban traffic management, and low income housing) or which are to remain within the purview of the public sector at least during a transitional period (e.g. electricity transmission and distribution, road maintenance, and urban transport infrastructure).

56. In line with the above, the Bank will seek to further improve the planning, financing, and management of public infrastructure projects in those geographical areas and among those services which are unlikely to attract private sector support in the short run. To correct existing regional development imbalances, such efforts will be predominantly oriented towards the Southern States and will involve the processing of a number of infrastructure projects in power transmission, road maintenance, rural roads, water systems and sanitation. As part of the ongoing Privatization Technical Assistance Loan (PAL), the Bank will also assist the Mexican authorities in further strengthening the

legal/regulatory framework for privatization. While the Bank is already extending such technical assistance to the National Water Commission and the Energy Regulatory Agency, its efforts will be further broadened to include telecommunications and transport agencies.

57. The Bank, with IFC assistance as appropriate, is proposing to review jointly with the Ministry of Finance the range of reforms that are necessary to attract private financing and the implications for public financing. This would include evaluating investment considerations and risk perceptions across the various sectors, focusing on sector specific policy and regulatory risks and the terms available in the financial markets for projects in Mexico. This assessment should reveal which sectors could benefit from policy reforms and which would continue to require direct public support. This proposed task would be reinforced by ongoing work on concession design, bidding strategies, and pricing policy which the Bank is currently supporting with the sectoral agencies through the Infrastructure Privatization Technical Assistance Loan. The Bank would be prepared to back up the Government—through its guarantee authority—where, despite appropriate sector reforms, Government related risks and project size and gestation would prevent the structuring of a complete financing package without Government guarantee.

58. Within this framework, IFC will work with private investors to expand its infrastructure pipeline, consistent with market demand and policy reforms, particularly in the sub-sectors cited above. IFC will undertake promotional work to ensure that investors and Government officials are fully aware of the range of products and services it offers. IFC will also assist the private sector in remedying some of the regulatory and financing constraints which have thus far held up the pace of privatization, mostly in the context of specific projects (as it is currently doing in the case of the Cancun water project in cooperation with Banobras). IFC can also advise Government officials, where appropriate, on the likely market response to alternative sectoral reforms.

59. IFC will also seek to complement and mobilize the resources of both local and foreign investors by offering the appropriate financing and capital market products to attract adequate equity investment as well as long term debt financing for the infrastructure sectors in Mexico. In this context, the establishment of one or more independently managed specialized funds to finance private sector infrastructure projects will be pursued. Bank support to these funds will be considered as appropriate. IFC will also seek to develop local capital markets to provide crucial domestic financing for infrastructure projects.

60. IFC's success in expanding and diversifying its infrastructure activities will depend heavily on the steps the Government will take to establish the regulatory framework required to attract domestic and foreign private investors in the sector. While the immediate opportunities lie in the sub-sectors where liberalization is the most advanced, IFC will also seek to initiate private power generation and assist in the privatization of water/sanitation and transport services as well.

61. *Petrochemicals.* When privatized, IFC will work with local and foreign investors to design sound project structures. IFC's role would be to give confidence to those partners (as many contractual arrangements on the input and output side will still be with Pemex) as well as to help in major funds mobilization.

Guarantees for Private Sector Participation in Infrastructure

Because of the newness of private participation across the infrastructure sectors in Mexico, there is a lack of precedents from successful projects on which lenders can evaluate credit and policy risks. Most projects proposed for private financing are of long gestation, requiring substantial amounts of long term debt, at maturities which far exceed those available in local financial markets and from international sources.Depending upon the market response to sectoral reforms, private financing may initially require some official support, particularly where Government remains directly involved (e.g. gas, power, water, municipal services), but also where new sector structures and regulations do not require direct government involvement but lack a proven track record (rails, airports, toll roads). The Bank, through its recently expanded guarantee authority, is prepared to back up Government if this leads to easier access to financing sources and better financing terms. At the same time, such support should be designed to minimize the government's risk exposure. The guarantee would be justified where the policy related risks are of a nature and projects of a size and gestation period that would prevent the structuring of a complete financing package even with support from other official financing and insurance agencies. The Bank would thus assume the role of guarantor of last resort, similar to its role as lender of last resort. Guarantees would be considered as a temporary measure to facilitate financing and execution of a few landmark transactions.

Based on discussions with prospective private sector lenders, judicious application of the Bank's guarantee authority will have a significant impact on direct investment in the infrastructure and energy sectors as: (i) commercial bank guarantee-covered resources can be additional to their normal country limits and (ii) guarantees are partial, leveraging more uncovered medium/long term debt than would otherwise be available. Guarantees could be developed on a project by project basis in those sectors deemed priority by the Government or on a sector-wide basis where a sectoral guarantee framework would be prepared and projects within the sector identified as eligible for guarantee coverage based on the attractiveness of the winning bidders offers.

A number of target sectors have now been identified in which Bank support in form of partial risk guarantees could be instrumental for attracting private investment.

- ***Gas Transport and Storage***. Distribution has been deregulated and opened for private participation, and third-party access was introduced in April 1996. However, PEMEX remains the monopoly producer, and, within most of Mexico except for the border areas, the monopoly source of supply in southern and central Mexico. On the users' side, Government entities, such as CFE, are among the primary anchor customers. Moreover, the regulatory framework is new and untested. The Bank has been closely monitoring developments in the gas sector and see good possibilities for the realization of several gas pipeline projects in the northern border states which could be candidates for Bank guarantee support, as well as concessioning Mexico City.

- ***Power.*** The regulatory framework for private participation has yet to be worked out. After further deregulation and demonopolization of CFE, at least in power production, there is good potential for private sector involvement and for guarantee support.

- ***Toll Roads and Other Transport***. Provided the Government implements a regulatory framework that is based on a more equitable risk sharing with private sector parties, the Bank envisions good potential for private toll roads and for Bank guarantee assistance in the future. There may be scope for other transport projects on a stand alone basis, for example with concessions negotiated specifically for the project, i.e. urban transport.

- ***Water Supply and Treatment, Waste Disposal***. These have proven to be the politically most sensitive sectors for privatization. The main issue is whether a regulatory framework can be designed and implemented that provides the basis for full cost recovery and adequate risk sharing between the public and private sectors.

MEXICO PRIVATE SECTOR STRATEGY: INFRASTRUCTURE DEVELOPMENT FY 1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Reduces infrastructure deficiencies which have posed a serious bottleneck to economic growth and international competitiveness by increasing private sector participation within an appropriate regulatory framework.	• Support the ongoing privatization process in telecommunications, ports, airports, railways, electricity and water and sanitation as well as secondary petrochemicals.	• Process completed in ports, railways , telecommunications. • Process underway in airports, water and sanitation, electricity and secondary petrochemicals.	• Sustained policy dialogue via: (i) supervision of PTAL; (ii) non-lending services; (iii) " just-in-time" ESW	• Equity and loan support to specific projects in privatized infrastructure sectors.
	• Support the development of legal, regulatory and financing frameworks that are transparent and predictable and would efficiently attract private investment.	• Strengthened energy (CRE) and water (CNA) agencies. • Establish transport and telecommunications regulatory agencies. • New instruments and investors resulting from pension reform.	• Sustained policy dialogue via: (i) supervision of PTAL and FTAL; (ii) non-lending services; and (iii) "just-in-time" ESW.	• Support for IBRD technical and advisory assistance.
	• Attract more non-recourse, private finance for the provision of infrastructure services.	• Planned project interventions in gas, electricity, ports and water and sanitation. • Possible restructurings in toll roads and airlines. • Concession designs for water and municipal services piloted at state and municipal levels. • Implement infrastructure finance facility.	• Advice on concession design. • Infrastructure Guarantees (FY98) for specific sectors/ projects. • Dialogue on infrastructure finance facility.	• Equity and loan transactions involving specific projects in privatized infrastructure sectors. • Promotion of new financing instruments and facilities. • Technical and/or financial support to specialized infrastructure financing facilities.

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5. Regional Development

62. Mexico's uneven regional development remains a serious obstacle to sustained and balanced private sector growth. Industrial activities are primarily concentrated in Mexico City and Monterrey and, to a lesser extent, within the triangle formed by these two cities and Guadalajara. Altogether the Central region—of which the Federal District is part—accounts for nearly 50% of GDP and 59% of commercial bank lending despite the fact that it covers only 8% of the national territory. Although a program intended to boost employment in the northern border area has in recent years led to the creation of a flourishing in-bond industry in the states of Baja California, Chihuahua, Coahuila, Sonora and Tamaulipas, overall government efforts to decentralize productive activities and foster more balanced regional development have thus far had modest results. With foreign investors seeking potential projects opened up by NAFTA, there are today renewed and promising opportunities to correct regional imbalances by promoting private sector development outside Mexico's major industrial centers. Given that the *maquiladora* sector is gradually moving away from the border areas, special emphasis should be also given—as part of these regionalization efforts—to identifying means to integrate more effectively the expanding *maquiladora* industries into the Mexican economy.

63. Although offering promising growth potential, a number of states severely trail the rest of the nation on basic social and economic indicators. This is particularly the case for the states of Chiapas and Oaxaca in southern Mexico, While rich in natural resources and climatic conditions, and strategically located next to Central America and the Gulf of Mexico, these states are the poorest in Mexico. GDP per capita is less than half the national average (US$1450 in Chiapas and US$1230 in Oaxaca in 1990, compared to US$3030 in Mexico), and social indicators are significantly lower than in the rest of the country. Population growth is more than double the national rate (4.5% in Chiapas vs. 2% for all of Mexico), infant mortality is about 50% higher, population per physician about double, and 62% of the population has not had elementary schooling compared to 29% for Mexico as a whole.

64. Social, economic and political conditions in the South have also deteriorated over the past decade. While the Mexican economy overall has grown, the real incomes of the Southern States have declined. In the northern region of the country, real expenditures were roughly constant from 1984 to 1989 for most households, then rose from 1989 to 1992, leading to positive growth between 1984 and 1992. In contrast, for the South there was a decline of 15-20% in the living standards of most households between 1984 and 1989, and then a further decline between 1989 and 1992 leading to an overall decline of about 30% between 1984 and 1992. The decline in the South held for almost all households.

65. Besides a lack of basic infrastructure, this unbalanced growth record can be largely attributed, on the one hand, to the different structure of the Southern States and, on the other hand, to the disappointing results of centrally controlled government programs implemented in these regions. These states are more dependent on agriculture than other regions and consequently have been relatively more afflicted by stagnating agricultural

prices in recent years. Highly fragmented land ownership and polarized political, social and economic structures have also resulted in few opportunities for advancement. Compounding this problem has been the fact that the federal interventions to assist the region --although significant in recent years[7]-- have failed to support sustained economic growth and employment. Recurrent problems in the selection, design, management, and implementation of centrally controlled government programs have led to disappointing results on the ground. The main contributing factors to this situation have been: lack of integrated approach to regional development, excessive sectoral fragmentation of investment projects, lack of resource allocation transparency and project accountability at federal and state levels, weak local project implementation and supervision capabilities, and limited public administration and institutional capacity at the state levels.

66. **Bank Group Strategy - Regional Development.** In line with the Government's regional development objectives, the Bank will support a special initiative in the Southern States of Chiapas and Oaxaca, the two poorest states in the country. This initiative aims to reduce the level of poverty in the region by stimulating the acceleration of private-sector led growth and improving the delivery and management of basic social services. Under this initiative, the Bank--in cooperation with--IFC will assist the Government in setting up a task force that will work with the local and foreign business community and civil society to identify and tackle specific constraints to the development of local productive private sector activities. Further, the Bank will support this endeavor in several ways, including (a) funding complementary infrastructure for private sector investment initiative and (b) providing technical assistance for public sector capacity building at state and local levels (see Box next page).

67. IFC will supplement the above Bank actions through targeted interventions in the region. Besides the structuring of a potential micro-enterprise project in Oaxaca, IFC will contribute towards alleviating the scarcity of long-term financing through funding of a small and medium scale enterprise credit line with one of the leading national banks represented locally. Additionally, it will help improve the private sector's access to equity finance by providing the Fondo Chiapas, a venture-capital fund investing in small and medium enterprises in the State of Chiapas, with the financial and technical assistance it presently needs to strengthen its long-term operational and institutional capabilities in that State. In association with Mexican corporates it will also seek to channel long-term financing in support of *ejidos* and indigenous communities participating in agricultural activities. Finally, with FIAS it will assist the State authorities in improving the local regulatory regime and incentives framework needed for the local private sector to operate on a competitive footing with the rest of the nation.

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7 Nationally, transfers from the federal government represent some 77% of consolidated expenditures of the states (85% and 93%, respectively, for Chiapas and Oaxaca). The majority of federal expenditure in Chiapas and Oaxaca are carried out under the Programa Nacional de Solidaridad (PRONASOL), a country-wide program that includes over 30 sub-programs.

The Southern States Initiative (SSI) Action Plan

The proposed SSI Action Plan consists of five broad elements:

- The Government will create a coordinating mechanism to establish a strategic plan to guide the development of the SSI, and to select, implement and monitor specific investments.
- The Government and the Bank will refocus ongoing projects relevant to the states of Chiapas and Oaxaca, to facilitate the immediate implementation of the SSI. Some eleven operations could be restructured, with a total value of approximately $360 million. In addition, the IDB has recently approved a program for small productive projects of $15 million.
- An agreement will also be reached to include specific components for the Southern States in new operations. Bank investment lending will be targeted to support infrastructure that complements private sector investments. Some eleven new investment operations will include specific components focused on Chiapas and Oaxaca.
- The Bank and the IFC, in partnership with the Government, will organize a task force to work with the business community and civil society to identify and tackle specific constraints to the development of productive activities.
- To ensure that funds are transferred to priority programs, civil society will participate in the design and implementation of the regional strategy, as well as the selection, financing and implementation of specific activities. These activities will be targeted geographically at areas with strong potential for the development of productive activities, and at priority areas, such as highly impoverished communities of small family farms.

MEXICO PRIVATE SECTOR STRATEGY: REGIONAL DEVELOPMENT FY 1997-99

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Foster productive activities in the least developed regions of the country.	• Work with government and private enterprise to identify and tackle constraints to development of productive sector in Southern States. • Decentralization of industrial promotion through (I) introduction of system of matching grants to cofinance state industrial programs and (ii) creation of information system to coordinate federal, state and local level promotion efforts. • Support private sector development in the State of Chiapas by: (i) improving the local investment climate, (ii) strengthening the capabilities of local financial institutions; (iii) increasing financial support to SMEs. • Provide microenterprise support in the State of Oaxaca.	• Actions initiated to address identified constraints to productive sector development in Southern States, relying predominantly on private initiative. • Strengthened fiscal and regulatory framework for private investments, including enforcement of land ownership and property rights. • Strengthening of Fondo Chiapas financial resources and project development capabilities. • Structuring of agribusiness project involving indigenous communities. • Development of microenterprise project with ADMIC.	• PHRD grant to: (i) identify constraints to private investment through workshops with private sector and government; (ii) support feasibility studies of public infrastructure identified to complement private investment. • Southern States Initiative (SSI), ESW. • PSD Competitiveness TA • Bank loan for state and municipal government. • Policy analysis on incentive framework.	• Technical assistance including IFC and FIAS. • Establishment of IFC-backed line of credit for SMEs. • Line of credit to leading financial intermediary. • Loan Transaction in Agribusiness.. • Private Venture Capital Fund (Fundo Chiapas) • Line of credit/equity participation in ADMIC.

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Annex 1.

IFC's Project Selection Criteria

The Group strategy leads to a number of IFC advisory and investment transactions as shown in the IFC instruments column in the matrices at the end of each strategy subset. These transactions have to be tested against generally applied criteria of Development Impact, IFC role and Profitablility (of the project as well as for IFC as an investor and lender).

- The Development Impact Test is straightforward: the whole thinking behind the strategy design has been geared to developmental impact enhanced through close cooperation between the Bank and IFC in the design and implementation phase. The ERR as part of the Development Impact Test will eliminate most commercially unviable transactions.

- The IFC Role Test is more complex and can actually force IFC to withdraw from some very developmental projects. The IFC role test is the test of "no alternative domestic or foreign financing available" and the proactive involvement of IFC in several ways. In Mexico, this proactive involvement will come in particular through:

  - Funds mobilization from the international syndicated loan markets on maturity terms only IFC can achieve.

  - Transfer of international technical and financial expertise and complex project design experience: demanded from IFC mainly by the medium scale sector. However, new financial products often need to be introduced first in larger corporations.

  - Partner of the foreign direct investor, who has not been exposed to Mexico in the past such as mid-size US, European and Japanese companies.

  - IFC as co-investor/lender in the newly privatized sectors joining domestic and foreign lead investors. IFC as generator of confidence is important for even strong partners due to untested regulatory environment. Role concentration in infrastructure, oil, petrochemicals, gas.

  - Agent of change in corporate governance actively including reporting and auditing, separation of the interest of owner and shareholder, opening of share capital to the public.

  - Creation of environmental awareness and assisting the client to meet the Bank Group environmental standards.

- The Profitability Test has to assure that IFC can achieve an adequate return on its equity investments and loans together with sound credit security arrangements. This requires first commercially viable transactions and second an adequate risk/reward profile for IFC. These requirements can often delay the project structuring process, especially in the newly privatized sectors. It is not only for IFC's protection, but also for establishing best practices for future financing from the market.

Lessons from
the Mexican Crisis

Attachment 2
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THE MEXICAN CRISIS: LESSONS FOR THE WORLD BANK

SUMMARY[1]

i. The Mexican crisis in 1994 presented a major challenge to policymakers in Mexico and the international financial community. A lot has since been written about the policy lessons for Mexico and other countries. The purpose of this internal review is to focus on the design and implementation of the World Bank's country assistance strategy: both in the lead-up to the crisis and the subsequent response. The objective is to draw lessons for the management of the Mexican program and, more generally, the role of the Bank in crisis situations.

ii. The basic conclusion of this review is that Bank staff did a good job prior to the crisis in highlighting the exchange rate problem. Given the political situation in Mexico, and genuine differences of view on how the macro situation would evolve, there was little more the Bank could have done to avert a crisis. Nor could we have accurately predicted the timing or size of the crisis. However, given the growing warning signs of potential trouble, the Bank should have been better prepared to respond. It took some time for the Bank to decide what its role should be. Once this was sorted out, the Bank's financial response was rapid. This signal of support, especially in the financial sector, was appreciated by the Mexicans. However, the Bank's performance on policy analysis and advice has been less satisfactory. Some of the much-needed analysis of the economic and social impact of the crisis is still to be completed. The main lessons and recommendations arising from this assessment—in terms of defining the Bank's role in crisis situations, gearing up to handle crises, and managing the crisis response—are summarized in paras. xii and xiii below.

The Bank's role before the crisis

iii. During the early 1990s, the Bank's program in Mexico was shaped by a strongly positive view of the Mexican strategy and the successful stabilization it had achieved. As private capital flows became more important, the lending program was scaled back and refocused away from adjustment lending toward overcoming longer-term development constraints (especially infrastructure and human resources). This lending and the Bank's policy dialogue were supported by an expanded economic and sector work (ESW) program in FY93-94 on the major development issues facing the Mexican economy. This culminated in a series of topical policy papers discussed with senior Mexican officials in mid-1994.

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[1] Based on a review commissioned by EXC and prepared by the Office of Senior Vice President, Development Economics, in mid-1996.

iv. In the area of *macro policy*, the Bank did good analytical work, which correctly identified that the overvalued exchange rate would become a major obstacle to growth, if Mexico did not take corrective action. However, like most observers, the Bank did not fully appreciate the shift in monetary policy during 1994 or the rapid change in the composition of debt (i.e., toward U.S. dollar-indexed *tesobonos*). These two factors turned out to be crucial determinants of both the occurrence and the severity of the crisis. In the *financial sector*, Bank staff highlighted weaknesses in the prudential regulatory system for banks and helped develop an action plan to improve bank supervision. However, in general, financial sector work was not a central element of the Bank's program in the pre-crisis period. This reflected a number of factors, including weak information on the health of the banking system, resistance from the Mexicans to Bank involvement in the financial sector, and an overly-optimistic view on what had been achieved by earlier reforms in the sector.

v. The exchange rate issue figured prominently in the Bank's policy dialogue with Mexican officials in the pre-crisis period. Although the Bank's warnings intensified during 1994, they went unheeded. There were several reasons for this:

- There were honest differences of opinion between the Bank and the GoM regarding the extent of overvaluation and the threat of an exchange rate crisis. These differences were exacerbated in the run-up to the 1994 elections, when the Mexicans wanted a buoyant economic situation and were reluctant to adopt deflationary policies.

- The IMF would normally be expected to take the lead on exchange rate issues. However, this did not seem to be high on the Fund's agenda in 1994 and, in the absence of an IMF program with Mexico, its own influence was rather limited during this period.

- The Bank's policy dialogue focused primarily on the exchange rate rather than on the overall consistency of macro policy or on second-best policy options more acceptable to the Mexicans. Stronger financial sector work might have also increased awareness of the vulnerability of the economy (via the banking system) to a crisis.

- In the absence of adjustment lending, the Bank lacked a formal vehicle for advice on macroeconomic management. Under these conditions, the dialogue might have benefited from greater use of world-class experts, respected by senior policymakers in Mexico, to work with them on developing a local consensus for policy change.

vi. Given staff concerns about the exchange rate in 1994, and the failure of the Mexicans to respond, why wasn't more attention given to revisiting the Bank's strategy in Mexico? Part of the answer obviously lies in the fact the Bank could not accurately predict the timing or size of the crisis. However, in addition, the motivation for the Bank to adjust was constrained by the fact that there was not a single perception of the Mexican

situation within the institution. The macro concerns of staff were not well-known to top management, who were debating whether or not to upgrade Mexico's creditworthiness rating in mid-1994. While both the Region and FRS argued against upgrading, and management agreed, there was little discussion of the short-term warning signals—already evident at this time—of a pending crisis. And, within the country department, many staff and even some managers working on sectoral issues were unaware of the macro concerns of their colleagues. As a result, their policy dialogue continued to be based on the assumption that the stabilization program would stay on track, with a smooth transition to longer-term growth and development. This inevitably sent mixed signals to the Mexicans, and diverted attention from looking at how to respond to a crisis situation (e.g., restructuring failed banks or providing social safety nets).

The Bank's response to the crisis

vii. Despite its pre-crisis warnings on the exchange rate, the Bank was ill-prepared when the crisis hit in December 1994. Insufficient effort was devoted to developing "what if" scenarios, examining alternative combinations of exchange rate, fiscal and monetary policies, and financing requirements. This was due in part to the poor flow of data, especially on reserve changes and *tesobonos* placements, which made it difficult to assess the risks ahead of time. While some information was available through informal channels and market sources, the Bank (and the Fund) should have made it clear that timely provision of official data is a prerequisite for an effective country relationship and assistance program. There was also too much willingness to accept the assertions of the Mexican authorities at face value (e.g., the Central Bank's assurance in April 1994 that they would not defend the exchange rate band if it became unsustainable, and that they were shifting to a monetary anchor). This reflected respect for the competence of the Mexican technical team, but there was probably also some element of "intimidation" from such a large and important client country.

viii. The Bank's initial response was also constrained by cautious signals from the top. Top management, including the President, believed that the Fund should take the lead in responding to the immediate liquidity crisis and the Bank should continue to focus on underlying structural and social issues. The hesitant response from the Mexicans, when asked what the Bank should do, tended to confirm this view. Combined with concerns over the level of Bank exposure in Mexico and the Region's preparedness to provide the policy underpinnings for a quick response, this led to a reluctance to consider another round of adjustment operations. As a result, the Region spent much of January examining possibilities for restructuring the portfolio with a view to creating headroom for new lending and to expediting disbursements under ongoing operations. The Region also shifted attention to getting the already negotiated Financial Sector Technical Assistance Loan to the Board.

ix. The pace picked up after a request from the U.S. Treasury for Bank assistance in the rescue operation it was orchestrating. Senior managers met on January 31, 1995 and agreed that the Bank should provide up to US$2 billion in the form of quick-disbursing loans to support reforms in the financial sector and basic social programs. Following this

decision, the Region moved ahead quickly with loan preparation and appraisal. Two of the three operations were ready by the end of May, but Board presentation was delayed until June 22 at the request of the Mexicans in order to benefit from the impending Bank decision on single currency loans. A third technical assistance loan for infrastructure privatization was approved in August. The commitment amounts were relatively small in the overall package of international support, and disbursements have been slower than expected. But, even so, the Bank's financial support was appreciated by the Mexicans, primarily as a signal of confidence in their approach to financial sector reform.

x. The advisory role of the Bank in response to the crisis was less satisfactory. As noted earlier, Bank staff were not well prepared in terms of how to respond to a crisis situation. Although the Bank had just negotiated a technical assistance loan for the financial sector, it lacked detailed knowledge and analysis of the banking system. Similarly in the social sectors, while the Region had worked on developing a pipeline of investment projects, this was of little use in a situation where the immediate priority was how best to cut the fiscal deficit while minimizing the impact on the poor, provide social safety nets for the poor and newly unemployed, and monitor the impact of the crisis on vulnerable groups. Some of the much-needed studies on the fiscal and financial impact of the crisis, and the longer-term impact of the crisis on the economy and social conditions, have not yet been completed. Of course, this is due in part to the inevitable short-run focus on managing the crisis itself. But it also reflects the run-down of technical resources deployed for ESW on Mexico (from an average of 11.2 staffyears in FY93-94 to 8.9 staffyears in FY95). Turnover of staff on the country team has also been high, with key departures on macro and financial sector work over the past year. By the end of 1995, there was only one country economist working full-time on the Mexican program; down from three in the early nineties.

xi. The Region was able to draw on staff resources from elsewhere in the Bank, especially the Central Vice Presidencies (CVPUs), to assist with the crisis response. For example, staff from FSD and DEC were involved in preparation of the Financial Sector Restructuring Loan. The Program of Essential Social Services and the work on infrastructure privatization also counted on the assistance of central staff. However, the Mexican experience also suggests that mechanisms for coordinating CVPU inputs, especially in a crisis situation, are far from perfect. Central staff often complain that they are called on at short notice, with little control over the overall design of the work or the final product. The Region, on the other hand, feels that central staff do not always share the urgency or commitment of people working in operations. Solutions to these problems lie beyond the scope of this review. However, it is to be hoped that they will be addressed by the ongoing work on professional networks. In addition, special Bankwide mechanisms may be needed to improve coordination in crisis situations.

Lessons and recommendations

xii. This review suggests the following issues to be addressed:

- vertical and horizontal communications within the Bank did not foster a shared perception of the Mexican situation prior to the crisis

- ESW was not adequately geared to thinking through the possible impacts of crises and the implications for the Bank

- the role of the Bank in crises was not clearly defined and communicated to the Region by top management, and no mechanism was in place to respond to crises

- follow-up on policy issues has been constrained by staff turnover and insufficient use of world-class experts to interact with the Mexicans

- the Bank's capacity to analyze financial sector issues and their links to the macro-economy remains inadequate

- the traditional focus of the Bank's debt monitoring on longer-term external debt is inadequate in view of the increasing integration of capital markets and the holding of shorter-term and domestic debt by foreigners

xiii. The main lessons and recommendations concern the Bank's role in crises, preparedness to respond, and response management and execution:

- *The Bank needs to clarify its role in crisis situations.* In practice, there are good reasons to stay actively engaged in the policy dialogue during these critical periods in a country's development. Depending on the circumstances, provision of financial assistance can either facilitate or distract from this role. Accordingly, it would be better to establish clear operating guidelines for such events, with triggers for action, rather than being pushed reluctantly into a delayed and *ad hoc* response. It is therefore recommended that a policy note on this issue, laying out alternative options for the Bank, be prepared for review by the Executive Committee. The note should clarify the preconditions for using adjustment lending in crisis situations (including how to handle exposure concerns) and suggest what new instruments, if any, are needed for liquidity financing and to sustain engagement on longer-term institutional reforms (especially in the financial sector).

- *ESW should analyze potential causes and consequences of crises.* Particular attention should be given to sources of vulnerability to external and domestic shocks, and the political determinants of the country's policy response. The IMF normally takes the lead in providing advice on macroeconomic matters. But the 1989 Concordat is clear that the Bank should also maintain its own analytical capacity in this area. Events in Mexico underscore the importance of the Bank's right to be heard, especially when our own views—on the urgency of the situation and the policy options—may differ from those of the Fund. In addition, the Bank brings a critical micro perspective to the macro dialogue,

including issues of financial sector reform and public spending on basic social programs. Prior work in these areas may help prevent a crisis and is essential to prepare a quick response once a crisis occurs.

- *The Bank needs to do a better job of monitoring vulnerable economies.* Macro surveillance is primarily the responsibility of the Fund. The Bank should establish clear procedures for accessing their enhanced surveillance of macro indicators. But, as evidenced by the Mexican situation, this cannot substitute for the Bank's own monitoring activities, including of external and domestic debt, financial sector performance and social conditions. Current efforts by FPI to put a Bankwide monitoring system in place—to provide an independent assessment of short-term developments and early warning signals to top management—warrant top priority. High-level lines of communication should also be established with the Fund, so that critical information can be exchanged quickly and confidentially.

- *Monitoring should be linked to contingency planning.* "What if" scenarios are useful for the dialogue with country officials on policy options. But they are also useful to consider options for the Bank's response to a crisis. We cannot predict a crisis any better than country officials or financial markets. But we can assess risks and make contingency plans. This should become standard practice for all high-risk countries identified by the Bankwide monitoring system. This will ensure that preparatory work is in place and that the Bank is ready to move fast if and when the crisis hits. This work should also feed into the country strategy. Where it involves sensitive information, the essential elements should be conveyed separately to Bank management and the Board, possibly through an oral statement.

- *The Bank must use its best people in responding to crisis situations.* There is no substitute for a cohesive and well-staffed country team. Credible interlocutors—able to gain the respect of their country counterparts and work alongside them—are essential. Institutional priorities should take precedence over personal preferences in staffing decisions, to ensure that the right people are working on the right issues. But even the best country teams cannot embody all of the expertise needed to respond effectively to crisis situations. Nor can one afford to assimilate this knowledge through time-consuming and costly review processes. CVPU staff and consultants must be fully integrated into the crisis response teams. Priority must be given to strengthening the Bank's financial sector expertise through recruitment, training and access to outside experts.

- *The Bank must establish clear lines of responsibility for crisis management.* Front-line responsibility obviously lies with Regional management and the country department. But Bankwide coordination is also essential to harness staff resources quickly, reach agreed positions on how the Bank will respond, and send clear signals to country authorities and world markets. For this, a

higher-level crisis response group, possibly chaired by the relevant Managing Director, is needed. With good monitoring and contingency planning, this group should be in place before the crisis hits or at least up-and-running immediately thereafter.

The World Bank
Washington, D.C. 20433
U.S.A.

SVEN SANDSTRÖM
Managing Director

October 4, 1996

Mark Malloch Brown
Shengman Zhang

AM Letter to Staff

Please see attached draft -- which is a reworking of the previous draft from Judith. Could I have your comments as soon as possible?

Thanks.

cc: Judith Maguire

(i) Conceptualisation
(ii) Deepening our
(iii) Sense Making

Practice applied

(1) Utilitarianism
(2) Moral Theories
(3) Justice Theory
(4) Interpretivist
(5) Public Discourse ethics Theory

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of 1818 Hyderab

Role of values is essential

— Who needs a theory of justice

Harald Baum — do we need a theory of justice? As a public policy instrum

Justice is a crucial concept

All public policy is dependent on moral principle behaviour

Justice -

Need norms of punishment families

Dialectical Process
Law making
BLINDNESS OF SUM
PLANNING -
SUM TOTALS
DISTRIBUTION

Female literacy as a region — more income

Social behaviour -

Values - Social decision

Harala - Tamil Nadu as the South
Vs North

Individuals as
Citizens as agents
not as patients

Utilitarianism
Theory
- Interpretivist
- Discourse ethics
theory

The World Bank
Washington, D.C. 20433
U.S.A

JAMES D. WOLFENSOHN
President

Draft
October 4, 1996

The 1996 Annual Meetings

Dear Colleagues,

I would like to share with you some personal reflections on the just-completed Annual Meetings. I am pleased to report that our shareholders gave strong endorsement to the Bank Group's efforts over the past year, and to our future direction. I credit this success to the hard work that all of you have done, and I thank you for it. I would like to express special appreciation to Shengman Zhang and the staff of the Joint Secretariat for the particularly smooth running of the Meetings this year, a point on which numerous Governors commented. This highly professional handling of the Meetings enhanced our credibility as a business-like, results-oriented institution.

In my Annual Meetings speech, I said that "We now have a committed and talented team -- staff and management -- working to improve the Bank Group and to prepare it for the next century. . . Our institution is on the move." I noted a number of our achievements over the past year: the IDA-11 agreement; forward movement on the Debt Initiative for the highly indebted poor countries (HIPC); expanded partnerships on a broad front; consolidation of our work on the private sector -- across the Bank, IFC, and MIGA; a strengthening of our work in post-conflict situations; and progress on our program of internal renewal. I also discussed our strategic agenda for the future, elaborating on four main themes:

- The need for *a new compact* between donors, investors, and recipients to ensure that sufficient resources go to the poor countries -- and to ensure that those resources are used efficiently and well. In this context, I raised the issue of corruption as a major obstacle to sound and equitable development -- and I committed the Bank Group to do everything we can to help excise this cancer.
- The need for a broader approach to development -- to better integrate the *social, cultural, and institutional issues* that underlie truly sustainable development. I particularly emphasized that without social advance, there can be no real economic advance.
- The need for a new global partnership to create and share development knowledge and make it a major driver of progress. The revolution in information technology offers us an unprecedented opportunity to capture the best global thinking and expertise on development, and make it accessible to our clients and partners -- to become, in effect, a *Knowledge Bank.* I believe that this will be of major significance for our work going forward.

- The need to continue our effort to revitalize the Bank Group -- to get closer to our clients, develop new products, ensure top quality in everything we do, and enhance our skills and ways of working. I noted that this would require some special up-front investment and that, as part of this effort, we were taking a fresh look at our finances and cost structure.

I concluded by emphasizing that we have a tremendous opportunity to invest in the future of the institution and, in the process, to invest in sustainable development. Based on the feedback I have received, I believe this point was well taken by our entire membership.

The most striking action to emerge from this year's Meetings was the endorsement and launch of the HIPC Debt Initiative. I am delighted by the unanimous support it received from our shareholders, and I would like to congratulate Nawal Kamel and her team on a magnificent job. The Governor for Denmark said that future generations may well look back on this Initiative as the building block which made it possible "for the poorest and most hopelessly indebted countries to exit from their debt problems."

While the Debt Initiative was perhaps the outstanding achievement of the 1996 Meetings, there were other important developments. There was consolidation of support behind the IDA-11 agreement. Vice President Gore, in his speech, underscored the importance of IDA to the world's poor and reaffirmed the U.S. commitment to IDA. The Development Committee also agreed to focus attention on building a stronger foundation for IDA's future at its next meeting in April.

We welcomed our 180th member country at these Meetings -- Bosnia-Herzegovina. We had an excellent meeting with Prime Minister Muratovic, who expressed his deep appreciation for the 14 projects which the Bank Group is already supporting to help his country recover from conflict.

Our African members launched a new program to build human and institutional capacity across the continent. This program has its roots in last year's Annual Meetings, when the African Governors requested our assistance in this critical area. After 12 months of hard work, they have presented an exciting proposal on how to proceed. The distinguishing feature of this program, in my view, is that it is African-led and African-owned -- with the Bank and other donors in a supporting role. The implementation of this African capacity building program can now begin, and I would hope to be able to report substantial progress by the time of next year's Meetings in Hong Kong.

Also for next year's Meetings, the Governor for Japan encouraged the Bank Group to develop further how we might better contribute to the promotion of private capital flows for infrastructure in the emerging economies -- reflecting the trust of a major shareholder in our capability in this area. The series of seminars at this year's Meetings, which effectively brought together the private sector with governments and non-governmental

organizations -- and which had a strong focus on infrastructure -- will help our thinking in this regard.

Beyond the constructive ideas that emerged from our discussions on these various issues, I was struck by our shareholders' continued, strong support for IFC and MIGA. During the Meetings, IFC launched its Extended Reach Initiative -- a $40 million fund that will put staff on the ground in 16 countries where IFC has never worked before and which face the toughest investment climate. Both the G-24 and the Development Committee also took note of MIGA's rapid growth and its need for an increase in capital.

All of this represents momentum and shareholder support on which we can build. In terms of immediate priorities over the next 12 months, they will be driven by the themes of my Annual Meetings speech:

- *First*, we will move forward with the IMF and our other partners to implement the Debt Initiative, beginning soon with the first few select countries.
- *Second*, we will also work with the IMF to build our capacity in helping our clients to strengthen their financial sectors, particularly to help address urgent problems in their banking systems.
- *Third*, we will work with any member country interested in designing national programs to address corruption.
- *Fourth*, we will intensify our efforts to better integrate the social, cultural, and institutional issues that underlie development into our country programs and strategies.
- *Fifth*, we will implement a strategy to give higher priority to the rural areas that are home to 70 percent of the world's poor -- a systemic approach that will address the interconnected dimensions of rural development.
- And *sixth*, we will work with others to build a global knowledge partnership, in which the Bank Group can play the role of "connector" -- to capture and disseminate development expertise and experience for our clients and partners.

These are not the only issues on which we will be working over the next year. But they can help to serve as yardsticks in measuring our performance against some specific objectives. One thing is clear: our success in achieving them depends on your commitment and hard work. What we have managed to accomplish over the past year is no accident. It has been done through the efforts of an extraordinarily dedicated group of people -- the staff and management of this institution. And I am proud of you. These Annual Meetings were a well-deserved recognition of our efforts over the past year. I am convinced that, working together, we can do even better in the year ahead.

James D. Wolfensohn

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Office of
CAIO KOCH-WESER
Managing Director
Operations, Policies & Programs

FACSIMILE TRANSMITTAL FORM

DATE: October 4, 1996

No. of Pages: 21
(including this page)

TO: Mr. James D. Wolfensohn

FAX #: (212)879-7767

FROM: Joanne Salop
Tel. Nos. (202)473-7499 (O)
(202)338-1155 (H)

MESSAGE:

The attached is the additional material for Monday's Mexico CAS meeting.

MEXICO
CAS
DISCUSSION

The World Bank
Washington, D.C. 20433
U.S.A

CAIO KOCH-WESER
Managing Director
Operations

October 4, 1996

Mr. James D. Wolfensohn

Jim,

Mexico CAS: Review Meeting

Here's the briefing package for the Mexico CAS review that you are chairing on Monday. The package contains:— the menu of issues that was distributed to participants; an annotated menu with commentary for your eyes only; and the minutes of the upstream review meeting that I chaired in July.

We have prepared the agenda as a menu, to allow broader coverage of the various issues. But with a one hour meeting, we will clearly not be able to cover them all. I would suggest the following selection:

Issues		Time Allocation
#1	Bank Group Priorities	15 minutes
#2 + #4	Participatory Dialogue	15 minutes
#5	Private Sector Strategy	15 minutes
#6 + #7	Risks	15 minutes

But other combinations are also possible.

We can discuss at your convenience on Monday.

Caio

A L L - I N - 1 N O T E

DATE: 04-Oct-1996 06:54pm

TO: See Distribution Below

FROM: Joanne Salop, EXC (JOANNE SALOP)

EXT.: 37499

SUBJECT: MEXICO: Joint Bank/IFC CAS Review with Mr. Wolfensohn
Agenda for the Discussion -- October 7, 4:30, E12-27

1. As previously announced in Ms. Horiguchi's September 18 EM, Mr. Wolfensohn will chair a meeting to discuss the Mexico Country Assistance Strategy (CAS) on October 7 at 4:30 p.m. in Conference Room E12-27. This is the first Bank Group CAS. It is to be discussed by Executive Directors on November 5.

2. The documentation circulated by Messrs. Adams and Burki on September 20 contains the CAS and Private Sector Strategy, which were prepared jointly by IFC and Bank staff. The package also includes (Attachment 2) the executive summary of the retrospective on the Mexico crisis that DEC prepared at the request of the Managing Directors, Operations.

3. A menu of possible discussion topics is attached. The menu items fall into three categories:

* priorities and products;
* relationships and partnerships; and
* risks and rewards.

The full menu -- which covers some issues that were discussed at earlier EXC and Regional meetings -- would clearly take more time to discuss than the one-hour allocated for the meeting. It is provided to allow the Chairman and participants to be selective in the issues they actually cover on Monday.

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Issues Menu for EMG Review of Mexico Bank-Group CAS
Chaired by Mr. Wolfensohn
October 7, 1996 -- Room E 12-27

I. Priorities and Products

1. The distribution of income in Mexico is highly skewed -- 34 percent of all Mexicans and 47 percent of Mexicans living in rural areas are poor. A root cause is the closed political, social, and economic system that prevents the poor from participating more productively in the economy. Against this background, the CAS identifies three themes -- growth, social development, and institution building -- as critical for reducing poverty. Within the three themes, it delineates the following priorities: sound macroeconomic policies; financial/capital market reform; efficient social sector spending; reduced regional disparities; improved legal and judicial frameworks; and effective decentralization.

(1) Does the EMG think that these are the right priorities for promoting poverty reduction in view of Mexico's development agenda and constraints? Is the proposed allocation of resources right -- about 70 percent of Bank resources for the growth theme and the remainder evenly divided between social development and institution building; and of IFC resources -- almost all for the growth theme?

(2) The sectoral distribution of Bank Group resources notwithstanding, the bottom line is that the Bank spends about $13 million per year on the Mexico program and IFC about $4 million. What are the benchmarks by which Bank and IFC managers want to be judged for use of these resources in Mexico in FY97 and FY98?

2. The Mexicans are very discerning clients who value high-quality analysis and work. Against this standard, the DEC report suggests that the Bank's ESW was too low in the 1994-95 period to support an effective policy dialogue. Resources have now been increased, but the balance between strategic products geared to informing public debate on key policy issues and technical products targeted to public sector officials is not spelled out in the CAS.

(1) Is the Government comfortable with our plans for greater outreach? Do we have the firepower to do it well and to contribute effectively to the needs of the sophisticated Mexican official "market"?

(2) Is IFC satisfied that the Bank's program of non-lending services is responsive to the constraints that it surfaces in its work with private businesses?

3. Bank portfolio performance has deteriorated since 1994. This is mostly due to the shrinking of matching funds because of the fiscal tightening in the wake of the peso crisis. But the increased decentralization to state and municipal governments of activities previously managed by the federal government is also a factor. That said, the environmental portfolio has been particularly badly hit, reflecting poor quality-at-entry because of hasty post-NAFTA preparations.

(1) Disbursements on investment lending are projected to rise sharply this year. Does this mean the problems have been solved?

(2) How will the Bank's enhanced field presence contribute to portfolio quality and results on the ground?

II. Relationships and Partnerships

4. Hacienda keeps a very close watch on Bank activities and contacts in Mexico -- even with other governmental groups but especially with NGOs. Meanwhile, it pays little attention to IFC's comings and goings.

(1) Is the Bank's "authorized" circle of interlocutors wide enough to be effective in pursuing our poverty-reduction mandate? Do we talk enough to state Governments, NGOs, community groups, and private business groups? With whom was the CAS discussed?

(2) With whom does IFC talk? Does IFC talk enough to Government, and particularly Hacienda? Who in Mexico is responsible for the overall climate for private sector development? With whom was the Private Sector Strategy discussed?

5. The CAS identifies five areas of collaboration between the Bank and IFC -- banking, capital market development, small- and medium-scale enterprise restructuring, infrastructure, and regional development. The environment, agriculture, and the energy sectors, while mentioned, are not singled out as major priorities for Bank Group collaboration.

(1) What are the environmental issues facing the private sector? Is this not an appropriate area for Bank Group collaboration and emphasis, especially in view of the difficulties the Bank's environmental portfolio are facing?

(2) What are the priorities for rural development in Mexico? Is agriculture -- research, extension, seed development, and so on -- not an area for private sector development? What is the Bank Group doing to help promote this?

(3) The energy sector -- power, oil & gas, and petrochemicals -- gets very little attention in the CAS, although it is slated to receive at least 20 percent of IFC investments in FY97. How is this related to the reform agenda in the energy sector, and the strategy for dealing with vested interests? What is the Bank doing in this area?

III. Risks and Rewards

6. Mexico has the largest Bank Group portfolio of all IBRD borrowers. (It has the largest IBRD exposure and the fourth largest IFC exposure.) With 12.1 percent of the IBRD portfolio, it is projected to remain above the Bank's 10 percent portfolio concentration guideline until the year 2001. Meanwhile, Mexico faces a very lumpy debt service profile, involving large net transfer payments to the Bank.

(1) Should we do more to help Mexico even out its payment profile by increasing the share of quick-disbursing lending above the planned 22 percent over the FY97-99 period?

(2) Or is reaching the 10 percent portfolio concentration guideline by 2001 of overriding importance?

7. The CAS is bullish on the near-term outlook.

(1) What is the downside, and the probability of its occurrence?

(2) Are we ready to move quickly if the need arises? Are we comfortable with the implications for exposure and portfolio concentration?

(3) If the financial sector crashes again, what will we do? In such an event, how will our current efforts to help reform the sector be judged?

This contains the same menu of issues that is being circulated to meeting participants. *It is annotated by commentary in boxes — to provide additional thoughts and information that is not being distributed to others.*

MENU OF ISSUES FOR EMG REVIEW OF MEXICO BANK-GROUP CAS CHAIRED BY MR. WOLFENSOHN OCTOBER 7, 1996 — ROOM E12-27

I. Priorities and Products

1. The distribution of income in Mexico is highly skewed — 34 percent of all Mexicans and 47 percent of Mexicans living in rural areas are poor. A root cause is the closed political, social, and economic system that prevents the poor from participating more productively in the economy. Against this background, the CAS identifies three themes — growth, social development, and institution building — as critical for reducing poverty. Within the three themes, it delineates the following priorities: sound macroeconomic policies; financial/capital market reform; efficient social sector spending; reduced regional disparities; improved legal and judicial frameworks; and effective decentralization.

(1) Does the EMG think that these are the right priorities for promoting poverty reduction in view of Mexico's development agenda and constraints? Does the EMG agree with the proposed allocation of Bank resources — about 70 percent for the growth theme and the remainder evenly divided between social development and institution building; and of IFC resources — almost all for the growth theme?

COMMENT: The growth theme in the CAS also includes rural development, labor markets, and environment, which collectively absorb almost 40 percent of Bank resources; so, in terms of "heavy metal" growth, the budgetary allocation is only about 30 percent. But the social development agenda covered in the CAS is mostly about human capital. While indisputably important, almost nothing is programmed for analyzing the social underpinnings and political economy of development and reform. *You may want to ask how we intend to put more emphasis on social and cultural issues — and their interplay with economic issues — in our project and analytic work.* Clearly these are central issues for poverty reduction in Mexico.

(2) The sectoral distribution of Bank Group resources notwithstanding, the bottom line is that the Bank spends about $13 million per year on the Mexico program and IFC about $4 million. What are the benchmarks by which Bank and

IFC managers want to be judged for their use of these resources in Mexico in FY97 and FY98?

COMMENT: The Mexico program is still in transition from the old culture, based on loan approvals and reports, to the new culture, based on results. *The message to Regional management and staff should be to steer towards large and tangible impact on the ground.* We need to do more for Mexico than finance projects. We need to alert the Mexicans to best-practices developed elsewhere, and to help and challenge them to implement those best-practices.

2. The Mexicans are very discerning clients who value high-quality analysis and work. Against this standard, the DEC report suggests that the Bank's ESW was too low in the 1994-95 period to support an effective policy dialogue. Resources have now been increased, but the balance between strategic products geared to informing public debate on key policy issues and technical products targeted to public sector officials is not clear.

(1) Is the Government comfortable with our plans for greater outreach? Do we have the firepower to do it well and to contribute effectively to the needs of the sophisticated Mexican official "market"?

COMMENT: Potentially our outreach efforts can be very helpful to the Government in informing public debate about the lessons of other countries in grappling with the issues that Mexico is now facing. But it will require a true partnership between Hacienda and the Bank based on trust — and on confidence in the Bank's judgment and ability to deliver quality products. *The Mexico program has staffed up somewhat. But we are not there yet in terms of world-class people. External recruitment will be needed to service this and other high-end "markets".*

(2) Is IFC satisfied that the Bank's program of non-lending services is responsive to the constraints that it surfaces in its work with private businesses?

COMMENT: This is the *quid pro quo* of getting IFC to focus more on development impact: *The Bank should listen more to the concerns on the enabling environment that IFC picks up in the private sector, and reflect these concerns in analytic work and the policy dialogue.*

3. Bank portfolio performance has deteriorated since 1994. This is mostly due to the shrinking of matching funds because of the fiscal tightening in the wake of the peso crisis. But increased decentralization to state and municipal governments of activities previously managed by the federal government has also been important. That said, the

environmental portfolio has been particularly badly hit, reflecting poor quality-at-entry because of hasty post-NAFTA preparations.

(1) Disbursements on investment lending are projected to rise sharply this year. Does this mean all the portfolio problems have been solved?

(2) How will the Bank's enhanced field presence contribute to portfolio quality and results on the ground?

COMMENT: According to Bob Picciotto, even when the Mexico portfolio had been doing well, Mexico was at best an average performer; in his view, Mexico should be performing at the level of the East Asian countries. *We need to challenge the Mexicans to that level of performance.*

II. Relationships and Partnerships

4. Hacienda keeps a very close watch on Bank activities and contacts in Mexico — even with other governmental groups but especially with NGOs. Meanwhile, it pays little attention to IFC's comings and goings.

(1) Is the Bank's "authorized" circle of interlocutors wide enough to be effective in pursuing our poverty-reduction mandate? Do we talk enough to state Governments, NGOs, community groups, and private business groups? With whom was the CAS discussed?

COMMENT: *You may want to remind Regional management of the importance you attach to participatory CASs, so that your perspective can be conveyed to Hacienda.*

(2) With whom does IFC talk? Does IFC talk enough to Government, and particularly Hacienda? Who in Mexico is responsible for the overall climate for private sector development? With whom was the Private Sector Strategy discussed?

COMMENT: *You may want to suggest that it would be useful if there were a central focus for the sectoral dialogue in Hacienda.* This would give us an interlocutor on private sector as well as other key sectoral reform issues. Regional Management should raise this with the Mexicans.

5. The CAS identifies five areas of collaboration between the Bank and IFC — banking, capital market development, small- and medium-scale enterprise restructuring, infrastructure, and regional development. The environment, agriculture, and the energy

sectors, while mentioned, are not singled out as major priorities for Bank Group collaboration.

(1) What are the environmental issues facing the private sector? Is this not an appropriate area for Bank Group collaboration and emphasis, especially in view of the difficulties the Bank's environmental portfolio are facing?

COMMENT: *You may want to ask whether, in light of the NAFTA-associated environmental undertakings, this should not be a key issue for the Bank Group Private Sector Strategy.*

(2) What are the priorities for rural development in Mexico? Is agriculture — research, extension, seed development, and so on —not an area for private sector development? What is the Bank Group doing to help promote this?

COMMENT: Public sector involvement in research and extension is minimal in Mexico. Thus the opportunity is there for the private sector leading the way, as for example Pulsar is doing in Chiapas. *Shouldn't IFC be leading other investors into these areas in other locations?*

(3) The energy sector — power, oil & gas, and petrochemicals — gets very little attention in the CAS, although it is slated to receive at least 20 percent of IFC investments in FY97. How is this related to the reform agenda in the energy sector, and the strategy for dealing with vested interests? What is the Bank doing in this area?

COMMENT: The energy sector in Mexico, including oil and gas, power, and petrochemicals, has been little touched by the reform movement. PEMEX has a monopoly in the supply and distribution of oil, petroleum products and natural gas. While gas transmission has been open to private investors, the regulatory environment is untested and both gas supply and gas based electricity are under state monopolies. Under these conditions, investors are not rushing to invest in gas transmission. There are enormous inefficiencies within PEMEX and unless upstream investments are opened and downstream markets are liberalized, the economy will not benefit from foreign investments and efficiencies they can bring. Mexico is the only country in the world that does not allow private risk investments upstream. *Given the sector's importance in the economy, and the difficulty of the issues, you may want to say that greater attention in the Bank Group's Private Sector Strategy is warranted.*

III. Risks and Rewards

6. Mexico has the largest Bank Group portfolio of all IBRD borrowers. (It has the largest IBRD exposure and the fourth largest IFC exposure.) With 12.1 percent of the IBRD portfolio, it is projected to remain above the Bank's 10 percent portfolio concentration guideline until the year 2001. Meanwhile, Mexico faces a very lumpy debt service profile, involving large *net* transfers to the Bank.

(1) Should we do more to help Mexico even out its payment profile by increasing the share of quick-disbursing lending above the planned 22 percent over the FY97-99 period?

(2) Or is reaching the 10 percent portfolio concentration guideline by 2001 of overriding importance?

COMMENT: If the authorities are prepared to move on big-ticket policy areas, such as the energy sector, we should be prepared to postpone the return to 10 percent. The actual and projected net transfers and net disbursement numbers are:

	FY94	FY95	FY96	FY97	FY98	FY99
			(in millions of US$)			
Net transfers from Mexico to the Bank	917	1169	1039	53	1131	1535
Net Disbursements from the Bank to Mexico	-10	-110	12	927	-133	-523

7. The CAS is bullish on the near-term outlook.

(1) What is the downside, and the probability of its occurrence?

(2) Are we ready to move quickly if the need arises? Are we comfortable with the implications for exposure and portfolio concentration?

(3) If the financial sector crashes again, what will we do? In such an event, how will our current efforts to help reform the sector be judged?

COMMENT: *The Region should further develop the downside scenario presented in para 19 of the CAS, with a particular focus on the implications for the financial sector.* However, the analysis is not to be included in the CAS, but used for internal emergency preparedness.

Mexico CAS: Minutes of EXC Review

1. Mr. Koch-Weser chaired the upstream review of the Mexico joint Bank-IFC CAS on July 19, 1996 at 10:00 a.m. Attendees included: Messrs./Mmes. Frank, Burki, Picciotto, Baird, Rigo, Binswanger, Husain, Lafourcade, Salop, Wilton, Cracco, Dahlman, Klein, Mody, Pasquier, Porter, Sierra, Dinh, Qureshi, Sadaat, Soladay, Swannack-Nunn, Molnar, Puymbroeck, and Young (IMF). The discussion followed the attached agenda.

2. The Chairman said that the meeting was a "first" in two respects: (1) It was the first joint Bank-IFC CAS. (2) It was the first EXC upstream CAS review. He welcomed the inputs that had been provided by DEC, FPI, HDD, and SEC. Also, the documentation submitted by the Region had several innovative features, designed to help make the CAS a slimmer, more focused and strategic document. The Regional representatives said that the CAS set poverty reduction as the overarching objective, supported by a three-pronged development agenda: growth with stability, social development, and modernization of the state. They said that they were looking forward to guidance from the meeting on a number of points. The IFC representative said that cooperation between the Bank and the IFC had started long before the joint CAS; he looked forward to a deepening of the relationship through the joint CAS process and the preparation of the Private Sector Strategy that would form part of the final CAS package.

Social and Political Economy Underpinnings

3. The Chairman asked about the social and political-economy underpinnings of development and reform. A speaker said that Mexico's excellent Poverty Assessment had shown that social programs tended to be hijacked by local elites, who determined the composition of the social programs. In contrast to countries in Central America, where social funds reflected the poor's concerns, in Mexico participation was lacking. He concluded that the Bank needed to be careful lest we end up supporting "poverty-reduction" programs that did not reach the poor. The Region took this assessment further, noting that in some instances there was a "conflictual" relationship of mistrust between the poor and Government. Another speaker said that in his view the situation was not so difficult as suggested. In his experience, decentralization held the key to participation. He said that in Mexico, the states were highly corrupt, but the municipalities -- given their greater proximity to the people -- were more accountable to them; Mexico was implementing some meaningful decentralization to the local level in social/rural programs. He said that the finding that decentralization mattered was robust across countries; recent cross-country research had borne this out.

4. A speaker stressed the importance of agricultural growth for improving the situation of the poor. He said that exchange rate policy was critical here. The appreciation of the real exchange

rate that had occurred during the 1990s had more than offset the positive impact of the various agricultural programs that the Government had put in place. In his view a very positive result of the peso crisis was the large depreciation of the real exchange rate, which was now helping to revitalize agriculture. Responding to a question, he said that research showed that a competitive real exchange rate -- and the overall terms of trade -- were far more important to the rural poor than price stability per se. Another speaker cautioned that there was often little the Government could do to control the real exchange rate -- especially in the face of massive capital inflows (or outflows).

5. The Region asked for guidance on participation. The Government did not want participation in the CAS -- either by a wide circle of people in Government, or by a wider circle of people outside Government. This was the dilemma. If the Bank were to force public discussion, the results for the relationship could be disastrous. One speaker acknowledged that the CAS was virtually a public document; given that perspective, he could understand the Government's concerns about the CAS's containing in-depth political economy analysis. The Chairman emphasized that we in the Bank needed to do the analysis which had to underpin our strategy -- regardless of what was ultimately included in the final document that went to the Board.

Private Sector Development

6. Mr. Frank said that the CAS should not neglect the real economy, and that it would be important to explore the potential sources of growth in Mexico and how the Bank and IFC could help. He said the CAS should also define the Bank Group's roles vis-a-vis the private sector. Was it as a catalyst -- in which case we would be wanting to develop our guarantee products (for which another speaker indicated that work was underway)? Was our supporting privatization an important role? Was there an important role to support judicial reform (another speaker asked if the Government wanted Bank involvement) and the like? He said these issues should be considered in depth in the CAS's private sector strategy.

7. A speaker said that a critical issue for the private sector in Mexico was the banking sector -- particularly the elimination of liability insurance and the reduction of moral hazard. In his view, capital market reform, which had been highlighted in the documentation, was not very important; as a general matter, the links between capital market reform and increased savings rates were not well-established. Another speaker asked about IFC's credit lines -- for example the recent operation with Banamex. The IFC representative said that these were fully consistent with the Bank's program. The idea was to support small and medium-scale enterprises, which IFC could not reach with direct loans.

8. A speaker said that productivity growth in Mexico had been quite low over the past 40-50 years. He said that this was due to the political system: If you are on the right side of the political

system in Mexico you can't lose; whereas if you are on the wrong side, you can't win. Against this background, he suggested three issues for the CAS: (1) deregulation, particularly at the state and municipal level; (2) institutional issues -- for example, despite major trade policy reforms, trade was still impeded because of customs administration; and (3) a bail-out orientation that tended to subvert good-faith initiatives aimed at restructuring. He also said that the Bank should take a position on the energy sector. The Government was seeking the Bank's seal of approval for a large transmission investment, which would be partly financed by IDB. Regrettably, the policy package for the investment was a step backwards in terms of energy sector policy.

9. The Chairman said that other private sector issues included the special relationship between the U.S. and Mexican economies. However, time prevented a full discussion of this and other issues. Closure on the private sector issues would not be reached in this meeting. They would be taken up further at the meeting on the private sector strategy to be chaired by Mr. Frank.

Bank Role, Portfolio, and Partnership

10. The representative from FPI, who had circulated a note in advance of the meeting, said that Mexico was the Bank's largest client with outstanding DOD of $13.2 billion. He said that given that Mexico was pushing against the Bank's exposure guideline, we had little room to maneuver in the event of another crisis. He suggested three areas for further consideration in the CAS: (i) the external liquidity situation, because Mexico has large amounts of inflexible debt; (ii) the size of the lending program, in conjunction with current levels of debt service; and (iii) the upside and downside triggers, given that we are a small player in the Mexican market. The Chairman emphasized that the CAS would have to have a very strong risk section in view of the above considerations.

11. The Chairman asked about the Bank's role. What role does the Government want us to play? What role are we playing now? And what role should we be playing? The Region said that this was a very difficult set of questions; the reality was that the Government was quite diverse. Some only wanted us to be financiers, others wanted us to provide advice; almost no one wanted us to be talking to outsiders. The Region said that the Bank had very little leverage at the sectoral level -- since all financing went to the central government pool. From this perspective, some sectoral ministries saw the Bank as a bit of a nuisance, while others did value high quality technical and policy advice from the Bank.

12. One speaker said that the Mexicans were extremely demanding clients. The critical issue was to provide them with excellent analytic work and then they would work with us. Another speaker said that it was clear that the Mexicans wanted the best people, continuity, and loyalty (with staff working with them and not

writing grey covers for publication in Washington). A third speaker said that all this was true -- except for the energy sector, which was immune to good advice.

13. The Chairman asked whether we had the right mix of non-lending versus lending services. One speaker said that there were too many loans, and that this absorbed too much of the administrative budget. A better solution might be to have fewer operations -- although they could be of the same total amount of money -- with the savings spent on analytic services. The Region said that the administrative budget situation would continue to be very difficult even with a restructured program.

14. The Chairman asked about the portfolio's deterioration since 1994. The Region said that this was due to two factors: (i) counterpart funding had been reduced because of the fiscal tightening necessitated by the financial crisis; (ii) new initiatives for increased decentralization to the states and municipalities had meant that a whole new set of relationships had to be developed and would involve restructuring of the portfolio. A speaker said that even when the portfolio had been doing well, Mexico was at best an average performer; in his view, Mexico should be performing at the level of the East Asian countries. The Chairman said that the CAS should ensure feedback of current portfolio performance into the design and selection of new operations.

Chairman's Summing Up

15. The Chairman said he had found the upstream review useful. He said that the documentation submitted by the Region had facilitated a focused discussion on the key issues. In concluding, he made the following points:

* The CAS should be very strategic, based on a clear vision of Mexico's future and the dynamics for reaching it. It should not just summarize the problems and the solutions.

* It should reflect a good understanding of the nexus of the political economy of growth and poverty and to factor into our design the understanding of the power structure in Mexico so that we would be able to ensure that the money we put into the country had paid off. In the end we might not be able to include much of this material in the Board document but it would be essential for framing the dialogue and for strategy formulation.

* The CAS should make clear the role of the Bank in terms of our strategic interventions and how they would relate to the central government, state government, and municipalities and to the NGOs.

* On private sector development, the Chairman said we should come back to this in the context of the meeting that Mr. Frank would chair. But it was clear that the CAS would need to be

a very strong joint product and would need to cover guarantee instruments much more.

* The financial risk analysis would need to be a central element of the CAS -- particularly in light of the very large exposure and debt service payments, and the nature of the creditworthiness and crisis management issues that had been raised by FPI.

* Referring to the discussion of the appropriate mix of non-lending and lending services and the administrative budget, the Chairman said that it was a very "busy" lending program. He suggested that it be revisited using a different mix of products, with an enhanced role for non-lending services.

Mexico CAS -- Agenda for EXC Review

1. Social and Political Economy Underpinnings

* The distribution of income in Mexico is highly skewed. Thirty-four percent of the population is poor -- 47 percent in rural areas -- and the incidence of poverty has risen with the recent financial crisis. The CAS diagnostic matrix ascribes poverty to limited effectiveness of Government social programs, low economic potential in poor -- particularly rural -- areas, and inadequacies of the safety net. What is the strategy for improving the targeting and effectiveness of social programs and the safety net? What is the Region's rural development strategy? (The strategic matrix mentions ESW on agricultural rural development but does not specify what it is; also, proposed lending is limited.) How does the Chiapas initiative fit into the broader poverty reduction strategy?

* Underlying the skewed distribution of income is a political, social, and economic system that prevents the poor from participating in the economy. What are the key barriers and how do they relate to the Government's economic reform agenda? How is the Bank program supporting the reduction and elimination of those barriers? The CAS package refers to political reforms -- democratization, decentralization and the rule of law -- as major elements of the Government's agenda. Clearly these reforms -- by opening up the system -- will have important implications for the poor. What is the outlook for them? If these efforts fail, what would be the likely social consequences? How is the Bank addressing the decentralization issue and supporting legal reform?

* The Board has welcomed participatory approaches to CASs. But the cover memo describes the Government's reluctance to involve "outsiders" (whether in or out of Government). How should participation be approached in the next stages of CAS preparation given Government reluctance/concerns in this area?

2. Private Sector Development

* The Bank lending program has a large financial sector component. But ongoing analytic work requested by the Operations Committee has not yet established the appropriateness of that involvement. In the event that that analysis suggests the desirability of much less involvement, what avenues of support would the Region propose as an alternative? How does IFC's substantial support for credit lines fit into the overall strategy for financial sector reform?

* The CAS is being prepared jointly by the Bank and IFC, and the country program matrix spells out the proposed IBRD and IFC programs. Is there full agreement between IBRD and IFC staff on the role of the private vs. the public sector in Mexico and on

the proposed programs of the two institutions? What are the key sources of synergy in the strategy? There is no mention of guarantees; what role is foreseen for guarantees in the Bank program? What are Mexico's intentions on MIGA?

* Clearly Mexico's relationship with the U.S. economy -- especially with NAFTA -- is a critical strategic external factor. How will the risks and opportunities of this special relationship be treated in the CAS?

3. Bank Role, Program, Portfolio, and Partnerships

* The Board wants strategic differences between the Bank and the Government to be highlighted in the CAS. As noted above, there are clear differences with Government on the consultation process to be followed for the CAS, and on the degree of specificity of the proposed actions. What are the other areas of difference on strategy and approach? More fundamentally, what role would the Government like the Bank to play in Mexico? What role should we be playing? What role have we been playing?

* Non-lending services could play a strategic role in informing public debate in Mexico -- for example, on the implications of different policy options for the poor. While the CAS package discusses an expanded role for ESW, it does not address the latter's strategic role. How is ESW -- through judicious selection and dissemination of studies, workshops, and advisory services -- and broader public information services to be used to promote the reform agenda? What is/would be the Government's view of such efforts -- given its concern about keeping the dialogue with the Bank restricted to "insiders". What role is EDI playing in Mexico?

* Portfolio performance has deteriorated markedly since the onset of the crisis. The portfolio matrix suggests that this is due to the lack of counterpart funds. Is this the only issue? What lies behind the difficulty in the portfolio on the environment? Looking ahead, the pipeline of proposed operations is mostly rated "High Reward". What criteria have been used to make these assessments? Are they realistic in light of past performance?

* What are the key risk vulnerabilities of the Mexican economy over the short-term and the long-term? What is the maturity and currency composition of external liabilities and assets? Given that Mexico is already stretching the Bank's exposure guideline, how would the Bank respond to a new crisis? The CAS package discusses the Bank's base case lending posture, and Bank exposure: what would constitute the Bank's high/low case? What are the triggers for moving to the high/low case? What is IFC's exposure? How would IFC respond to an improvement/deterioration in the economy?

* The budgetary implications of the proposed strategy are not

spelled out. Is the ambitious program of services -- lending, non-lending, portfolio management -- that is proposed adequately funded, taking into account also the additional costs arising from the relocation to Mexico City?

* IDB's lending program is almost as big as the Bank's and we have parallel loans in the lending program. What are the areas of conflict with IDB? of duplication? of synergy?

Atsuko

Mexico: Joint Bank-IFC CAS Review

Monday, October 7, 1996
4:30 - 5:30 pm
E1227 Conference Room

Monday, 4 NOV 1996
4:30-6:30 pm

A L L - I N - 1 N O T E

DATE: 04-Oct-1996 06:54pm

TO: See Distribution Below

FROM: Joanne Salop, EXC (JOANNE SALOP)

EXT.: 37499

SUBJECT: MEXICO: Joint Bank/IFC CAS Review with Mr. Wolfensohn
Agenda for the Discussion -- October 7, 4:30, E12-27

1. As previously announced in Ms. Horiguchi's September 18 EM, Mr. Wolfensohn will chair a meeting to discuss the Mexico Country Assistance Strategy (CAS) on October 7 at 4:30 p.m. in Conference Room E12-27. This is the first Bank Group CAS. It is to be discussed by Executive Directors on November 5.

2. The documentation circulated by Messrs. Adams and Burki on September 20 contains the CAS and Private Sector Strategy, which were prepared jointly by IFC and Bank staff. The package also includes (Attachment 2) the executive summary of the retrospective on the Mexico crisis that DEC prepared at the request of the Managing Directors, Operations.

3. A menu of possible discussion topics is attached. The menu items fall into three categories:

* priorities and products:

* relationships and partnerships; and

* risks and rewards.

The full menu -- which covers some issues that were discussed at earlier EXC and Regional meetings -- would clearly take more time to discuss than the one-hour allocated for the meeting. It is provided to allow the Chairman and participants to be selective in the issues they actually cover on Monday.

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TO:	Richard Frank	(RICHARD FRANK)
TO:	Caio Koch-Weser	(CAIO KOCH-WESER)
TO:	Jessica P. Einhorn	(JESSICA EINHORN)
TO:	Sven Sandstrom	(SVEN SANDSTROM)
TO:	Akira Iida	(AKIRA IIDA)
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CC:	Andres Rigo Sureda	(ANDRES RIGO)
CC:	Atsuko Horiguchi	(ATSUKO HORIGUCHI)
CC:	Bernard Pasquier	(BERNARD PASQUIER)
CC:	Orsalia Kalantzopoulos	(ORSALIA KALANTZOPOULOS)
CC:	Yasmin Saadat	(YASMIN SAADAT)

Issues Menu for EMG Review of Mexico Bank-Group CAS
Chaired by Mr. Wolfensohn
October 7, 1996 -- Room E 12-27

I. Priorities and Products

1. The distribution of income in Mexico is highly skewed -- 34 percent of all Mexicans and 47 percent of Mexicans living in rural areas are poor. A root cause is the closed political, social, and economic system that prevents the poor from participating more productively in the economy. Against this background, the CAS identifies three themes -- growth, social development, and institution building -- as critical for reducing poverty. Within the three themes, it delineates the following priorities: sound macroeconomic policies; financial/capital market reform; efficient social sector spending; reduced regional disparities; improved legal and judicial frameworks; and effective decentralization.

(1) Does the EMG think that these are the right priorities for promoting poverty reduction in view of Mexico's development agenda and constraints? Is the proposed allocation of resources right -- about 70 percent of Bank resources for the growth theme and the remainder evenly divided between social development and institution building; and of IFC resources -- almost all for the growth theme?

(2) The sectoral distribution of Bank Group resources notwithstanding, the bottom line is that the Bank spends about $13 million per year on the Mexico program and IFC about $4 million. What are the benchmarks by which Bank and IFC managers want to be judged for use of these resources in Mexico in FY97 and FY98?

2. The Mexicans are very discerning clients who value high-quality analysis and work. Against this standard, the DEC report suggests that the Bank's ESW was too low in the 1994-95 period to support an effective policy dialogue. Resources have now been increased, but the balance between strategic products geared to informing public debate on key policy issues and technical products targeted to public sector officials is not spelled out in the CAS.

(1) Is the Government comfortable with our plans for greater outreach? Do we have the firepower to do it well and to contribute effectively to the needs of the sophisticated Mexican official "market"?

(2) Is IFC satisfied that the Bank's program of non-lending services is responsive to the constraints that it surfaces in its work with private businesses?

3. Bank portfolio performance has deteriorated since 1994. This is mostly due to the shrinking of matching funds because of the fiscal tightening in the wake of the peso crisis. But the increased decentralization to state and municipal governments of activities previously managed by the federal government is also a factor. That said, the environmental portfolio has been particularly badly hit, reflecting poor quality-at-entry because of hasty post-NAFTA preparations.

(1) Disbursements on investment lending are projected to rise sharply this year. Does this mean the problems have been solved?

(2) How will the Bank's enhanced field presence contribute to portfolio quality and results on the ground?

II. Relationships and Partnerships

4. Hacienda keeps a very close watch on Bank activities and contacts in Mexico -- even with other governmental groups but especially with NGOs. Meanwhile, it pays little attention to IFC's comings and goings.

(1) Is the Bank's "authorized" circle of interlocutors wide enough to be effective in pursuing our poverty-reduction mandate? Do we talk enough to state Governments, NGOs, community groups, and private business groups? With whom was the CAS discussed?

(2) With whom does IFC talk? Does IFC talk enough to Government, and particularly Hacienda? Who in Mexico is responsible for the overall climate for private sector development? With whom was the Private Sector Strategy discussed?

5. The CAS identifies five areas of collaboration between the Bank and IFC -- banking, capital market development, small- and medium-scale enterprise restructuring, infrastructure, and regional development. The environment, agriculture, and the energy sectors, while mentioned, are not singled out as major priorities for Bank Group collaboration.

(1) What are the environmental issues facing the private sector? Is this not an appropriate area for Bank Group collaboration and emphasis, especially in view of the difficulties the Bank's environmental portfolio are facing?

(2) What are the priorities for rural development in Mexico? Is agriculture -- research, extension, seed development, and so on -- not an area for private sector development? What is the Bank Group doing to help promote this?

(3) The energy sector -- power, oil & gas, and petrochemicals -- gets very little attention in the CAS, although it is slated to receive at least 20 percent of IFC investments in FY97. How is this related to the reform agenda in the energy sector, and the strategy for dealing with vested interests? What is the Bank doing in this area?

III. Risks and Rewards

6. Mexico has the largest Bank Group portfolio of all IBRD borrowers. (It has the largest IBRD exposure and the fourth largest IFC exposure.) With 12.1 percent of the IBRD portfolio, it is projected to remain above the Bank's 10 percent portfolio concentration guideline until the year 2001. Meanwhile, Mexico faces a very lumpy debt service profile, involving large net transfer payments to the Bank.

(1) Should we do more to help Mexico even out its payment profile by increasing the share of quick-disbursing lending above the planned 22 percent over the FY97-99 period?

(2) Or is reaching the 10 percent portfolio concentration guideline by 2001 of overriding importance?

7. The CAS is bullish on the near-term outlook.

(1) What is the downside, and the probability of its occurrence?

(2) Are we ready to move quickly if the need arises? Are we comfortable with the implications for exposure and portfolio concentration?

(3) If the financial sector crashes again, what will we do? In such an event, how will our current efforts to help reform the sector be judged?

Atanko

The World Bank
Washington, D.C. 20433
U.S.A

CAIO KOCH-WESER
Managing Director
Operations

October 4, 1996

Mr. James D. Wolfensohn

Jim,

Mexico CAS: Review Meeting

Here's the briefing package for the Mexico CAS review that you are chairing on Monday. The package contains:— the menu of issues that was distributed to participants; an annotated menu with commentary for your eyes only; and the minutes of the upstream review meeting that I chaired in July.

We have prepared the agenda as a menu, to allow broader coverage of the various issues. But with a one hour meeting, we will clearly not be able to cover them all. I would suggest the following selection:

	Issues	Time Allocation
#1	Bank Group Priorities	15 minutes
#2 + #4	Participatory Dialogue	15 minutes
#5	Private Sector Strategy	15 minutes
#6 + #7	Risks	15 minutes

But other combinations are also possible.

We can discuss at your convenience on Monday.

Caio

A L L - I N - 1 N O T E

DATE: 04-Oct-1996 06:54pm

TO: See Distribution Below

FROM: Joanne Salop, EXC (JOANNE SALOP)

EXT.: 37499

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Issues Menu for EMG Review of Mexico Bank-Group CAS
Chaired by Mr. Wolfensohn
October 7, 1996 -- Room E 12-27

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1. The distribution of income in Mexico is highly skewed -- 34 percent of all Mexicans and 47 percent of Mexicans living in rural areas are poor. A root cause is the closed political, social, and economic system that prevents the poor from participating more productively in the economy. Against this background, the CAS identifies three themes -- growth, social development, and institution building -- as critical for reducing poverty. Within the three themes, it delineates the following priorities: sound macroeconomic policies; financial/capital market reform; efficient social sector spending; reduced regional disparities; improved legal and judicial frameworks; and effective decentralization.

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2. The Mexicans are very discerning clients who value high-quality analysis and work. Against this standard, the DEC report suggests that the Bank's ESW was too low in the 1994-95 period to support an effective policy dialogue. Resources have now been increased, but the balance between strategic products geared to informing public debate on key policy issues and technical products targeted to public sector officials is not spelled out in the CAS.

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3. Bank portfolio performance has deteriorated since 1994. This is mostly due to the shrinking of matching funds because of the fiscal tightening in the wake of the peso crisis. But the increased decentralization to state and municipal governments of activities previously managed by the federal government is also a factor. That said, the environmental portfolio has been particularly badly hit, reflecting poor quality-at-entry because of hasty post-NAFTA preparations.

(1) Disbursements on investment lending are projected to rise sharply this year. Does this mean the problems have been solved?

(2) How will the Bank's enhanced field presence contribute to portfolio quality and results on the ground?

II. Relationships and Partnerships

4. Hacienda keeps a very close watch on Bank activities and contacts in Mexico -- even with other governmental groups but especially with NGOs. Meanwhile, it pays little attention to IFC's comings and goings.

(1) Is the Bank's "authorized" circle of interlocutors wide enough to be effective in pursuing our poverty-reduction mandate? Do we talk enough to state Governments, NGOs, community groups, and private business groups? With whom was the CAS discussed?

(2) With whom does IFC talk? Does IFC talk enough to Government, and particularly Hacienda? Who in Mexico is responsible for the overall climate for private sector development? With whom was the Private Sector Strategy discussed?

5. The CAS identifies five areas of collaboration between the Bank and IFC -- banking, capital market development, small- and medium-scale enterprise restructuring, infrastructure, and regional development. The environment, agriculture, and the energy sectors, while mentioned, are not singled out as major priorities for Bank Group collaboration.

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(3) The energy sector -- power, oil & gas, and petrochemicals -- gets very little attention in the CAS, although it is slated to receive at least 20 percent of IFC investments in FY97. How is this related to the reform agenda in the energy sector, and the strategy for dealing with vested interests? What is the Bank doing in this area?

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6. Mexico has the largest Bank Group portfolio of all IBRD borrowers. (It has the largest IBRD exposure and the fourth largest IFC exposure.) With 12.1 percent of the IBRD portfolio, it is projected to remain above the Bank's 10 percent portfolio concentration guideline until the year 2001. Meanwhile, Mexico faces a very lumpy debt service profile, involving large net transfer payments to the Bank.

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(1) What is the downside, and the probability of its occurrence?

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(3) If the financial sector crashes again, what will we do? In such an event, how will our current efforts to help reform the sector be judged?

This was prepared by Caio's staff & forwarded to you Fri night. It outlines ~~the~~ a suggested discussion of issues.

This contains the same menu of issues that is being circulated to meeting participants. *It is annotated by commentary in boxes — to provide additional thoughts and information that is not being distributed to others.*

MENU OF ISSUES FOR EMG REVIEW OF MEXICO BANK-GROUP CAS
CHAIRED BY MR. WOLFENSOHN
OCTOBER 7, 1996 — ROOM E12-27

I. Priorities and Products

1. The distribution of income in Mexico is highly skewed — 34 percent of all Mexicans and 47 percent of Mexicans living in rural areas are poor. A root cause is the closed political, social, and economic system that prevents the poor from participating more productively in the economy. Against this background, the CAS identifies three themes — growth, social development, and institution building — as critical for reducing poverty. Within the three themes, it delineates the following priorities: sound macroeconomic policies; financial/capital market reform; efficient social sector spending; reduced regional disparities; improved legal and judicial frameworks; and effective decentralization.

(1) Does the EMG think that these are the right priorities for promoting poverty reduction in view of Mexico's development agenda and constraints? Does the EMG agree with the proposed allocation of Bank resources — about 70 percent for the growth theme and the remainder evenly divided between social development and institution building; and of IFC resources — almost all for the growth theme?

COMMENT: The growth theme in the CAS also includes rural development, labor markets, and environment, which collectively absorb almost 40 percent of Bank resources; so, in terms of "heavy metal" growth, the budgetary allocation is only about 30 percent. But the social development agenda covered in the CAS is mostly about human capital. While indisputably important, almost nothing is programmed for analyzing the social underpinnings and political economy of development and reform. *You may want to ask how we intend to put more emphasis on social and cultural issues — and their interplay with economic issues — in our project and analytic work.* Clearly these are central issues for poverty reduction in Mexico.

(2) The sectoral distribution of Bank Group resources notwithstanding, the bottom line is that the Bank spends about $13 million per year on the Mexico program and IFC about $4 million. What are the benchmarks by which Bank and

IFC managers want to be judged for their use of these resources in Mexico in FY97 and FY98?

COMMENT: The Mexico program is still in transition from the old culture, based on loan approvals and reports, to the new culture, based on results. *The message to Regional management and staff should be to steer towards large and tangible impact on the ground.* We need to do more for Mexico than finance projects. We need to alert the Mexicans to best-practices developed elsewhere, and to help and challenge them to implement those best-practices.

2. The Mexicans are very discerning clients who value high-quality analysis and work. Against this standard, the DEC report suggests that the Bank's ESW was too low in the 1994-95 period to support an effective policy dialogue. Resources have now been increased, but the balance between strategic products geared to informing public debate on key policy issues and technical products targeted to public sector officials is not clear.

(1) Is the Government comfortable with our plans for greater outreach? Do we have the firepower to do it well and to contribute effectively to the needs of the sophisticated Mexican official "market"?

COMMENT: Potentially our outreach efforts can be very helpful to the Government in informing public debate about the lessons of other countries in grappling with the issues that Mexico is now facing. But it will require a true partnership between Hacienda and the Bank based on trust — and on confidence in the Bank's judgment and ability to deliver quality products. *The Mexico program has staffed up somewhat. But we are not there yet in terms of world-class people. External recruitment will be needed to service this and other high-end "markets".*

(2) Is IFC satisfied that the Bank's program of non-lending services is responsive to the constraints that it surfaces in its work with private businesses?

COMMENT: This is the *quid pro quo* of getting IFC to focus more on development impact: *The Bank should listen more to the concerns on the enabling environment that IFC picks up in the private sector, and reflect these concerns in analytic work and the policy dialogue.*

3. Bank portfolio performance has deteriorated since 1994. This is mostly due to the shrinking of matching funds because of the fiscal tightening in the wake of the peso crisis. But increased decentralization to state and municipal governments of activities previously managed by the federal government has also been important. That said, the

environmental portfolio has been particularly badly hit, reflecting poor quality-at-entry because of hasty post-NAFTA preparations.

(1) Disbursements on investment lending are projected to rise sharply this year. Does this mean all the portfolio problems have been solved?

(2) How will the Bank's enhanced field presence contribute to portfolio quality and results on the ground?

COMMENT: According to Bob Picciotto, even when the Mexico portfolio had been doing well, Mexico was at best an average performer; in his view, Mexico should be performing at the level of the East Asian countries. *We need to challenge the Mexicans to that level of performance.*

II. Relationships and Partnerships

4. Hacienda keeps a very close watch on Bank activities and contacts in Mexico — even with other governmental groups but especially with NGOs. Meanwhile, it pays little attention to IFC's comings and goings.

(1) Is the Bank's "authorized" circle of interlocutors wide enough to be effective in pursuing our poverty-reduction mandate? Do we talk enough to state Governments, NGOs, community groups, and private business groups? With whom was the CAS discussed?

COMMENT: *You may want to remind Regional management of the importance you attach to participatory CASs, so that your perspective can be conveyed to Hacienda.*

(2) With whom does IFC talk? Does IFC talk enough to Government, and particularly Hacienda? Who in Mexico is responsible for the overall climate for private sector development? With whom was the Private Sector Strategy discussed?

COMMENT: *You may want to suggest that it would be useful if there were a central focus for the sectoral dialogue in Hacienda.* This would give us an interlocutor on private sector as well as other key sectoral reform issues. Regional Management should raise this with the Mexicans.

5. The CAS identifies five areas of collaboration between the Bank and IFC — banking, capital market development, small- and medium-scale enterprise restructuring, infrastructure, and regional development. The environment, agriculture, and the energy

sectors, while mentioned, are not singled out as major priorities for Bank Group collaboration.

(1) What are the environmental issues facing the private sector? Is this not an appropriate area for Bank Group collaboration and emphasis, especially in view of the difficulties the Bank's environmental portfolio are facing?

COMMENT: *You may want to ask whether, in light of the NAFTA-associated environmental undertakings, this should not be a key issue for the Bank Group Private Sector Strategy.*

(2) What are the priorities for rural development in Mexico? Is agriculture — research, extension, seed development, and so on —not an area for private sector development? What is the Bank Group doing to help promote this?

COMMENT: Public sector involvement in research and extension is minimal in Mexico. Thus the opportunity is there for the private sector leading the way, as for example Pulsar is doing in Chiapas. *Shouldn't IFC be leading other investors into these areas in other locations?*

(3) The energy sector — power, oil & gas, and petrochemicals — gets very little attention in the CAS, although it is slated to receive at least 20 percent of IFC investments in FY97. How is this related to the reform agenda in the energy sector, and the strategy for dealing with vested interests? What is the Bank doing in this area?

COMMENT: The energy sector in Mexico, including oil and gas, power, and petrochemicals, has been little touched by the reform movement. PEMEX has a monopoly in the supply and distribution of oil, petroleum products and natural gas. While gas transmission has been open to private investors, the regulatory environment is untested and both gas supply and gas based electricity are under state monopolies. Under these conditions, investors are not rushing to invest in gas transmission. There are enormous inefficiencies within PEMEX and unless upstream investments are opened and downstream markets are liberalized, the economy will not benefit from foreign investments and efficiencies they can bring. Mexico is the only country in the world that does not allow private risk investments upstream. *Given the sector's importance in the economy, and the difficulty of the issues, you may want to say that greater attention in the Bank Group's Private Sector Strategy is warranted.*

III. Risks and Rewards

6. Mexico has the largest Bank Group portfolio of all IBRD borrowers. (It has the largest IBRD exposure and the fourth largest IFC exposure.) With 12.1 percent of the IBRD portfolio, it is projected to remain above the Bank's 10 percent portfolio concentration guideline until the year 2001. Meanwhile, Mexico faces a very lumpy debt service profile, involving large *net* transfers to the Bank.

(1) Should we do more to help Mexico even out its payment profile by increasing the share of quick-disbursing lending above the planned 22 percent over the FY97-99 period?

(2) Or is reaching the 10 percent portfolio concentration guideline by 2001 of overriding importance?

COMMENT: If the authorities are prepared to move on big-ticket policy areas, such as the energy sector, we should be prepared to postpone the return to 10 percent. The actual and projected net transfers and net disbursement numbers are:

	FY94	FY95	FY96	FY97	FY98	FY99
			(in millions of US$)			
Net transfers from Mexico to the Bank	917	1169	1039	53	1131	1535
Net Disbursements from the Bank to Mexico	-10	-110	12	927	-133	-523

7. The CAS is bullish on the near-term outlook.

(1) What is the downside, and the probability of its occurrence?

(2) Are we ready to move quickly if the need arises? Are we comfortable with the implications for exposure and portfolio concentration?

(3) If the financial sector crashes again, what will we do? In such an event, how will our current efforts to help reform the sector be judged?

COMMENT: *The Region should further develop the downside scenario presented in para 19 of the CAS, with a particular focus on the implications for the financial sector.* However, the analysis is not to be included in the CAS, but used for internal emergency preparedness.

Mexico CAS: Minutes of EXC Review

1. Mr. Koch-Weser chaired the upstream review of the Mexico joint Bank-IFC CAS on July 19, 1996 at 10:00 a.m. Attendees included: Messrs./Mmes. Frank, Burki, Picciotto, Baird, Rigo, Binswanger, Husain, Lafourcade, Salop, Wilton, Cracco, Dahlman, Klein, Mody, Pasquier, Porter, Sierra, Dinh, Qureshi, Sadaat, Soladay, Swannack-Nunn, Molnar, Puymbroeck, and Young (IMF). The discussion followed the attached agenda.

2. The Chairman said that the meeting was a "first" in two respects: (1) It was the first joint Bank-IFC CAS. (2) It was the first EXC upstream CAS review. He welcomed the inputs that had been provided by DEC, FPI, HDD, and SEC. Also, the documentation submitted by the Region had several innovative features, designed to help make the CAS a slimmer, more focused and strategic document. The Regional representatives said that the CAS set poverty reduction as the overarching objective, supported by a three-pronged development agenda: growth with stability, social development, and modernization of the state. They said that they were looking forward to guidance from the meeting on a number of points. The IFC representative said that cooperation between the Bank and the IFC had started long before the joint CAS; he looked forward to a deepening of the relationship through the joint CAS process and the preparation of the Private Sector Strategy that would form part of the final CAS package.

Social and Political Economy Underpinnings

3. The Chairman asked about the social and political-economy underpinnings of development and reform. A speaker said that Mexico's excellent Poverty Assessment had shown that social programs tended to be hijacked by local elites, who determined the composition of the social programs. In contrast to countries in Central America, where social funds reflected the poor's concerns, in Mexico participation was lacking. He concluded that the Bank needed to be careful lest we end up supporting "poverty-reduction" programs that did not reach the poor. The Region took this assessment further, noting that in some instances there was a "conflictual" relationship of mistrust between the poor and Government. Another speaker said that in his view the situation was not so difficult as suggested. In his experience, decentralization held the key to participation. He said that in Mexico, the states were highly corrupt, but the municipalities -- given their greater proximity to the people -- were more accountable to them; Mexico was implementing some meaningful decentralization to the local level in social/rural programs. He said that the finding that decentralization mattered was robust across countries; recent cross-country research had borne this out.

4. A speaker stressed the importance of agricultural growth for improving the situation of the poor. He said that exchange rate policy was critical here. The appreciation of the real exchange

rate that had occurred during the 1990s had more than offset the positive impact of the various agricultural programs that the Government had put in place. In his view a very positive result of the peso crisis was the large depreciation of the real exchange rate, which was now helping to revitalize agriculture. Responding to a question, he said that research showed that a competitive real exchange rate -- and the overall terms of trade -- were far more important to the rural poor than price stability per se. Another speaker cautioned that there was often little the Government could do to control the real exchange rate -- especially in the face of massive capital inflows (or outflows).

5. The Region asked for guidance on participation. The Government did not want participation in the CAS -- either by a wide circle of people in Government, or by a wider circle of people outside Government. This was the dilemma. If the Bank were to force public discussion, the results for the relationship could be disastrous. One speaker acknowledged that the CAS was virtually a public document; given that perspective, he could understand the Government's concerns about the CAS's containing in-depth political economy analysis. The Chairman emphasized that we in the Bank needed to do the analysis which had to underpin our strategy -- regardless of what was ultimately included in the final document that went to the Board.

Private Sector Development

6. Mr. Frank said that the CAS should not neglect the real economy, and that it would be important to explore the potential sources of growth in Mexico and how the Bank and IFC could help. He said the CAS should also define the Bank Group's roles vis-a-vis the private sector. Was it as a catalyst -- in which case we would be wanting to develop our guarantee products (for which another speaker indicated that work was underway)? Was our supporting privatization an important role? Was there an important role to support judicial reform (another speaker asked if the Government wanted Bank involvement) and the like? He said these issues should be considered in depth in the CAS's private sector strategy.

7. A speaker said that a critical issue for the private sector in Mexico was the banking sector -- particularly the elimination of liability insurance and the reduction of moral hazard. In his view, capital market reform, which had been highlighted in the documentation, was not very important; as a general matter, the links between capital market reform and increased savings rates were not well-established. Another speaker asked about IFC's credit lines -- for example the recent operation with Banamex. The IFC representative said that these were fully consistent with the Bank's program. The idea was to support small and medium-scale enterprises, which IFC could not reach with direct loans.

8. A speaker said that productivity growth in Mexico had been quite low over the past 40-50 years. He said that this was due to the political system: If you are on the right side of the political

system in Mexico you can't lose; whereas if you are on the wrong side, you can't win. Against this background, he suggested three issues for the CAS: (1) deregulation, particularly at the state and municipal level; (2) institutional issues -- for example, despite major trade policy reforms, trade was still impeded because of customs administration; and (3) a bail-out orientation that tended to subvert good-faith initiatives aimed at restructuring. He also said that the Bank should take a position on the energy sector. The Government was seeking the Bank's seal of approval for a large transmission investment, which would be partly financed by IDB. Regrettably, the policy package for the investment was a step backwards in terms of energy sector policy.

9. The Chairman said that other private sector issues included the special relationship between the U.S. and Mexican economies. However, time prevented a full discussion of this and other issues. Closure on the private sector issues would not be reached in this meeting. They would be taken up further at the meeting on the private sector strategy to be chaired by Mr. Frank.

Bank Role, Portfolio, and Partnership

10. The representative from FPI, who had circulated a note in advance of the meeting, said that Mexico was the Bank's largest client with outstanding DOD of $13.2 billion. He said that given that Mexico was pushing against the Bank's exposure guideline, we had little room to maneuver in the event of another crisis. He suggested three areas for further consideration in the CAS: (i) the external liquidity situation, because Mexico has large amounts of inflexible debt; (ii) the size of the lending program, in conjunction with current levels of debt service; and (iii) the upside and downside triggers, given that we are a small player in the Mexican market. The Chairman emphasized that the CAS would have to have a very strong risk section in view of the above considerations.

11. The Chairman asked about the Bank's role. What role does the Government want us to play? What role are we playing now? And what role should we be playing? The Region said that this was a very difficult set of questions; the reality was that the Government was quite diverse. Some only wanted us to be financiers, others wanted us to provide advice; almost no one wanted us to be talking to outsiders. The Region said that the Bank had very little leverage at the sectoral level -- since all financing went to the central government pool. From this perspective, some sectoral ministries saw the Bank as a bit of a nuisance, while others did value high quality technical and policy advice from the Bank.

12. One speaker said that the Mexicans were extremely demanding clients. The critical issue was to provide them with excellent analytic work and then they would work with us. Another speaker said that it was clear that the Mexicans wanted the best people, continuity, and loyalty (with staff working with them and not

writing grey covers for publication in Washington). A third speaker said that all this was true -- except for the energy sector, which was immune to good advice.

13. The Chairman asked whether we had the right mix of non-lending versus lending services. One speaker said that there were too many loans, and that this absorbed too much of the administrative budget. A better solution might be to have fewer operations -- although they could be of the same total amount of money -- with the savings spent on analytic services. The Region said that the administrative budget situation would continue to be very difficult even with a restructured program.

14. The Chairman asked about the portfolio's deterioration since 1994. The Region said that this was due to two factors: (i) counterpart funding had been reduced because of the fiscal tightening necessitated by the financial crisis; (ii) new initiatives for increased decentralization to the states and municipalities had meant that a whole new set of relationships had to be developed and would involve restructuring of the portfolio. A speaker said that even when the portfolio had been doing well, Mexico was at best an average performer; in his view, Mexico should be performing at the level of the East Asian countries. The Chairman said that the CAS should ensure feedback of current portfolio performance into the design and selection of new operations.

Chairman's Summing Up

15. The Chairman said he had found the upstream review useful. He said that the documentation submitted by the Region had facilitated a focused discussion on the key issues. In concluding, he made the following points:

* The CAS should be very strategic, based on a clear vision of Mexico's future and the dynamics for reaching it. It should not just summarize the problems and the solutions.

* It should reflect a good understanding of the nexus of the political economy of growth and poverty and to factor into our design the understanding of the power structure in Mexico so that we would be able to ensure that the money we put into the country had paid off. In the end we might not be able to include much of this material in the Board document but it would be essential for framing the dialogue and for strategy formulation.

* The CAS should make clear the role of the Bank in terms of our strategic interventions and how they would relate to the central government, state government, and municipalities and to the NGOs.

* On private sector development, the Chairman said we should come back to this in the context of the meeting that Mr. Frank would chair. But it was clear that the CAS would need to be

a very strong joint product and would need to cover guarantee instruments much more.

* The financial risk analysis would need to be a central element of the CAS -- particularly in light of the very large exposure and debt service payments, and the nature of the creditworthiness and crisis management issues that had been raised by FPI.

* Referring to the discussion of the appropriate mix of non-lending and lending services and the administrative budget, the Chairman said that it was a very "busy" lending program. He suggested that it be revisited using a different mix of products, with an enhanced role for non-lending services.

Mexico CAS -- Agenda for EXC Review

1. Social and Political Economy Underpinnings

* The distribution of income in Mexico is highly skewed. Thirty-four percent of the population is poor -- 47 percent in rural areas -- and the incidence of poverty has risen with the recent financial crisis. The CAS diagnostic matrix ascribes poverty to limited effectiveness of Government social programs, low economic potential in poor -- particularly rural -- areas, and inadequacies of the safety net. What is the strategy for improving the targeting and effectiveness of social programs and the safety net? What is the Region's rural development strategy? (The strategic matrix mentions ESW on agricultural rural development but does not specify what it is; also, proposed lending is limited.) How does the Chiapas initiative fit into the broader poverty reduction strategy?

* Underlying the skewed distribution of income is a political, social, and economic system that prevents the poor from participating in the economy. What are the key barriers and how do they relate to the Government's economic reform agenda? How is the Bank program supporting the reduction and elimination of those barriers? The CAS package refers to political reforms -- democratization, decentralization and the rule of law -- as major elements of the Government's agenda. Clearly these reforms -- by opening up the system -- will have important implications for the poor. What is the outlook for them? If these efforts fail, what would be the likely social consequences? How is the Bank addressing the decentralization issue and supporting legal reform?

* The Board has welcomed participatory approaches to CASs. But the cover memo describes the Government's reluctance to involve "outsiders" (whether in or out of Government). How should participation be approached in the next stages of CAS preparation given Government reluctance/concerns in this area?

2. Private Sector Development

* The Bank lending program has a large financial sector component. But ongoing analytic work requested by the Operations Committee has not yet established the appropriateness of that involvement. In the event that that analysis suggests the desirability of much less involvement, what avenues of support would the Region propose as an alternative? How does IFC's substantial support for credit lines fit into the overall strategy for financial sector reform?

* The CAS is being prepared jointly by the Bank and IFC, and the country program matrix spells out the proposed IBRD and IFC programs. Is there full agreement between IBRD and IFC staff on the role of the private vs. the public sector in Mexico and on

the proposed programs of the two institutions? What are the key sources of synergy in the strategy? There is no mention of guarantees; what role is foreseen for guarantees in the Bank program? What are Mexico's intentions on MIGA?

* Clearly Mexico's relationship with the U.S. economy -- especially with NAFTA -- is a critical strategic external factor. How will the risks and opportunities of this special relationship be treated in the CAS?

3. Bank Role, Program, Portfolio, and Partnerships

* The Board wants strategic differences between the Bank and the Government to be highlighted in the CAS. As noted above, there are clear differences with Government on the consultation process to be followed for the CAS, and on the degree of specificity of the proposed actions. What are the other areas of difference on strategy and approach? More fundamentally, what role would the Government like the Bank to play in Mexico? What role should we be playing? What role have we been playing?

* Non-lending services could play a strategic role in informing public debate in Mexico -- for example, on the implications of different policy options for the poor. While the CAS package discusses an expanded role for ESW, it does not address the latter's strategic role. How is ESW -- through judicious selection and dissemination of studies, workshops, and advisory services -- and broader public information services to be used to promote the reform agenda? What is/would be the Government's view of such efforts -- given its concern about keeping the dialogue with the Bank restricted to "insiders". What role is EDI playing in Mexico?

* Portfolio performance has deteriorated markedly since the onset of the crisis. The portfolio matrix suggests that this is due to the lack of counterpart funds. Is this the only issue? What lies behind the difficulty in the portfolio on the environment? Looking ahead, the pipeline of proposed operations is mostly rated "High Reward". What criteria have been used to make these assessments? Are they realistic in light of past performance?

* What are the key risk vulnerabilities of the Mexican economy over the short-term and the long-term? What is the maturity and currency composition of external liabilities and assets? Given that Mexico is already stretching the Bank's exposure guideline, how would the Bank respond to a new crisis? The CAS package discusses the Bank's base case lending posture, and Bank exposure: what would constitute the Bank's high/low case? What are the triggers for moving to the high/low case? What is IFC's exposure? How would IFC respond to an improvement/deterioration in the economy?

* The budgetary implications of the proposed strategy are not

spelled out. Is the ambitious program of services -- lending, non-lending, portfolio management -- that is proposed adequately funded, taking into account also the additional costs arising from the relocation to Mexico City?

* IDB's lending program is almost as big as the Bank's and we have parallel loans in the lending program. What are the areas of conflict with IDB? of duplication? of synergy?

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The World Bank
Washington, D.C. 20433
U.S.A.

MICHAEL BRUNO
Senior Vice President
and Chief Economist

October 5, 1996

Mr. James D. Wolfensohn

Mexico CAS - EXCOM Review

Dear Jim,

Unfortunately, I will be in Japan addressing the OECF conference when this meeting is scheduled to take place. As you may know, DEC and I personally have been rather involved with Mexico over the last few months. We have followed the evolution of this CAS and I would like to take this opportunity to make a few observations for your consideration. Lyn Squire, who has worked extensively on Mexico, will attend the meeting on my behalf.

Let me begin with the lessons for the Bank from the Mexican crisis. The main findings from the study that we were commissioned to undertake are summarized in Attachment 2 of the CAS. They point to the need for Bankwide action to improve the monitoring of vulnerable countries and to clarify the Bank's role in crisis situations. Follow-up in both of these areas is now underway. In the case of Mexico, the main policy errors that led to the 1994 crisis have indeed been corrected and we share the view that a recurrence is unlikely in the near future. But Mexico is still on the Bank's watchlist of crisis-prone economies. We must stay on top of the macro situation (we did a better job than the Fund in anticipating the 1994 crisis) and have a clear plan of action to respond whenever pressures reemerge. To do this effectively, we must build a strong relationship of trust with the Mexicans, and bring the best expertise -- from both inside and outside the Bank -- to work with the Mexicans on their policy concerns.

Let me now turn to the CAS itself. I support the focus on the long term -- to build the framework and credibility for a wider policy horizon. However, as we have learnt from past experience in Mexico, it will be much more difficult to maintain growth over the medium term than to get a small boom after a big bust. Success with NAFTA is critical and it depends importantly on the dispersion of those *grupos* that now survive through protection and special access. In fact, some of these *grupos* are part of the financial system and their close relationship with the government and the party constrain the ability of the authorities to implement the kind of transparent, efficient and accountable rules and institutions we would like to see established. The institutions now in place are insufficient to give savers and investors the confidence needed to think big and with a view to the long-term. Short-termism will continue notwithstanding the "end of the crisis."

These aspects are recognized and are reflected in the CAS. However, the links between objectives and instruments need to be developed. In particular, how can a small player like the Bank be effective in the Mexican context? Where are our main points of influence and leverage? The Mexico Department is in transition and, expectedly, there will be changes in the program and modality of assistance over the coming years. Some of these are signaled in the CAS: the shift toward more non-lending services and the consolidation of the lending program into fewer projects.

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But much more work is needed to bring substance to these proposals and develop the capacity to deliver a "new-style" program in Mexico. For example, the shift toward ESW is justified in terms of the shift from project to sector lending (Par. 62). But we should recognize that high-quality analytical work has rewards on its own -- and may even be charged on its own. On the lending side, more than half of our lending over the next four years is tied on one way or another to the financial sector. But this may be putting too many eggs in one basket, given what we already know about the political-economy of reform in the sector.

The Bank does face a problem in having to "maintain its disbursements at a high level" (Par. 66). How much of that would be to repay the IMF and the US Treasury? Is there a sense that these transfers are inevitable, given the status-quo? If so, would it make sense to entertain a program which takes that as given? A program that then tries to focus on areas where our assistance has an impact, instead of searching for "high value lending vehicles"? Strategically, should we be thinking of a sharper partition between our financing contribution and our analytical-policy contribution? Then we could transfer resources more efficiently (at lower budget cost), based on past policy and on the credibility of new commitments. New analytical work would be focused on a few selected issues of interest to Mexico and with real capacity on our side. Hopefully, these issues would lead to new policies, and we could reasonably claim some influence though not necessarily conditionality.

Within this framework, we should continue to support projects focusing on social and poverty-related issues, notably in the rural sector. We appreciate your interest in the Southern States Initiative. Poverty in Chiapas, Guerrero and Oaxaca is extreme. Nevertheless, it seems that the government already spends the equivalent of one minimum wage per month per person in transfers and subsidies to these states (at least to Chiapas) with dismal results. It is not the case that "money is a problem." The issues, rather, seem to be political, cultural and organizational -- and very complex. All the evidence is that more money and "assistance" will not by themselves make an impact. The case for concentrated regional growth in Chiapas and Oaxaca has not been made. Are we sure that the answer to these problems does not lie in faster growth in Mexico overall? Does it not depend on the transition to more local autonomy, even at the village level? Is this something the current regime will tolerate let alone encourage?

I hope these comments and observations are useful.

With best regards,



Michael Bruno

cc: Messrs./Mmes Einhorn, Frank, Kaji, Koch-Weser, Sandstrom, Salop, Shilling, Horiguchi (EXC) Lindbaek (CEXVP) Iida (MIGAEX) Shihata (LEGVP) Zhang (SECVP) Malloch-Brown (EXTVP) Burki (LACVP) Adams (CLOVP) Lafourcade (LACMXC) Baird, Squire, Vieira da Cunha (DEC).

THE WORLD BANK/IFC/M.I.G.A.

OFFICE MEMORANDUM

DATE: September 30, 1996

TO: Distribution

FROM: Shahid Javed Burki, LACVP
Daniel Adams, CLOVP

EXTENSION: 82332
30665

SUBJECT: **Mexico: Joint Bank-IFC CAS - EXCOM Review**

1. Please find attached the draft Mexico CAS package. This package will be reviewed at an EXCOM meeting chaired by Mr. Wolfensohn that will be held on Monday, October 7, at 4.30 PM in conference room E-12-27. The Board date for the Mexico CAS is November 5.

2. The package includes the draft CAS and two major attachments: a Private Sector Strategy paper (PSS); and a paper summarizing lessons for the Bank based on an internal Bank review of the Mexican crisis.

3. The Mexico CAS is the first joint Bank-IFC CAS. The document integrates the Bank and IFC programs within a unified strategic framework, and the two staffs have collaborated closely in preparing it. The PSS, also prepared jointly, spells out in more detail key elements of the agenda for private sector development and Bank-IFC collaboration.

4. The Mexico CAS is also the first to be prepared under the new CAS procedures being piloted Bankwide. As part of these new procedures, it has benefited from an upstream EXC review chaired by Mr. Koch-Weser that was held on July 19. The PSS was reviewed at a meeting chaired by Mr. Frank on September 10. On the same day, the CAS package was discussed at a Regional Operations Committee meeting chaired by ourselves.

5. There is broad agreement with the Mexican Government on the development strategy and partnership with the Bank Group. Individual elements of the proposed country assistance strategy have been the subject of discussion with our Mexican counterparts for some time as part of our regular dialogue in respective sectors. We are treating the CAS as a 'living" document and are proposing further discussion in a retreat format in the near future where we hope to have a broader range of interlocutors on the Mexican side than has been the case so far.

6. We are also seeking a fuller, broader discussion of the PSS document that has been prepared as part of the CAS framework. The Government values IFC's past and present activities in Mexico, but also acknowledges that it itself could be more forceful in

promoting active partnerships and dialogue between IFC and the private sector. The PSS has not yet been the subject of much discussion with the private sector.

7. The Zedillo Administration so far has demonstrated a strong commitment to reform, both in adhering to a tough stabilization program in the face of a severe recession and in initiating significant institutional reforms. But, looking ahead, the development agenda outlined in the CAS will certainly test the Government's resolve in persevering with reform in circumstances that socially and politically will remain difficult, as well as the Government's implementation capabilities. One major challenge will be in maintaining the necessary restraint in macroeconomic policy in the face of popular and political pressures that are bound to intensify in the run-up to the general elections scheduled for July 1997. Another will be in pushing through critical structural and institutional reforms—those supportive of competition, the rule of law, and more open, decentralized and accountable government—that will inevitably face resistance from entrenched interests, especially from within the ruling party.

8. Mexico's prospective external financing requirements, including a hump in debt service during 1998-99, require that the Bank maintain a high level of disbursements over the next three years. The CAS proposes a Bank lending program of $5.5 billion over FY97-99. IFC expects to be able to increase its investments in Mexico to a total of about $1 billion over the same period, and expects to mobilize an additional $1.2 billion through syndications. Within its proposed lending program, the Bank plans a shift toward fewer, larger sector-based operations that focus on broader issues of sector policy and institutional framework and expenditure priorities. The Bank also plans to enhance significantly the role of non-lending services in its program, responding to client demand for more policy analysis and advice. These shifts toward more sector-type loans and more non-lending services will be mutually supportive and reinforcing, and should contribute to a substantial enhancement of our country policy dialogue.

9. The consolidation of the Bank lending program into fewer projects, together with improved efficiency in portfolio management that we hope to achieve, will release more of the Bank's administrative budget for non-lending services. Nonetheless, the present budgetary envelope for the Mexico program may prove inadequate to support the strengthening and upgrading of non-lending services that the CAS proposes, taking into account also the additional costs arising from the decentralization of the Bank's Mexico Department to the field. The budgetary implications of the country assistance strategy proposed in the CAS will need to be assessed carefully at the next budgetary review.

Distribution

Messrs.\Mmes. Wolfensohn, Einhorn, Frank, Kaji, Koch-Weser, Sandstrom, Salop, Horiguchi (EXC), Lindbaek (CEXVP), Iida (MIGEX), Shihata (LEGVP), Bruno (DECVP), Zhang (SECVP), Malloch Brown (EXTVP), Lafourcade, Dahlman, Qureshi, Swannack-Nunn (LAMXC), Paul, Cracco, Soladay (CLAD).

CAS

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WBG ARCHIVES

MEXICO
COUNTRY ASSISTANCE STRATEGY

FY97-99

(EXCOM REVIEW DRAFT)

SEPTEMBER 30, 1996

CURRENCY EQUIVALENT

Currency Unit	=	Mexico New Peso (MexN$)
US$1.00	=	MexN$7.54 (September 30, 1996)

ABBREVIATIONS AND ACRONYMS

AFORES	Administradoras de Fondos para el Retiro
EDI	Economic Development Institute
EFF	Extended Fund Facility
ESW	Economic and Sector Work
FOVI	Fondo De Operacion Y Financiamento Bancario a la Vivienda
FOVISSSTE	Fondo para la Vivienda de los Trabajadores del ISSSTE (Government Workers' Housing Fund)
GAB	General Arrangements to Borrow
IDB	Inter-American Development Bank
IDF	Institutional Development Fund
INFONAVIT	Instituto del Fondo Nacional de la Vivienda de los Trabajadores (National Workers' Housing Fund Institute)
NAFTA	North American Free Trade Agreement
NGO	Non-Governmental Organization
O&M	Operations and Maintenance
PROCEDE	Programa de Certificacion de Derechos Ejidales y Titulacion de Solares Urbanos
PROCAMPO	Programa Nacional de Modernisation Del Campo
PRODUCE	The Agriculture Investment Program
PROFORESTAL	Productos Forestales Mexicanos
PROSSE	Programa de Servicios Sociales Esenciales (Program of Essential Social Services)
PTAL	Privatization Technical Assistance Loan
SAGAR	Secretaria de Agricultura Ganadera y Desarrollo Rural
SME	Small and Medium Enterprises
SSI	Southern States Initiative

Mexico
Country Assistance Strategy

Table of Contents

I. Introduction

II. Economic and Social Context

III. Mexico's Development Agenda

IV. Economic Outlook and Risks

V. Mexico-Bank Group Development Partnership

VI. Instruments of Partnership

VII. Size of Bank Group Program, Country Risk and Creditworthiness

VIII. Collaboration with Other Organizations

IX. CAS Priorities and Success Criteria

X. Agenda for Board Consideration

Annexes

1. Bank Group Budget Matrix
2. Bank Portfolio Matrix
3. Bank Program of Lending and Non-Lending Services
4. Bank Fact Sheet
5. IFC Portfolio and Investment Program
6 Economic and Exposure Indicators
7. Mexico at a Glance

Attachments

1. Private Sector Strategy Paper
2. The Mexican Crisis: Lessons for the World Bank

I. Introduction

1. The FY97 Mexico CAS is the first to be prepared under the new CAS procedures being piloted Bankwide, and is also the first joint Bank-IFC CAS. It contains several innovations and new emphases:

- This CAS has been prepared with a view to making this document the main driver of the Bank Group country program, the central tool for our partnership with the client and for managing our resources in the service of client needs and priorities.

- The new CAS emphasizes a shift of focus from inputs—projects, reports—to outputs—results on the ground. It does this by: defining development objectives and strategies in key areas of Bank Group[1] support with greater clarity and specificity; and establishing benchmarks against which to measure progress. The specific instruments of support the Bank Group will deploy—lending, investments, guarantees, advice, portfolio management—and the related allocation of our budget are articulated within this more strategic and results-oriented framework.

- Bank and IFC programs are integrated within a unified strategic framework. A jointly prepared Private Sector Strategy paper (Attachment 1) spells out in more detail key elements of the agenda for private sector development and Bank-IFC collaboration.

- The CAS has been formulated through a more participatory process involving the client. It will be a "living" document, with the strategy, performance benchmarks, and our instruments of support evaluated, together with the client, against actual results and adapted as necessary.

- The development agenda and the Bank Group assistance strategy are defined in a more thematic framework, focused on three core themes of growth with stability, social development, and modernization of the state, all linked together by the overarching objective of this CAS—raising human welfare and reducing Mexico's high poverty.

- Improving portfolio quality is an emphasis that cuts across the proposed strategy, and will be supported by another important innovative dimension of the CAS—the decentralization of the Bank's Mexico Department to the field. This change will help improve project implementation; allow a closer, more proactive policy dialogue; and facilitate stakeholder participation. IFC also is strengthening its field office.

2. The previous (FY95) CAS focused on the causes of the 1994 financial crisis and the Bank Group's response in the short term. This CAS has a longer horizon, addressing the challenges Mexico faces over the next several years in its transition from crisis to healthy growth. It spans the remainder of the term of the Zedillo Administration, which

[1] "Bank Group" in this document refers to both IBRD and IFC while "Bank" refers only to the former.

ends in the year 2000. Lessons learned from the crisis, summarized in an accompanying paper (Attachment 2), underpin the strategy for the future.

II. Economic and Social Context

3. Mexico has responded to the financial crisis that erupted in 1994 with a strong adjustment program. The Government's program has comprised: a substantial tightening of monetary and fiscal policies; a large exchange rate adjustment through moving to a floating exchange rate regime; steps to deal with the severe distress in the banking system; initiation of further structural reforms (in social security, deregulation and privatization); and measures to strengthen the social safety net to cushion the impact on the poor. The Government program has been supported by a large international financial package.

4. Thanks to this adjustment effort, Mexico has made substantial progress in a relatively short period of time in restoring financial stability and creating conditions for a resumption of growth. Fueled by improved competitiveness resulting from the exchange rate adjustment, resurgent exports have drastically cut the current account deficit, correcting a fundamental imbalance underlying the 1994 financial crisis (Table 1). Inflation is on a downward course, dropping from a monthly peak rate of 8 percent in April 1995 to an average of 1.5 percent in recent months. The reduction of inflation has allowed the *peso* to stabilize and interest rates to decline, with the annual rate on the benchmark 28-day *cetes* falling from a peak of around 80 percent during the crisis to 25-30 percent in recent months. Improved investor confidence is reflected in progress in restoring Mexico's access to international capital markets, which has permitted Mexico to refinance some of its external obligations on more favorable terms and, together with the international assistance package, rebuild foreign reserves.

Table 1: Summary Economic Indicators

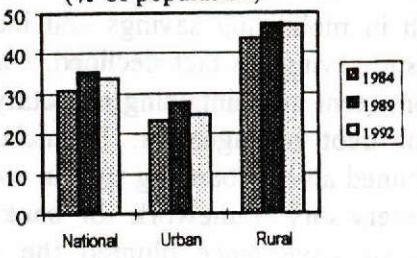
	Actuals		Est.	Projected				
	91-93	94	95	96	97	98	99	2000
Average Real Growth Rates %):								
GDP	2.4	3.5	-6.9	3.0	3.5	4.0	5.0	5.0
Exports (GNFS)	3.3	7.3	28.4	16.5	8.4	8.2	8.0	7.0
Shares of GDP (%):								
Gross domestic investment	23.7	23.5	19.4	19.2	20.6	21.9	23.7	24.1
Gross national savings	17.4	16.0	18.7	18.0	19.0	20.0	21.6	22.1
Non-financial public sector balance	0.4	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3
Current account balance	-6.3	-7.8	-0.3	-1.2	-1.6	-1.9	-2.0	-2.0
External debt	35.9	36.1	64.4	54.9	52.3	49.5	46.2	42.5
Other:								
Annual inflation (CPI, end of year) (%)	15.9	7.0	51.3	27.0	12.5	9.0	7.0	5.0
Real exchange rate (annual change, depreciation +) (%)	-7.6	3.8	45.2	-11.7	–	–	–	–
Gross intl. reserves/imports (mos.)	5.5	1.3	4.4	3.2	3.1	2.7	2.4	2.5
Debt service/ GNFS exports plus current transfers (%)	41.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4

5. The crisis and the adjustment it necessitated led to a sharp contraction in economic activity in 1995, with GDP falling by as much as 6.9 percent, domestic fixed investment plunging by 30 percent, and formal sector unemployment doubling. But a recovery is now under way, led by exports that continue to grow strongly and supported by an incipient revival in domestic demand as adjustment policies succeed in restoring financial stability. On present trends, GDP growth of around 3 percent is expected for 1996.

6. This improving outlook is contingent upon continued firm implementation of the Government's adjustment program. While investor confidence has recovered, it remains fragile and vulnerable to policy slippages and shocks. Also, the banking system problems remain a major concern. With the decline in interest rates and the upturn in economic activity, bank portfolios, afflicted by large non-performing loans, are beginning to stabilize. Government efforts in support of bank restructuring have helped strengthen bank capital positions and improve accounting practices and prudential controls. Nonetheless, the banking system remains fragile. Fiscal costs associated with the various Government bank support programs are currently estimated at around 9 percent of GDP in present value terms, and will be a source of pressure on an already tight fiscal position.

7. The recession in 1995 in all probability increased the incidence of poverty, from levels that were already high. High poverty rates have persisted nationally, but they are especially high in rural areas (Chart 1). The poverty picture is reflected in a highly unequal distribution of income; in 1992, the bottom 20 percent of the population received only 4.1 percent of income compared with 55.3 percent by the top 20 percent. Reducing these high levels of poverty and inequality is essential, not only on grounds of human welfare and equity but also to preserve social stability without which sustained economic progress cannot be achieved. The growth process needs to involve, and draw on the productive potential of, a broader mass of population and the lagging regions. Poverty is highly concentrated in the southern states, and it was rebellion in one of these states—Chiapas—that contributed to the economic instability in 1994. The recent rash of rebel activity originated in another poor southern state—Guerrero. Whatever may be the specific political factors associated with such unrest inimical to national stability, poverty provides a fertile ground for it. The rise in unemployment and the erosion of living standards caused by the recession are reflected also in a general increase in crime. Social discontent could mount if the still fragile economic recovery falters, raising the stakes for Mexico to consolidate and build on the recent economic gains.

Chart 1: Incidence of Poverty
(% of population)



Source: World Bank, *Mexico Poverty Assessment, 1996*

8. Political reforms—democratization, decentralization, rule of law—are a major element of the Zedillo Administration's agenda. These reforms will strengthen public institutions and are necessary for stronger, stable growth and more effective poverty reduction programs in the long run, but inevitably add to uncertainties in the short run.

President Zedillo faces strong resistance from entrenched interests, including from within the ruling party, to these reforms. Against this background, an important recent achievement is the enactment of a major electoral reform that supports the transition toward a more pluralistic political system. This reform will provide a more level playing field to political parties in the congressional elections scheduled for July 1997. Opposition parties are expected to strengthen their position in Congress in these elections. Mounting political pressures in the run-up to the elections will test the Government's determination to persevere with monetary and fiscal discipline. Creating a more democratic, open political system is important to another major thrust of the present Administration's institutional reform agenda—devolving more responsibilities to states and municipalities. Unaccompanied by effective democratization, decentralization runs the risk of decentralized authority being captured by powerful local elites.

III. Mexico's Development Agenda

9. The reforms of the mid- to late 1980s and early 1990s reoriented the economy toward market-led growth and international integration, and redefined private and public sector roles. Yet they did not deliver the expected rapid growth, poverty reduction and improvements in social welfare. Lasting macroeconomic stability also was not achieved, as the 1994 crisis makes clear. Why? Structural reforms, though significant, did not go far enough in mobilizing savings and increasing productivity, the fundamentals of growth. Domestic savings in fact declined. Macroeconomic management, though improving, was not consistent in maintaining monetary and fiscal discipline, external competitiveness, and prudent debt management. Financial stability and efficient resource allocation were undermined also by banking system weaknesses, reflecting a deficient incentive, regulatory and supervisory framework for banks. Public institutional weaknesses undermining the quality of governance blunted the edge of expenditure programs aimed at poverty reduction. How can Mexico do better? Analysis suggests the need to:

- pursue sound macroeconomic policies in a consistent and sustained manner, reducing Mexico's vulnerability to periodic financial crises;

- extend and deepen the structural reforms that Mexico has been implementing—opening up markets to true competition, increasing private sector participation in the economy, mobilizing domestic resources, reforming the financial system; and

- initiate new, second-generation reforms, with a focus on strengthening the institutional foundation for growth and development.

10. The central, overarching development objective is a broad-based improvement in the level of human welfare and reduction of Mexico's high poverty. This implies a development agenda with three core, interrelated themes: growth with stability; social development; and modernization of the state. Mexico's development strategy, articulated most recently in the National Development Plan 1995-2000 (the *sexenio* of the Zedillo Administration), captures this agenda well, emphasizing the same core themes. The Bank

Group agrees with the thrust of the Government strategy and the CAS outlines the development agenda, in common with the Plan document, within a framework defined by these three themes. The Country Strategy Matrix (Table 3) identifies the main performance issues in each of these thematic areas and outlines how the proposed development strategy would address the identified issues.

11. ***Growth with Stability***. Moving Mexico onto a higher and sustainable growth path is indispensable if serious inroads are to be made into Mexico's persistent and widespread poverty. A first priority is to consolidate the still fragile economic recovery. At the same time, reforms must continue that will support stronger growth in the medium term. Key elements of the agenda are:

- Maintaining fiscal and monetary discipline to underpin *macroeconomic stability*, together with an exchange rate policy that supports competitiveness.

- Strengthening the fundamentals of growth—*saving and productivity*. Key to mobilizing domestic savings to support higher investment will be: raising public savings, including through tax reform; and boosting private savings through successful completion of the pension system reform the Government has initiated, and sound development of financial/capital markets (especially rapid restoration of confidence in the banking system). Areas of emphasis in raising productivity will be: removing regulatory (trade, domestic and foreign investment) barriers to efficient private sector development, at federal and lower levels; fostering a competitive environment for small and medium-scale enterprises; strengthening infrastructure, especially through increased private investment; making labor markets more flexible and upgrading education and training; and improving the functioning of agricultural markets.

- Fostering longer-term sustainability of growth through improved *environmental management*, moving beyond the introduction of regulations to the promotion of necessary investments in environmental infrastructure and the development of institutions (national and local) and markets for sustainable development.

12. ***Social Development.*** Stronger growth is essential to reduce poverty and inequality, but programs targeted to the poor also are necessary. Poverty in Mexico has remained persistently high, especially in rural areas where the incidence of poverty is almost twice as high as in urban areas, indicating that the programs adopted so far have not been very successful. A two-pronged effort is needed for greater effectiveness:

- Better targeting and improving the quality of *basic social services*—education, health, nutrition, safety nets. At about 55% of federal programmable expenditure, social sector spending in Mexico is large. The main challenge is increasing its effectiveness and efficiency. Recent initiatives by the Government to better target food subsidy schemes, improve social safety nets for the rural poor, and restructure the *Solidaridad* program that supports basic economic and social infrastructure development

(including a major decentralization of the program, recently renamed *Programa de Bienestar*, to the municipal level) are important steps in that direction.

- Promoting in an effective and sustainable way *the productive sector in the poor areas*, especially the southern states, to expand income-earning opportunities for the poor and thereby break the vicious circle of poverty—through agrarian reforms, development of rural financial markets, stronger private sector and community (including women, indigenous people) participation in the development of productive activities (agriculture, forestry, rural industry), and provision of basic infrastructure.

13. ***Modernization of the State***. The agenda for reform in the coming years will be increasingly institutional in nature. An example is the financial sector. Past reforms focused on liberalization of controls. The next set of reforms must focus on strengthening prudential regulation and supervision, accounting and reporting standards, and bank management. Similarly, deregulation of controls on private investment and commerce—domestic and foreign—must be supported by legal and judicial reforms to provide a level playing field, ensure enforceability of contracts, and establish the rule of law. Such institutional reforms are essential to consolidate and make effective earlier reforms. In many countries, including Mexico, liberalization unaccompanied by timely institution-building contributed importantly to the banking system crises that developed. There are similar issues with respect to the machinery of government itself: the main problems with many public expenditure programs are not due to a lack of funding allocation but institutional deficiencies. Compared to earlier reforms, institutional reforms would be more complex and painstaking: for example, it is easy to tear up interest and credit controls but a lot harder to develop good regulatory and supervisory systems and train management and staff. The institutional agenda, accordingly, will have two main thrusts:

- Strengthening the *institutional underpinnings of markets* to ensure they function efficiently and equitably—institution-building in the financial sector; accounting, auditing, and reporting standards; commercial laws (property rights, bankruptcy, securitization); judicial reform.

- Modernizing *public administration* to improve the quality of governance and increase the effectiveness of public programs, e.g., improving the efficiency and transparency of the budget system, upgrading the civil service, and decentralizing responsibilities to state and municipal levels where that would improve service delivery—basic social services, local infrastructure—backed by steps to strengthen fiscal and institutional capacities and accountability at these levels.

IV. Economic Outlook and Risks

14. ***Base Case***. The next few years represent a crucial transition for Mexico—from crisis to sustainable growth. Given steady progress on the above agenda, Mexico can build on its recent gains in stabilizing the economy and restoring growth. Growth in the next 2-3 years will likely be moderate, averaging 3-3.5 percent, with economic fragility diminishing

but continuing for much of this period. Provided Mexico successfully completes this transition, growth could rise to a higher plateau of around 5 percent in later years (projections are summarized in Table 1 and detailed in Annex 7). The projected gradual recovery of growth assumes that it will take time for gains in macroeconomic stability and market confidence to solidify and private investment to rebound, for the banking system to return to health, and for the structural and (especially) institutional reforms to bear fruit.

15. As imports recover with economic growth, the current account deficit will widen again. But if Mexico maintains the new dynamism of its exports by not allowing the competitive advantage conferred by the *peso* depreciation to be eroded, the deficit can be contained to below 2 percent of GDP, consistent with an improvement in Mexico's external debt indicators in the medium term. Besides containing the rise in external debt, Mexico is taking steps to improve its maturity profile. Debt service, nevertheless, will remain high in the next three years, especially in 1998-99 when the bulk of the crisis-related financing Mexico received is to be repaid, keeping the reserve position tight. To support faster growth, domestic investment will need to increase, but is projected to be financed mainly from higher domestic savings. The base case assumes that three fundamental lessons of the recent crisis—the need to maintain a competitive exchange rate, raise domestic savings, and prudently manage public debt—are well understood.

16. The base case economic outlook depends crucially on an orderly resolution of the banking system problems. The Government will need to move vigorously on the next phase of system reform (para. 30). A related challenge will be in fiscal management. Budgetary costs of bank support programs, together with the transitional fiscal costs of social security reform, could add up to 2.5-3 percent of GDP in each of the next several years. These additional expenditures will need to be absorbed without relaxing the fiscal discipline Mexico must maintain as part of its stabilization program.

17. ***High Case***. The growth outcome will depend fundamentally on the pace and comprehensiveness with which Mexico pursues the development agenda outlined in Section III. A real opportunity exists for achieving higher growth than forecast in the base case: the country's development potential is immense; major new growth opportunities are offered by NAFTA; and substantial structural reforms have been implemented since the late 1980s which have yet to yield their full growth dividend. An aggressive reform effort, that removes constraints to higher and more efficient private investment, can tap this potential, permitting growth to exceed 5 percent toward the end of the decade and allowing a faster reduction of poverty. Such an upside scenario has a parallel in Chile's experience, where the reform momentum triggered by a crisis similar to Mexico's helped put the country on a markedly higher growth path following the initial adjustment phase.

18. ***Low Case.*** The base case economic outlook is subject to two main risks: strains in the banking system; and the vulnerability of Government reform program to social and political disruption. A collapse of the banking system has been averted, but the crisis has left behind a highly fragile system. Improved macroeconomic conditions should contribute to a strengthening of bank portfolios, but a renewed deterioration is possible if the

economic recovery falters or if the Government fails to press ahead with financial sector reform. On the political front, the Government's adherence to a tight stabilization program in the face of a steep recession provides a reassuring demonstration of its commitment to adjustment. Nonetheless, political pressures will continue to test the Government's resolve, especially in the run-up to the 1997 elections.

19. A downside scenario was developed to examine the implications of an interplay of these risks. It assumes that a lack of political will keeps the Government from aggressively pursuing the agenda for restructuring the banking system and weaning it from public support programs. Fiscal costs of bank and debtor support continue to mount, reaching 15% of GDP in present value terms (they are assumed to be contained to about 10% in the base case). These higher costs show up as a rise in the fiscal deficit as political difficulties render the Government unable to absorb them without relaxing fiscal discipline. This sets off a vicious cycle of a renewed rise in inflation and interest rates, declining investor confidence, and a narrowing of access to foreign capital. With the rise in inflation, the *peso* initially appreciates in real terms but becomes increasingly vulnerable to volatility as investor confidence dips. The recovery from the crisis is protracted, with growth stagnating around 2 percent in the next 2-3 years. Mexico is able to continue to meet its external debt service obligations, but at lower income and import levels. An additional risk in this scenario is that the economy remains vulnerable to shocks over an extended period.

20. ***External Environment***. Mexico's integration into international trade and capital markets has increased appreciably since the late 1980s. This brings important benefits—wider markets for trade, increased access to foreign capital and technology. But it also confronts policymakers with new challenges, as Mexico's experience vividly demonstrates. Especially important is the need for stricter discipline in macroeconomic management, including sound financial sector management, given the increased mobility and potential volatility of capital. For Mexico, with increased international integration, the payoffs to sound policies are larger, but so are the penalties for policy errors.

21. Mexico's exposure to external shocks—developments in export markets, foreign interest rates, capital flows—is sizable, but the country has taken steps since the 1994 crisis to reduce its exposure and vulnerability to such shocks. First, the surge in exports fueled by the restoration of a competitive exchange rate has substantially expanded the export base. Oil, whose price is particularly subject to volatility, remains a major source of exports and fiscal revenues, but its contribution has now dropped to 15-20 percent from around 30 percent in the mid- to late 1980s. Second, the large reduction in the current account deficit has reduced Mexico's dependence on capital inflows. Third, Mexico has been able to improve the maturity structure of its external debt, reducing its reliance on the more volatile short-term portfolio flows. The accumulated stock of nearly $30 billion in dollar-indexed short-term domestic securities (*tesobonos*), which played an important role in the financial crisis, has all been retired, mostly replaced with longer-maturity external debt. Fourth, the financial cushion available to absorb shocks, virtually depleted after the 1994 crisis, has been strengthened, through replenishment of reserves and restoration of access to international capital markets. A decline in external risk is also

indicated by some summary exposure indicators shown in Table 2. Despite these improvements, however, Mexico remains vulnerable to external shocks, especially over the next three years when the debt service will stay high and international reserves relatively low, requiring strict adherence to prudent macroeconomic policies.

22. New trade opportunities created by NAFTA are a key element in Mexico's export prospects. But NAFTA also brings challenges: firms must become more flexible and efficient to stand the test of increased competition, in domestic as well as export markets. With closer integration, the sensitivity to the U.S. economy rises. About three-quarters of Mexican exports now go the U.S. A strong resurgence of protectionist sentiment or a marked slowdown in growth in the U.S. market would have important implications for Mexico, though both appear unlikely at this time. U.S. electoral politics may temporarily slow the implementation of some aspects of NAFTA in 1996, but a serious backtracking on the agreement is considered unlikely. The medium-term growth outlook for the U.S. economy remains positive. At present levels, a 1 percent decline in U.S. GDP is estimated to lower Mexico's total exports by around $1 billion. As Table 2 indicates, another source of sensitivity to developments in the U.S. economy is interest rates. Some rise in U.S. rates in the period ahead is likely, but current forecasts do not point to a sharp surge.

Table 2: Summary Indicators of External Exposure

Source of Shock	Magnitude of Shock[1]	Annual Impact of Shock[2] (% of exports)	
		1994-96	1997-99
Terms of Trade	4.3% deterioration	6.2	6.5
International Interest Rates	290 basis points rise	3.6	2.4
Manuf. Export Volume	5.7% decline	2.7	3.1
Private Capital Inflows (excl. FDI)	$8.4 billion decline	11.9	8.0
Total[3]		24.4	20.0

[1]Measured as one standard deviation of three-year moving average of time series for past 10-15 years.
[2]Impact, in terms of exports of goods and services, of deterioration in the shock variable from the base case path over the three-year period by the indicated magnitude.
[3]These shocks are unlikely to occur simultaneously and so their impact is not additive; the total is shown merely to illustrate the change in overall exposure to these shocks over the two periods.

V. Mexico-Bank Group Development Partnership

23. The Bank Group assistance strategy for the next three years has been designed, in consultation with the Government, to support key elements of Mexico's development agenda outlined in Section III. The CAS Matrix (Table 3) maps Bank Group assistance strategy into the three core themes of this agenda—growth with stability, social development, and modernization of the state, all linked together by the overarching objective of raising human welfare and reducing poverty. The matrix relates Bank and IFC instruments of support to the main elements of this strategic framework and defines benchmarks against which performance will be monitored. The Budget Matrix (Annex 1) shows how the Bank and IFC plan to allocate their resources in support of this program. While details of the country assistance program are in the CAS Matrix, key features of, and issues in, the program are highlighted here. Four features cut across the program:

- As Mexico is likely to remain in a difficult state of transition from crisis to sustainable growth for much of the next three years, part of Bank Group operations will continue to focus on the short term and assist the Government in dealing with the crisis and its effects (Box 1 provides an update on the Bank Group's crisis response). Increasingly, however, the Bank Group will focus on operations that will help lay the basis for stronger growth and speedier reduction of poverty in the medium to long term.

- The agenda for private sector development will be pursued through more focused, concerted Bank and IFC efforts, utilizing the framework of a jointly prepared Private Sector Strategy (PSS, Attachment 1). Key areas of Bank-IFC collaboration, as detailed in the PSS, will be: banking, capital market, small and medium-scale enterprise restructuring, infrastructure, and regional development.

- A major emphasis across the Bank portfolio will be to improve portfolio quality and results on the ground—through better quality at entry and improved implementation.

- IFC will focus more on small and medium-scale enterprise development and ensure that its operations catalyze and not displace private investment.

Growth with Stability

24. A large part of the Bank Group lending and non-lending program over the next three years will support the fundamentals of sustainable growth: sound macroeconomic management, higher savings and productivity, and improved environmental management.

25. ***Macroeconomic Management***. Supporting sound macroeconomic management and financial stability will remain a major focus for the Bank. The Bank has stepped up its macroeconomic monitoring. In combination with enhanced surveillance by the IMF and more timely provision of economic data by the Government, this should help institute an improved warning system for any emerging problems and assist in contingency planning and policy dialogue. While the IMF will lead the dialogue on the stabilization program and exchange rate and liability management, the Bank Group will concentrate on issues relating to savings, investment and productivity; public expenditures; and financial sector management. Policy dialogue in these areas will be underpinned by analytical work carried out in the framework of both the ESW program and related lending operations, and supported by an enhancement of Bank analytical capacity.

26. ***Raising Savings and Productivity***. Strengthening these fundamentals of growth will motivate much of the Bank Group program in finance and private sector development.

27. *Strengthening the Tax System*. Part of the increase in national savings must come from higher public savings. Restraining expenditure growth and improving expenditure efficiency will remain important, but tax reform to raise more revenue also will be necessary. This is particularly so given the large new expenses the Government faces in the years ahead because of social security reform and banking system support (para. 16).

Box 1: Bank Group's Crisis Response in Mexico: An Update

Financial Sector Restructuring. A Financial Sector Restructuring Loan ($1 billion) has supported a substantial sector adjustment program. Bank supervision has been close. Measures supported by the second tranche released in July included: implementation of revised accounting standards for banks and other financial institutions that will assist supervisors in better assessing the condition of banks and also strengthen market-based supervision by providing investors with more transparent information; and issuance of revised capital rules for brokerage firms and agreement on an implementation schedule for credit exposure limits for development bank lending to commercial banks. Through an operation approved in July, including up to $100 million of IFC's own resources and up to $200 million in syndicated financing, IFC is helping Banamex, the largest commercial bank, develop a loan restructuring facility for viable medium-size enterprises.

Essential Social Services Loan (PROSSE). Out of a loan of $500 million, disbursements totaled $302 million by July. Under the loan, the Government committed to two courses of action: protecting budgetary allocations for high priority social programs targeted to the poor; and initiating a system of monitoring and evaluating social expenditures to increase their efficiency. PROSSE-related budget allocations rose from 5.67 billion pesos in 1995 to 8.76 billion pesos in 1996; and the finance secretariat has established a monitoring and evaluation unit for social expenditures.

Privatization Technical Assistance Loan. Disbursements have so far been modest under this $30 million loan, largely due to delay in privatization in electricity (the largest component of the loan) and secondary petrochemicals. But other privatizations are broadly on track—in telecommunications, railways, ports and airports. As the divestiture process winds down, greater attention is being given to regulatory and cross-sectoral issues.

Portfolio Restructuring. Since the 1994 crisis the Bank has restructured a number of projects with partial cancellations of about $860 million. Projects involving on-lending, especially in environment, were affected due to the reluctance of states/municipalities and private enterprises to borrow at the high interest rates prevailing in Mexico. Social sectors also were affected, due to the reduced dollar amounts needed to support the same level of peso expenditures and revised priorities following the crisis.

Non-Lending Services. The Bank has stepped up macroeconomic monitoring, and both the Bank and IFC have increased non-lending activities, including analysis of financial sector and enterprise restructuring issues and new approaches to addressing the problems of the poor southern states.

Important reforms implemented since the early 1980s have modernized Mexico's tax system and improved its efficiency. However, the system needs to generate more revenue to support Mexico's stabilization and growth objectives. The centerpiece of further tax reform should be the strengthening of the VAT, which would both bring in more public revenue as well as improve incentives for private saving and investment by shifting the balance of revenue collection from income toward consumption. Currently, because of a narrow base and extensive noncompliance, revenue from the VAT is only about 3 percent of GDP (compared with 6 percent in Argentina and over 8 percent in Brazil and Chile). Reform of the VAT needs to include a broadening of the tax base by drastically limiting the extensive zero rating and exemptions now allowed, a rise in the tax rate, and improvement in tax compliance. Tax administration needs to be strengthened in general. At the subnational level, more effective use needs to be made of the property tax which remains greatly underutilized in Mexico. The Government is preparing a set of tax reform proposals and the Bank will support this effort through ESW and technical assistance.

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
Overarching Development Objective: Raising the level of human welfare for all Mexicans and reducing poverty. Incidence of poverty to be reduced by about 3 percentage points by 1999 (latest estimate 34% in 1992).					
GROWTH WITH STABILITY Lack of a stable macroeconomic foundation.	• Policies supporting financial stability and competitiveness not followed consistently, especially in the context of increased and more volatile international capital flows. • Financial stability undermined also by serious banking system weaknesses (reflecting deficient incentive, regulatory and supervisory framework).	**Maintain Macroeconomic Stability** • Adhere to macroeconomic policies supportive of financial stability, competitiveness, and sustainable growth. • Promote sound financial sector development (see below).	• Compliance with IMF stabilization program. • GDP growth around 5% by 1999. • Inflation below 10% by 1998. • Average export growth at twice GDP growth rate or more in 1997-99 • Gross national savings 22% of GDP by 2000 (16% in 1994).	Annual CEMs Macro Policy Dialogue, Policy Notes, Monitoring	
Low and unstable growth. GDP grew only 3 % p.a. over the 5 years preceding the recent financial crisis (2% if averaged over 10 years), and plunged 6.9% in 1995 as a result of the crisis.	Weak fundamentals of growth: • Low and declining national saving rate. – Inadequate mobilization of public savings, including through the tax system.	**Strengthen Fundamentals of Growth** **(a) Mobilize Savings** **Fiscal Policy** • Increase public savings; reorient tax system toward consumption.	• Broaden VAT base; increase VAT revenue to GDP ratio.	CEM on Savings (97)	
	– Disincentives to private saving from a defined benefit, PAYG pension system.	**Pension System Reform** • Shift from defined-benefit PAYG system to fully-funded, defined- contribution system for private/public sector workers. • Support implementation of new pension system through regulations, strengthened monitoring and enforcement capacity.	• Enactment of new Social Security Law and legislation governing pension fund management, and of appropriate regulatory framework for AFORES. • Restructure INFONAVIT. • Extend pension reform to public sector workers (ISSSTE).	Contr. Savings I (97) CEM on Savings (97) Contr. Savings II (98) Contr. Savings III (99	TA and equity support to AFOREs
	– Fragile and underdeveloped financial system, providing inadequate security, access and instrument diversity to savers/investors.	**Financial System Development** • Restore health of **commercial banking system** by: accelerating resolution of troubled banks and portfolios; improving prudential regulation and supervision, incentives and market discipline.	• Adoption of OECD-comparable disclosure and accounting standards, prudential regulations, capital rules. • Newly established Asset Disposal Agency (VVA) fully functional. • Phase-out of comprehensive deposit insurance.	FSRL I (ongoing), Banking ESW (97) Ongoing FTAL FSRL II (97)	Venture Capital Loan Restructuring Credit
		• Support development of **capital markets** by: reforming market for housing finance; deepening and diversifying markets for securities.	• Define narrower, viable role for Government (FOVI, INFONAVIT, FOVISSSTE) in housing finance. • Issuance of quality mortgage and non-mortgage-backed securities.	Housing Finance (97) Guarantees ESW	TA Equity Investments
		• Strengthen **financial market infrastructure**: reform legal/regulatory framework for secured lending; upgrade regulatory and supervisory framework of securities markets; further develop ancillary financial information services.	• Functioning collateral and credit registries. • Credit and rating information readily available. Disclosure rules followed on public offerings.	Ongoing FTAL ESW Financial Infra. (98)	TA support and underwriting facilities
		• Expand access to and efficiency of **rural financial markets**.	• Pilot program initiated to improve delivery of rural financial services. • Phase-out Government support for BANRURAL and FIRA by: liberalizing interest rates; reducing subsidy dependence index.	Rural Finance TA (97) Rural Finance (99)	Venture Capital Funds
		• Rationalize role of **development banks** and improve their financial viability.	• Implementation of action plan for development banks agreed under FSRL I. Cessation of first tier lending.	CEM on Public Credit Programs (98)	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments (ii) IBRD	IFC
	• Generally low level and growth of productivity.	(b) Increase Productivity			
	– Limited development of SME segment of industry, enterprise problems exacerbated by current financial distress.	<u>Environment for Private Enterprise</u> • Facilitate restructuring/debt workouts/exit of distressed enterprises.	• Reform of regulatory/institutional framework for bankruptcy/liquidation/foreclosure/securitization.	Ongoing FTAL/ESW Fin. Infra. (99)	Credit lines TA on Corporate Restructuring Direct Lending
		• Enhance competition by supporting efficient growth of SMEs through: improved access to finance; technology diffusion; regulatory reform to provide level playing field.	• Increased, market-based financial flows to SMEs. Increased SME participation in exports, including indirectly through subcontracting.	Ind. Pol. Study (98) PSD Competitiveness TA (98)	Venture Capital Funds Institution-Building, e.g. leasing, factoring
	– Structural reforms (trade and investment deregulation, competition, privatization), though significant, did not go far enough, or not complemented by necessary institutional strengthening (as in financial sector).	• Extend trade and investment (domestic and foreign) deregulation and the privatization program.	• Further simplification of domestic trade and investment regulations at federal/state/local levels, and further liberalization of foreign investment regime. • Roll-back of tariff increases implemented in 1995 in response to financial crisis (on textiles, clothing, footwear, leather products). • Significant progress on privatization of petrochemical plants; completion of ongoing privatization in telecommunications; progress on privatization in other infrastructure sectors (see below).	Productivity CEM (97) Ind. Pol. Study (98) ESW PTAL (96)	Individual projects
	– Inefficiencies in infrastructure provision including lack of appropriate policy and regulatory framework for private participation.	<u>Infrastructure</u> • Accelerate restructuring and privatization in transport and energy sectors. • Improve public provision and financing of transport infrastructure; attract long-term private finance at federal/state levels; enhance infrastructure planning/implementation capacities at state level. • Strengthen municipal water and sanitation utilities and promote private participation.	• Improved legal/regulatory framework for private participation in ports, railways, airports, power, oil and gas. • New infrastructure financing mechanisms (e.g. road maintenance fund). • Improved urban transport services in medium cities/MCMA. • Water Master Plans prepared for 155 municipalities; water systems expanded in Southern States; pilot initiated for concessioning arrangements in municipalities.	PTAL (96) Federal Roads (97) Trans. & Dist. (97) Water & Sanitation II (ongoing), III (99) SSI (98) Guarantees Infr. Policy Notes	Privatization TA Individual projects, esp. in newly opened sectors Infrastructure Fund
	– Labor market rigidities and lack of a modern training system.	<u>Labor Market/Training</u> • Improve incentives for employment in formal sector; increase coverage and quality of labor market information; modernize labor-industrial relations	• As part of social security reform, tax wedge on payroll reduced.	Contr. Savings I, II (97,98) Health Reform (98)	
		• Expand access to training for displaced/unemployed workers; improve quality and relevance of training through increased private participation; promote continuous on-the-job training in SMEs.	• More unemployed workers receiving scholarships through PROBECAT; SME workers receiving training through CIMO increased. • Labor competency standards for occupational clusters developed under private sector leadership; independent certification agencies established.	Training Assessment, other ESW (97) Ongoing projects	
	– Agricultural/rural productivity constrained by uncertain land tenure and property rights and inefficiencies/gaps in rural infrastructure and producer services.	<u>Agriculture/Rural Development</u> • Develop rural agricultural markets; increase security of land tenure, water and property rights.	• Increased role of producers marketing organizations; land titling/registration expanded; registry of water rights established.	ESW, Water Management (96), DRD II (ongoing)	Venture Capital Microlending projects in export-oriented enterprises
		• Better target agricultural research/extension/rural infrastructure	• Design of competitive grants fund for research and extension completed.	Other Ongoing Projects Rural Poverty Report, Agr. Policy Notes	
		• Promote income-generating programs.	• Non-timber forest products fund established to pilot income-generating activities for communities with forestry resources.	Nat. Res. Manag. (98) CEM on Poverty (99)	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
Risks to long-term sustainability of growth arising from environmental stress.	Environmental concerns not effectively integrated into economic and sector policy. Environmental strategy/priorities not clearly defined and widely disseminated. Deficiencies in institutional framework: • Weak institutional capacities of environmental agencies, especially at state and municipal levels. • Lack of clear division of institutional responsibilities and framework for decentralization. • Coordination problems on cross-sectoral environmental issues. • Incentive distortions from legal/regulatory deficiencies, e.g. unclear/insecure water rights.	**Improve Environmental Management** • Agree and establish environmental priorities. • Strengthen environmental institutions at federal/state/municipal levels. • Establish foundation for effective management of industrial pollution. • Formulate regulatory framework for solid waste management. • Promote greater cross-sectoral participation to reduce air pollution in MCMA. • Improve natural resource management by: improving water use through establishment of water markets and transfer of existing water infrastructure to water users; promoting sustainable use of forestry resources.	• Dissemination of environmental priorities. • Roles clarified and responsibilities transferred to subagencies. • Pilot Pollution Release and Transfer Register started; demo SME project on environmental management systems implemented; cross-sectoral Industrial Pollution Working Group established. • Federal/local regulations for solid waste management issued. • Integrated transport and air quality management strategy developed for MCMA. • Water availability increased/losses reduced/quality improved; mechanisms to approve water rights transfers established; river basin councils established. • TA/training program for community groups on forest management initiated.	ESW (97, 98) Northern Border/other ongoing projects, Env. TA II (98) ESW, Seminars, Non-lending Services Solid Waste II (ongoing) Pollution Control (99) Water Management (96) Nat. Res. Manag. (98) ESW	Support to private waste management projects
SOCIAL DEVELOPMENT Persistence of high poverty. Overall and extreme poverty incidence 34% and 8%, respectively, in 1992, compared with 31% and 6% in 1984. Poverty incidence likely rose with recent financial crisis. Concentration of poverty in rural areas (47% incidence in 1992) and in Southern States.	Low, erratic economic growth (see above). Low effectiveness of Government social expenditure programs (safety nets/nutrition, education, health) in building the human capital of the poor: • Expenditure on social services high (55% of federal spending) but impact constrained by poor targeting and low expenditure efficiency. • Access to basic social services expanded but service quality remains deficient. • Safety nets especially inadequate in rural areas. • Deficiencies in public administration undermining service delivery: lack of effective decentralization; inefficiency, resource leakages, poor accountability.	**Better Target and Improve Quality of Basic Social Services** **Social Safety Net/Nutrition** • Cushion impact of financial crisis on the poor, especially on unemployed/underemployed in marginal rural areas. • Improve targeting and type of food subsidies. **Health** • Improve access to basic health services for the poor by targeting lowest income states. • Establish a financially viable health insurance system under the new Social Security (IMSS) law. • Increase role of private sector in delivering health services. • Decentralize more responsibilities to states and adopt more equitable system of federal budget transfers to states. • Ministry of Health shifts increasingly from service delivery to regulatory and quality control functions	• Private short-term employment provided to 600,000 people in first year through PESE, self-targeted to the poorest through payment of 80% of minimum wage. • Generalized urban food subsidies replaced with targeted subsidies; overhead costs of targeted subsidies reduced by shifting from in-kind to cash transfer system. • Nutrition program for mothers and children under 5 years initiated in poor rural areas; combined deworming, school feeding and micro-nutrient program implemented in rural primary shcools. • Basic health care package introduced in 11 poorest states. • Incentive/structural changes in IMSS health system to limit fiscal costs; transparent, sustainable financing mechanisms in place for delivery of IMSS health services. Financing and delivery of health services separated. • Pilot alternative scenarios for public/private mix. • Agreed decentralization, supported by TA, in place; allocation criteria revised for federal transfers, complemented by an improved monitoring system. • Inspectors/MIS monitoring placed in states; parameters of licensing defined for health service providers/licensing procedures initiated for hospitals and laboratories.	PROSSE (ongoing) Poverty Assessment (97) Rural Poverty (97) Nutrition (98) CEM on Poverty (99) Policy Notes Basic Health II (96) Poverty Assessment, Other ESW (97) Health Reform (98) CEM on Poverty (99) Basic Health II (96) Basic Health II (96) Health Reform (98), ESW	

Table 3: Mexico Country Assistance Strategy Matrix, 1997-99

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Development Objectives/Issues	Diagnosis	Strategy/Actions	Progress Benchmarks	Instruments IBRD	Instruments IFC
	Potential for development of the productive sector in poor regions, especially in the South, inhibited by: • Deficient rural land and financial markets, and limited access to supportive rural infrastructure. • Inadequate involvement of private sector in efforts to develop the productive sector in poor regions. • Insufficient participation of civil society and the poor themselves (especially women, indigenous people) in the design and implementation of poverty reduction programs. Weak development of the poor's social capital (community/producer organizations).	**Education** • Increase access to and quality of basic education, especially in poor rural areas. Focus investments on most cost-effective inputs (teaching materials, teachers and supervision) in an integrated manner. **Expand income-earning opportunities in poor regions, especially Southern States** • Work with private enterprise and civil society to identify and tackle constraints to development of productive sector in these regions. • Improve targeting of agricultural/rural development programs that affect the poor, especially indigenous communities and rural women. Encourage increased community participation in development.	• In PARE states with poorest education indicators: primary education repetition reduced, primary completion rate increased; retention of teachers in isolated rural areas increased; coverage of non-formal initial (0-4 years) education services increased. • New equitable budget system for federal transfers to states established. • Action Program initiated to address identified constraints to productive sector development in two Southern States (Chiapas, Oaxaca), involving increased private participation. • Targeting/effectiveness of programs such as PRODUCE, PROFORESTAL improved/monitored.	PROSSE (ongoing), Primary Education II (ongoing), Primary Education III (98), Poverty Assessment (97); CEM on Poverty (99); Other ESW (SSI) (98) Policy Notes IDF Rural Poverty Report (97); CEM on Poverty (99); Other ESW	Credit Line Direct Lending Private Equity and Venture Capital Funds (Fondo Chiapas) TA
MODERNIZATION OF THE STATE Public institutional framework has important weaknesses, as it has been slow to adapt to the changing role of government in development.	Liberalization of markets not underpinned by strengthening of regulatory and institutional framework to ensure markets function efficiently and fairly in supporting private sector development: • Weak prudential regulation and supervision in financial sector. • Accounting, auditing and reporting standards not adequately upgraded and enforced. Slow modernization of commercial laws (property rights, bankruptcy, securitization, etc.) and judicial system. Public administration increasingly in need of modernization, to support efficient execution of a narrower, more focused role of government: • Federal budget system in need of reform, to support improved expenditure and performance management. • Insufficient progress on administrative and fiscal decentralization. Weak institutional capacities and accountability at the local level. • Need to develop more modern, professional civil service, to improve quality of governance.	**Strengthen institutional underpinnings of markets** • Strengthen regulatory, legal and institutional framework underpinning financial markets and private commerce. **Modernize Public Administration** • Modernize budgetary process at federal level. • Decentralize more fiscal and functional responsibilities to state and municipal levels, backed by enhancement of institutional capacities and accountability at these levels.	• Continued progress on prudential regulation and supervision, accounting and reporting standards, commercial laws (bankruptcy, securitization). • Progress on legal/judicial reforms to improve enforceability of contracts. • Improved framework for medium-term expenditure management; improved performance management through budget; stronger auditing arrangements. • Actions on fiscal and functional decentralization within an agreed/coherent overall strategy for decentralization. • State and municipal capacity building programs under implementation. • Improved utilization of property taxation.	FSRL II (97) Financial Infra. (99) Ongoing FTAL, ESW Non-lending Services ESW (97), IDF, Seminars. State & Municipal Management TA (98) SSI (98)	

28. *Reforming the Pension System.* The Bank is working closely with the Government on a major pension system reform. With effect from 1997, the pay-as you-go system for private sector workers will be replaced by a fully-funded, defined-contribution system composed of private pension funds (AFORES), a reform that can give a major boost to private savings. Progress benchmarks over the next three years include the establishment of laws and regulations governing the new private pension funds and their investment regime, a fundamental restructuring of INFONAVIT (the housing component of the pension system), and the extension of pension reform to public sector workers. Bank support will include technical assistance on regulatory issues and adjustment operations to assist with the transitional fiscal costs of pension reform. IFC will assist through advisory services, equity support to AFORES, and acting as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable partners.

29. *Ensuring Sound Financial System Development.* Given its importance to the restoration of financial stability and growth, the financial sector (including the banking system, specialized financial institutions and the capital market) accounts for about a quarter of the Bank's proposed lending program and also about one-third of IFC's planned investments. Managing the crisis in banking remains a priority, but Bank Group support will shift increasingly to strengthening the underlying regulatory and institutional framework ensuring sound future development of banks and of the financial system more broadly. Toward this end, the Bank, in coordination with IFC and IDB, has worked out with the Government a comprehensive sector strategy and a program of support.

30. For the *banking system*, the strategy broadly has three elements: (i) expediting the resolution of problem banks and bank assets and limiting fiscal costs (accelerated resolution of intervened banks, proactive encouragement of sale/merger/consolidation of weak banks, early disposal of impaired portfolio acquired by Government); (ii) improving the incentive regime and reducing moral hazard (ensuring adequacy of genuine private risk capital, phase-out of the comprehensive liability protection, avoidance of new subsidy schemes); and (iii) strengthening the regulatory and institutional underpinnings (prudential regulation and supervision, accounting and reporting standards, legal framework for bank-borrower interaction, commercial laws including bankruptcy and securitization). Efforts in these areas will build on the progress already achieved under the first Financial Sector Restructuring Loan (Box 1). Bank instruments to support these efforts include analytical work and technical assistance and a second financial sector adjustment operation. IFC will provide complementary technical assistance as well as long-term loan and equity investments, including loan syndication and equity funds mobilization, to support bank restructuring and facilitate investment by new foreign partners.

31. Complementing these priorities, the Bank and IFC will support key elements of the reform agenda for the broader financial system. First, the financial system in Mexico remains dominated by commercial banks, but the establishment of a privately managed pension system will open important new opportunities for the development of the *capital market*. In addition to supporting sound development of the new pension system (para. 28), the Bank Group will promote capital market growth through: reforming housing

finance by restructuring, phase-out or privatization of public housing finance institutions (principally FOVI, INFONAVIT, and FOVISSSTE); developing the markets for mortgage and asset-backed securities; fostering the development of non-bank financial institutions such as mutual and venture capital funds, leasing and factoring; and upgrading capital market regulatory and informational infrastructure—strengthening of accounting and disclosure rules, collateral laws, credit and rating information, and the technical capacities of regulatory agencies. In these efforts, the Bank and IFC will complement each other, with the former focusing more on improving the regulatory and institutional framework and the latter on facilitating actual investments and transactions (such as supporting the first institutions in mortgage finance and asset securitization). Second, the Bank is helping the Government draw up a reform program, including pilot initiatives, to develop rural financial markets that remain characterized by uneven coverage, high segmentation and low efficiency. Third, the Bank will continue to provide advice on reform options for rationalizing the role of development banks that still account for about one-third of banking system assets. To the extent they are privatized, IFC could help these institutions orient themselves to the market.

32. *Improving Environment for Private Enterprise*. More vigorous, efficient growth of the private sector is an objective that cuts across the development agenda. Details of the Bank Group assistance strategy in key areas of private sector development are in the Private Sector Strategy paper (Attachment 1), but the strategy essentially has two elements. The first priority is to respond to the immediate problems for private enterprise resulting from the financial crisis. Restoring the banking system to health so it can resume its financial intermediation role and support recovery in private investment is a priority, as outlined above. A related priority is the restructuring of viable enterprises that are financially distressed by a combination of recession and high interest rates. Small and medium-scale enterprises (SMEs) have been particularly hard hit. The second element of the Bank Group strategy is to remove constraints to private sector development that are longer-term in nature and predate the crisis: continuing regulatory and administrative barriers to trade and investment, particularly at state and municipal levels; inadequacies of the commercial legal framework, that especially disadvantage SMEs, encourage "crony capitalism" and contribute to a concentrated industrial structure; bottlenecks to the privatization program; infrastructure deficiencies; and skill constraints. Removing these constraints will also help attract more foreign direct investment, that is beneficial to productivity growth and contributes to macroeconomic stability by bringing in longer-term capital that is less susceptible to volatility than short-term portfolio flows.

33. The Bank will support these goals through: ESW and technical assistance on productivity, competitiveness, industrial policy, and judicial system reform; a financial infrastructure loan aimed, *inter alia*, at improving the legal framework for financial restructuring (bankruptcy, liquidation, foreclosure, securitization); and operations supporting increased private participation in infrastructure, and skill development (see below). IFC will focus on supporting privatization initiatives and increasing market-based financial flows, particularly to SMEs, through technical assistance and financial investments (both direct investments in a few larger SMEs and indirect support through

credit lines and venture capital funds). The Bank Group strategy will seek to further privatization both in sectors previously opened to private enterprise and in sectors that so far have remained largely closed, including petroleum.

34. *Upgrading Infrastructure*. Among the major Latin American countries, Mexico perhaps has the least developed physical infrastructure. Deficiencies in infrastructure—in access, efficiency, quality—constitute a major constraint to productivity, competitiveness and growth. Infrastructure development, therefore, will remain an important area of Bank Group involvement. However, the focus of support will shift to promoting increased, more efficient private participation. The greatest opportunity for expanding and improving infrastructure services lies in removing statutory restrictions on competition, reducing intrusive government regulations and price distortions, and promoting private participation within an appropriate regulatory environment. At the same time, more efficient public investment and operating modalities are required for those services which will not attract private financing (e.g., secondary roads, urban traffic management, low income housing) or will remain within public purview at least during a transitional period (e.g., electricity transmission and distribution, road maintenance, urban transport infrastructure).

35. Bank Group support to infrastructure accordingly will have two emphases: privatization and development of regulatory capacities in transport, telecommunications, energy, and water and sanitation; and improvements in the planning, financing and management of public infrastructure. Through the PTAL (Box 1), the Bank will provide technical assistance to improve the regulatory framework for private participation—restructuring options for introducing competition, concession design, bidding rules, tariff policies, appropriate use of government guarantees. The Bank's guarantee instrument will be used to attract more private financing into infrastructure. In all sectors where the Bank may lend to support public infrastructure development, such as road transport and power, the aim will be to improve the overall sector policy regime and institutional capacities, rather than limiting attention to the investments directly financed by the loans. Two key criteria for Bank assistance for public infrastructure will be: whether it complements and promotes private participation; and whether it improves services in the underserved, poorer areas. Increasing private role in power and water and sanitation will be particular priorities, as these sectors have lagged behind others in privatization. An improved regulatory regime for private participation and a quickened pace of privatization would pave the way also for increased IFC investment activities in infrastructure, with the IFC supporting private infrastructure investments with long-term funds that might otherwise be difficult to obtain. For model or pilot infrastructure privatization projects in newly opened sectors, IFC's transaction design experience will be made fully available.

36. *Modernizing Labor Markets and Training*. In the aftermath of the 1994 crisis, reemployment and retraining programs to cushion the impact on displaced workers were a priority. With a recovery now under way, Mexico needs to resume the longer-term agenda of modernizing labor markets and the training system necessary to compete in rapidly changing international markets. Through formal and nonformal analytical work and ongoing projects, the Bank will assist the Government in identifying options for improving

the regulatory environment in the labor market—reducing rigidities such as high non-wage costs of formal sector employment and regulatory/legal constraints to flexibility in labor use, improving labor market information, modernizing labor-industrial relations. In training, Bank support will seek to strengthen public training institutions and improve incentives for provision of training by private enterprises to upgrade their workers' skills.

37. *Raising Rural Productivity*. Raising rural productivity is important both to growth and poverty reduction. The Bank will support this objective through a step-up in its non-lending services as well as through selective lending operations. Areas of emphasis will be: raising the efficiency of rural agricultural markets via improvements in the policy and regulatory framework and promotion of producer marketing associations; improving the efficiency of SAGAR's investment program and rationalizing farm subsidy programs (e.g., PROCAMPO); increasing the impact on the poor of rural income-generating programs (PRODUCE, PROFORESTAL); assessing the suitability of the new land titling program for *ejido* lands (PROCEDE) for the rural poor and indigenous communities; and supporting institutional reform, especially institutional strengthening at the state and municipal levels to underpin ongoing decentralization in agriculture. Through the planned Southern States Initiative, the Bank and IFC jointly will support the development of private rural productive activities in the poor states of Chiapas and Oaxaca (para. 47).

38. ***Improving Environmental Management***. Dealing with environmental problems is particularly challenging during a recession. Over the past year, the financial crisis has significantly limited available resources for environmental programs, and several Bank-financed projects have been cut significantly. Against this background, the Bank's urban environmental strategy (dealing with "brown" issues) will follow a three-track approach. The first track concentrates on satisfactorily implementing the Bank's current portfolio; the second focuses on providing urgent institutional strengthening to the Environment Ministry, as well as supporting the decentralization effort by providing technical assistance at the local level; and the third aims to maintain and deepen the dialogue on specific urban/industrial environmental issues through a variety of non-lending services, drawing on the strengths of different parts of the Bank.

39. In natural resource management ("green" issues), Bank assistance will focus on: providing technical assistance and training to forestry communities on sustainable resource management; and improving water use through clarifying water rights and promoting the role of water users' associations in O&M.

Social Development

40. In addition to promoting stronger, sustainable economic growth, as outlined above, the Bank will support poverty reduction through improving the effectiveness of programs specifically targeted to the poor. Bank support will have two main thrusts: improving the targeting and efficiency of basic social services; and better tapping the productive potential of the poor regions. These objectives will be pursued through a substantial strengthening of ESW, selective lending operations, and improving portfolio

quality including restructuring existing operations. A poverty assessment, a rural poverty report, and work relating to the Southern States Initiative, all to be completed in FY97, will provide a comprehensive analytical framework for an enhanced policy dialogue. Across Bank interventions, a common theme will be increased civil society participation, especially by the more vulnerable groups (rural women, indigenous communities).

41. ***Improving Social Services***. With Government social spending already large, the Bank assistance strategy will focus on improving the quality, efficiency, and sustainability of this spending and increasing its poverty impact.

42. *Social Safety Net.* Through ESW and a proposed nutrition project, the Bank will support ongoing Government efforts to rationalize the various nutrition and food subsidy programs, including consolidating these programs, linking nutritional programs with basic health care and education, and correcting the imbalance in social safety net programs against rural areas (where most of the extreme poor live). Also, building on the lessons learned in PROSSE (Box 1), the Bank will seek to improve rural employment programs.

43. *Health.* The Government has launched a major effort to redesign the financing and delivery of health care. As part of this effort, the Basic Health II project approved in FY96 is supporting measures to improve the coverage and quality of health services, particularly in the eleven poorest states, and to decentralize responsibilities to states to improve service delivery. The new social security law that takes effect in 1997 includes, in addition to pension system reform (para. 28), important changes in the financing of health insurance for private workers. A priority is to ensure that the new structure that results from this reform is efficient and financially sustainable. Proposed Bank health sector ESW and lending will assist in this task through analysis of alternative modes of health financing and delivery, demonstration projects, and support to related institutional reform.

44. *Education*. With a national primary school enrollment rate of 98 percent, the key issue is to raise the quality and efficiency of basic education, particularly in the poorest states which still have high levels of drop-out and repetition and low levels of cognitive achievement and absorption in secondary education. Through the ongoing Primary Education project and a proposed basic education project, the Bank will assist in improving the quality of school entrants through expansion in pre-school education targeted toward the poorest states, upgrading primary education through investments in cost-effective inputs (teaching materials, in-service teacher training), and expanding access to low-cost lower secondary education in under-served rural areas (e.g., through TV).

45. ***Unleashing the Productive Potential of Poor Regions***. The incidence of poverty is highest in the southern states (65 percent compared with a national average of 34 percent in 1992), and has been rising. While these states account for about 15 percent of Mexico's population, they contain well over half of those classified as extremely poor. The poverty rate in their indigenous communities is alarmingly high at around 80 percent. Despite relatively high levels of public expenditures in recent years, deficiencies in the design and implementation of government programs, including limited local and private

sector participation, have led to disappointing results on the ground, failing to make these states fuller participants in national economic growth.

46. The *Southern States Initiative (SSI)* aims at better tapping the productive potential—in agriculture, forestry, industry—of the two poorest southern states of Chiapas and Oaxaca through an innovative multi-sectoral approach that emphasizes increased private sector and community participation and more decentralized government decision-making. The SSI, being prepared in close collaboration with the federal and state governments, community and private sector representatives, and IDB, will introduce a greater regional emphasis in Bank Group operations in Mexico, responding to the high regional concentration of poverty.

47. Based on ongoing analytical work, the SSI envisages a two-pronged Bank Group assistance strategy. The first priority is to restructure the existing Bank portfolio in these states (11 projects) to make it more responsive to local development needs. Second, selective new Bank Group interventions will be identified to help mobilize private investment in productive activities. The Bank would provide financing for key infrastructure and technical assistance to state and local governments to build capacities for better service delivery, improve the regulatory and incentive regime for business, and establish institutional mechanisms for consultation with the private sector. IFC would provide financing and technical assistance to enhance SME and microenterprise access to finance (e.g., through the Fondo Chiapas, a venture capital fund) and possible direct investment in identified projects. The Bank and IFC together, in partnership with the Government, will organize a task force including representatives of local and international business community and civil society to develop specific ideas for promoting private productive activities in these states, including attracting foreign investment.

Modernization of the State

48. Second-generation, institutional reforms will feature more prominently in Bank operations. The present Administration's strong commitment to these reforms expands opportunities for Bank-country partnership. Besides the institution-building components in individual projects, as indicated above, the Bank will support broader, systemic institutional reform associated with a changing role of government in development.

49. ***Strengthening the Institutional Underpinnings of Markets.*** With the liberalization of markets, the government's role shifts from the exercise of direct controls to strengthening the legal and institutional framework underlying markets to ensure they function efficiently and fairly in supporting private enterprise. Much of the Bank Group's assistance to the financial sector will be aimed at beefing up financial and capital market infrastructure (prudential regulation and supervision, accounting and reporting standards, financial and commercial laws), as noted above. In addition, the Bank will support, mainly through non-lending services, government initiatives in modernizing the judicial system.

50. ***Modernizing Public Administration.*** Besides providing an efficient market setting for private enterprise, the apparatus of the state needs to be modernized to improve the delivery of services that, even with an increased private role in the economy, will remain in the public domain, e.g., basic social and infrastructure services. The Bank will help in this effort, mainly through ESW and IDF-supported technical assistance, on two important fronts, building on ongoing work. First, we will support the modernization of the federal budget system, to improve links between planning and budgeting and upgrade financial and performance management. Second, we will support ongoing government initiatives to decentralize responsibilities for local services to state and municipal administrations. The Bank is currently working on these initiatives with sector ministries, particularly in health and education. Planned analytical work on intergovernmental fiscal relations responds to the need to ensure that decentralization initiatives in individual sectors take place within a sound, coherent overall framework for fiscal decentralization. Key issues are: making federal transfers more efficient and equitable; mobilizing local revenues to reduce heavy state and municipal dependence on the federal budget; and strengthening fiscal accountability. This will be complemented by technical assistance to strengthen state and municipal capacities for fiscal management.

Portfolio Management

51. Bank portfolio performance, which had generally been good, has been adversely affected since the 1994 crisis by fiscal constraints, high domestic interest rates that have reduced demand for funds onlent to states and municipalities, and an acceleration of fiscal and administrative decentralization. Problem and "at risk" projects have increased and disbursements on the investment portfolio have declined (see Portfolio Matrix, Annex 2). To help restructure the portfolio to reflect new, post-crisis priorities, the Mexican authorities canceled the $650 million of the Bank's portfolio anticipated in the previous CAS, plus additional amounts of about $210 million, for a total of around $860 million. The authorities may cancel additional as yet undetermined amounts during FY97-99. We will accept the project implementation consequences of such prior and future cancellations in the interest of responsive portfolio management if such cancellations appear justified under individual project circumstances.

52. The reorganization and decentralization of the Bank's Mexico Department will facilitate a closer, more active dialogue with the client and a dynamic portfolio management strategy where operations are viewed as instruments that may be adjusted during implementation to improve effectiveness. This more flexible strategy is essential to better portfolio management in the present Mexican context of change in priorities and institutional setting. The Bank strategy to deal with problem projects as well as more generic portfolio management issues is outlined below.

53. *Decentralization.* The Government's new emphasis on decentralization has resulted in a shift of project implementation responsibilities. The affected projects will be restructured and the roles of line ministries, state and municipal governments, and development banks in the portfolio (present and future) will be reassessed. As

procurement and disbursement are being transferred to state and municipal governments, training will need to be provided to help them assume these functions effectively.

54. *Budget Process*. The attractiveness of Bank funding to implementing agencies is reduced by the requirement in the Mexican budget system that it be included within each agency's budget ceiling, thus not providing any "additionality" to the recipient. While this procedure is fiscally sound, agencies are likely to prefer the use of other, unconditional budget funds in order to avoid the burdens associated with the Bank procurement, disbursement and auditing processes. This incentive problem will be addressed in two ways: by ensuring that Bank involvement brings real value-added to the client, through quality inputs, and responds to the client's priorities; and by building greater flexibility in Bank operations through simplifying projects and conditionality and showing greater responsiveness to restructuring ongoing projects to reflect changing client priorities. Other budget process issues, e.g., late release of budgeted funds, will be addressed as part of the broader dialogue on modernization of the budget system (para. 50).

55. *Resettlement and Participation.* As the Government does not have an overall agreed approach to resettlement and participation (of NGOs, civil society), the Bank has had difficulty with some ministries on projects involving resettlement or where participation issues have been important. To reach a common understanding on these issues, the Bank and Government have agreed to convene a workshop to discuss the Bank's operational directives and guidelines as well as the experience of other countries. The Bank will continue to endeavor, as much as possible, to involve stakeholders outside the Government in project design and implementation.

56. *Procurement and Auditing*. A training program aimed at improving procurement skills of staff at executing agencies, especially at state and municipal levels, will be discussed with the Government. To improve the timeliness and quality of audits, and in anticipation of the need for states to implement externally funded projects in the near future, we will: broaden the mandate of the regional audit staff to develop financial management and audit strategies with our clients; strengthen capacity in the Mexico office to follow up on disbursements and audits and provide feedback to executing agencies; and ensure that ARCS is sufficiently updated to be a useful instrument to team leaders.

57. *Development Impact and Benchmarks*. Performance benchmarks agreed within the CAS framework (Table 3) will be used to monitor the impact on the ground. Intermediate targets for FY98 on portfolio implementation will be: problem projects below 10 percent (23 percent in FY96); average duration as problem projects before restructuring or closing less than 3 months; and average time from Board approval to effectiveness less than 3 month.

58. The 1994 crisis also affected the IFC portfolio; however, as the long-term fundamentals of the companies represented in the IFC portfolio remain strong, the impact is viewed as temporary and reversible as the economy recovers. IFC's portfolio performance in Mexico has in the past been good. Mexico has one of the lowest

cancellation and droppage ratios in the Corporation. The loan and equity returns have been moderately above IFC's average and interest collection has been 100 percent (see Annex 5 for details). The strengthening of IFC's field office will be used to bolster expertise transfer during the implementation phase of projects.

VI. Instruments of Partnership

59. As outlined above, the proposed country assistance program will deploy the full range of Bank Group instruments—Bank lending and non-lending services, guarantees, portfolio management, IFC's investment and advisory activities. Within this range, there will be some shifts in the mix of instruments in order to tailor the Bank Group program closely to the changing development agenda and client needs.

60. The role of *non-lending services* in the Bank's country program will be enhanced, responding to client demand for more policy analysis and advice. Increased emphasis will be placed on nonformal economic and sector work (ESW) that is demand driven and responds quickly to policymakers' specific analytical needs, such as policy notes and working papers. Stepped-up macroeconomic monitoring (para. 25) would contribute to the dialogue on macro policy and contingency planning. Formal ESW will be directed at filling major knowledge gaps in important areas of the country assistance program—productivity, financial and capital market development, effectiveness of poverty programs, decentralization (Annex 3). The impact of ESW will be enhanced through closer interaction with policymakers and wider dissemination (seminars, workshops). The relocation of the Bank's Mexico Department to the field will help with these objectives. The Bank does face constraints in Mexico in broadening participation and dissemination to stakeholders outside the core Government agencies, but we will continue to exert efforts in that direction. For example, in the ongoing work on the Southern States Initiative, the Bank has been able to broaden participation to include local governments and civil society. IFC also is stepping up its advisory services (especially in capital market development).

61. Delivering an expanded program of non-lending services that are of sufficiently high quality to be of value in a country like Mexico will require strengthening the Bank's country economic team. It will also require tapping more effectively resources in the Bank's research complex as well as building closer partnerships with outside institutions involved in analytical work on Mexico (including those in Mexico). These partnerships will be strengthened both through regular ESW and technical assistance operations. In dissemination and training activities, we will make greater use of the increased services being offered by the EDI.

62. Within the Bank's *lending* program, there will be a shift away from traditional projects toward sector investment loans—in finance, infrastructure, social services—that address broader issues of sector policy and institutional framework and expenditure priorities (Annex 3). The reason for this shift is threefold. First, with an expanding private sector role in the provision of public services, especially in infrastructure, an increasingly important focus of Bank operations will be to support the establishment of a policy and institutional framework conducive to private participation. Second, given the Mexican

budget process, and the limited "additionality" of Bank funds (para. 54), sectoral programs provide a better means to influencing expenditure priorities than individual projects. Third, in coming years Mexico will be implementing major public institutional reforms such as decentralization that, because of their breadth, are better supported through sector operations. The increased emphasis on ESW will support the proposed shift to sector-based operations, and will be reinforced by the analytical work carried out directly in preparing these operations. Both together would contribute to a substantial enhancement of our country policy dialogue.

63. Focusing the lending program on fewer, well-chosen operations in key sectors of the country assistance strategy, and improved efficiency in portfolio management, would release more budgetary resources for non-lending services. Over FY97-99, about 37 percent of the Department's operations budget will be allocated to these services, compared with 21 percent over the preceding three years (Annex 1).

64. Increased private investment in infrastructure will be supported also through a more proactive approach to the use of Bank *guarantees* in mobilizing private financing (para. 35), along with IFC's syndicated loan mobilization program. The Bank has made an indicative provision for guarantees in our FY97-99 country assistance program of up to 10 percent of the proposed total Bank lending. The gas, power and water sectors have been identified as the most promising initial candidates for the use of guarantees.

VII. Size of Bank Group Program, Country Risk and Creditworthiness

65. ***Base Case***. The Bank lending program approved under FY94 and FY95 CASs was for annual commitments of up to $1.5 billion (excluding the FY95 crisis year for which commitments of up to $2.5 billion were approved). The FY97 CAS proposes the same average level of baseline lending over the next three years, but it also proposes that the shortfall of close to $1 billion in FY96 (due to carryover of the preparation of some projects into FY97) be reprogrammed into the next three-year program. That would give total commitments of up to $5.5 billion over FY97-99. The proposed lending program presupposes that the policy framework remains sound, the major elements of the base case economic scenario are realized, and efforts to improve portfolio quality are sustained.

66. Given the high debt service payments Mexico faces during the next three years, when the bulk of the emergency financial assistance received in 1995 falls due for repayment, it is important for Mexico that the Bank maintain its disbursements at a high level. Of the proposed total commitments during FY97-99, about $1.25 billion could be in adjustment lending—to support financial system and social security reform. There are both balance of payments and fiscal grounds for adjustment lending during this period. It is envisaged that adjustment lending will no longer be necessary beyond this period.

67. ***Alternative Lending Scenarios***. Given exposure limitations, higher Bank lending than in the base case is not feasible even if Mexico's performance turns out to be better than assumed in the base case. This is not likely to be a constraint on Mexico because, in

such a scenario, Mexico would enjoy improved access to world capital markets. Indeed, in these circumstances, Bank lending could decline relative to the base case in outer years.

68. The Bank's lending response to a downside economic scenario would depend on the causes of the deterioration in economic performance (Table 4). If the main cause is slippages in policy, lending would be lower. For example, in the downside scenario analyzed in Section IV, where follow-up on the reform agenda in the financial sector is slow and piecemeal, lending could fall to around two-thirds of the base-case level, perhaps even lower. In the extreme case where policy slippages were grave enough to reverse progress in restoring macroeconomic stability and call into question the country's overall creditworthiness, a prospect considered unlikely, lending could be limited only to critical programs in poverty reduction and human resource development. Such a scenario could result, for example, from a major loss of fiscal discipline and an associated rapid build-up of public debt or a serious erosion of external competitiveness through currency overvaluation. Lower lending could also result if there is insufficient progress on improving portfolio quality. The foregoing suggests three main triggers for lower lending: slippages in macroeconomic management (specific macroeconomic policy targets to form part of a continuing IMF program); failure to press ahead resolutely with financial sector reforms; and lack of progress in addressing key constraints in portfolio management.

69. If, in contrast, the deterioration in economic performance results mainly from an exogenous shock, and the Government's policy response is adequate, a temporary rise in Bank lending may be necessary. If the shock causes an external financial crisis, which opens a large balance of payments financing gap, the additional financing needed would come mainly within the framework of an IMF program. Resources available to respond to such financial emergencies are being increased through the enlargement of the GAB. The Bank's role as a source of additional fast-disbursing financing in this situation would be limited, focused on cushioning the impact on the poor, such as the PROSSE loan made during the recent crisis to protect critical social programs (Box 1). The amounts involved would be relatively small and should not alter significantly the projected path of Bank exposure to Mexico. This is the only possibility we envisage where Bank lending could be somewhat higher than in the base case. Canceling undisbursed amounts of previous loans that may not remain a priority in a crisis to create room for more quick-disbursing lending, if necessary, would also be an option, as was done in 1995.

Table 4: Alternative Bank Lending Scenarios

Cause of deviation from base case →	Negative shocks		Policy slippages
Bank lending response →	Limited, temporarily higher lending, if policy response adequate	Lower lending, if policy response inadequate	Lower lending

Note: Higher and lower lending is defined relative to the base case.

70. ***Country Risk and Creditworthiness***. With an export-led revival of growth and continued progress on the adjustment program, the base case scenario envisages Mexico's

creditworthiness indicators to recover in coming years from the impact of the recent crisis. This outlook is sensitive to internal and external risks—banking system, adverse developments in export and capital markets. However, in the most likely alternative scenarios that can be envisaged based on these risks, Mexico's economic situation, though weakening relative to the base case, is not expected to deteriorate to a point where Mexico is unable to meet its debt service obligations (see Section IV). A larger shock causing a more serious financial crisis cannot of course be ruled out, such as a political shock triggering a major capital outflow. But Mexico is reducing its vulnerability to such risks. It is strengthening its reserve position and improving the maturity profile of its debt. Its current policies—a floating exchange rate, more responsive monetary management, tighter fiscal discipline—position it better to deal with capital market volatility. The present Administration's political and social reform agenda should contribute to making the political and social fabric more resilient. And, as noted above, provided Mexico's economic policies remain on track, it should be able to obtain additional balance of payments support if that became necessary in the event of a major shock.

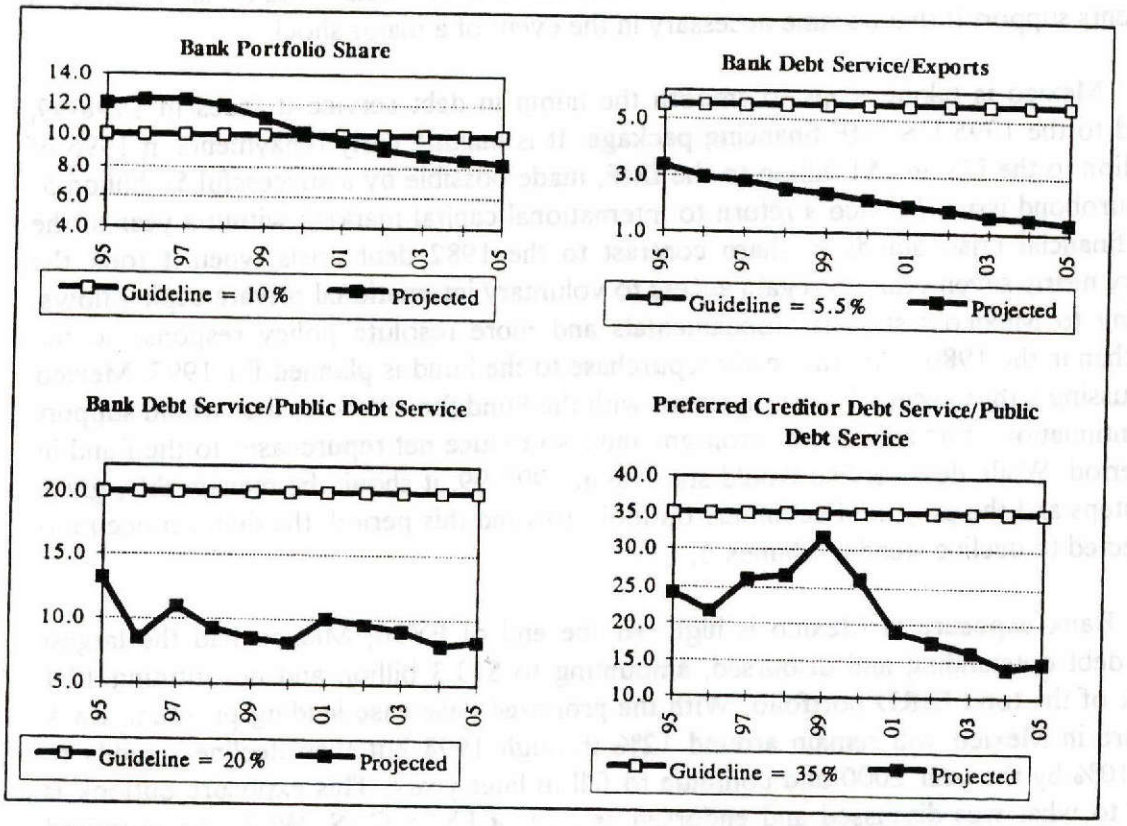
71. Mexico is taking steps to smooth the hump in debt service it faces in 1998-99, related to the 1995 US-IMF financing package. It is making early repayments in 1996 of $7 billion to the US and $1 billion to the IMF, made possible by a successful $6 billion 5-year eurobond issue. Mexico's return to international capital markets within a year of the 1994 financial crisis stands in sharp contrast to the 1982 debt crisis when it took the country nearly seven years to regain access to voluntary international private capital flows, attesting to Mexico's stronger fundamentals and more resolute policy response to the crisis than in the 1980s. Another early repurchase to the Fund is planned for 1997. Mexico is discussing a three-year EFF arrangement with the Fund for 1997-99, that would support the continuation of its adjustment program and also reduce net repurchases to the Fund in that period. While debt service would still rise in 1998-99, it should be manageable, given these steps and the projected economic outlook. Beyond this period, the debt service ratio is expected to decline steadily (Annex 6).

72. Bank exposure in Mexico is high. At the end of FY96, Mexico had the largest IBRD debt outstanding and disbursed, amounting to $13.3 billion and constituting 12.1 percent of the total IBRD portfolio. With the proposed base case lending program, Bank exposure in Mexico will remain around 12% through 1998 but then decline steadily to about 10% by the year 2000 and continue to fall in later years. This exposure outlook is similar to what was discussed and endorsed as part of FY95 CAS. While the proposed lending program would keep Bank exposure above the 10% guideline for a few years, the proposed lending is necessary to support adjustment and reforms that would allow an orderly reduction in the exposure. Bank exposure is expected to remain within the other exposure guidelines (Chart 2).

73. The risks to the Bank from the Mexico program are not only financial; the Bank's reputational capital also is at stake. Mexico is a large and important client country trying to emerge from a major financial crisis that continues to be the focus of much international attention. The Bank is, and is seen to be, closely involved in supporting Government

efforts in crisis management and reform in some major policy areas, a partnership that will become closer with the placement of the Bank's Mexico Department in the field. A key, and visible, area of Bank support is the rehabilitation of a financial system shaken by a severe banking crisis. A tougher, longer-term challenge involving close Bank engagement is the reduction of Mexico's high poverty and income inequality and acute regional disparities in development. The proposed Southern States Initiative constitutes a bold, innovative move to face this challenge head-on, in a setting that is socially and politically a difficult one. Potential rewards in these areas of Bank assistance are high, but so are risks. This CAS has argued that these risks are well worth taking. But both the financial and reputational stakes for the Bank make it imperative that every effort is made to ensure the job is well done.

Chart 2: Bank Exposure Ratios



74. ***IFC Investment Program.*** In response to the present widespread corporate financial distress and the emerging private sector financing needs as the economy recovers, IFC plans to increase its investment in Mexico appreciably in the next three years. A total of about $1 billion in investments is planned over FY97-99. In addition, IFC expects to mobilize about $1.2 billion through related syndications. At the end of 1995, IFC's Mexico portfolio amounted to about $650 million and represented 7.6 and 6.6 percent of total investments disbursed and held, respectively. These exposure levels make IFC's Mexico portfolio the fourth largest in the Corporation, but allow head room for an increase in investment. Planned IFC investments are an integral part of overall Bank

Group assistance program in support of private sector development, as outlined above. The bulk of the planned IFC investments in FY97-99 will be in financial/capital market development and manufacturing (about 30 percent each) and infrastructure (20 percent), with the balance in petrochemicals and agribusiness (Annex 5). The sectoral composition of planned IFC investments will reflect two important strategic thrusts: an increased focus on the promotion of SMEs within manufacturing; and support to private investment in newly opened infrastructure sectors. Another strategic emphasis will be to enhance the catalytic effect of IFC investments.

VIII. Collaboration with Other Organizations

75. Mexico's current stand-by arrangement with the IMF is on track. It has been extended by six months, to February 1997, to provide time for discussion of a three-year extended arrangement (EFF) that would succeed the stand-by and provide continued Fund support to and monitoring of Mexico's adjustment program (para. 69). Bank-Fund collaboration will remain active in macroeconomic management and will intensify in structural reform (para. 25). The EFF program is likely to incorporate several areas of structural reform—social security, taxation, financial sector reform, privatization, intergovernmental fiscal relations, reform of subsidy programs—where close Fund-Bank collaboration will be essential.

76. Collaboration with the IDB has increased in the past two years. The Bank's response to the Mexican crisis was closely coordinated with the IDB. In the period ahead, major areas of collaboration will include the financial system, social security reform, and the Southern States Initiative—all priority areas in our CAS. Our lending program includes several parallel loans. Over the next three years, IDB commitments are expected to average about $1.2 billion a year. Besides lending operations, collaboration is increasing in non-lending services. The present Administration's emphasis on institutional reform is opening new areas for collaboration, e.g., in decentralization. Collaboration in the field will intensify with the relocation of our Mexico Department to Mexico City. We have consulted with the IDB at several stages of the preparation of this CAS.

IX. CAS Priorities and Success Criteria

77. Like the challenge of development itself, the policy agenda discussed in the preceding sections is multi-faceted. The proposed country assistance strategy—defined in terms of the three themes of growth with stability, social development, and modernization of the state—will assist the Government in several key areas of this agenda. Within this strategic framework, the following will constitute the core priorities of our program over the next three years:

- *Growth with Stability*: (i) supporting sound macroeconomic management through enhanced monitoring and closer dialogue, especially on structural and micro underpinnings of macro policy; and (ii) ensuring sound financial and capital market

development, particularly restoring banking system stability and supporting comprehensive pension system reform.

- *Social Development*: (i) improving the efficiency and quality of social sector spending, including the targeting of safety nets and efficiency and quality of basic health and education; and (ii) making a dent in regional concentrations of poverty through the planned Southern States Initiative.

- *Modernization of the State*: (i) improving the regulatory, legal and judicial framework to facilitate private enterprise, foster competition, and provide a level playing field; and (ii) supporting an orderly and efficient process of fiscal and administrative decentralization.

78. Performance benchmarks we will use to evaluate progress in these priority (and other) areas are set out in the CAS Matrix (Table 3). The critical test of the success of the proposed country assistance strategy will be its effectiveness in reducing poverty, the objective that overarches the Bank Group program.

X. Agenda for Board Consideration

79. The Board may wish to comment on the following topics:

- Assisting Mexico recover from the financial crisis remains a priority, but Bank Group support increasingly should focus on the longer-term development agenda.

- Achieving better results on the ground in reducing Mexico's high poverty, both in its national and regional dimensions, is imperative and the CAS must treat that as its central challenge.

- Second generation, institutional reforms today are at the forefront of Mexico's development agenda and crucial to the effectiveness of the Bank Group portfolio.

- Evolving development agenda and client needs call for enhancing the role of non-lending services in the Bank Group program.

- There will be a strategic shift in the IFC program toward the promotion of small and medium-scale enterprises and support to private investment in newly opened infrastructure sectors.

ANNEXES

Annex 1: Mexico Country Assistance Strategy
(a) Bank Budget Matrix (FY97-99)
(US$'000)

CAS Objective	FY 97				FY 97	FY 97-99
	Lending & Supervision	Non-Lending	Total	% of Total	Trust Funds (disb. in FY97)	% of Total
I. Growth with Stability			**7,922**	**69.6**		60.0
A. Maintain Macro-Stability		434	434	3.8		
B. Strengthen Fundamentals of Growth						
(i) Mobilize Savings						
Pension Reform	440	28	468	4.1	300	
Financial System Development	753	354	1,107	9.7	986	
(ii) Enhance Productivity						
PSD	864	300	1,164	10.2		
Infrastructure (incl. housing)	1,183	150	1,333	11.7	254	
Labor Markets		77	97	10.4		
Ag/Rural Development	1,483	250	1,733	15.2	72	
C. Foster Sustainability of Growth						
Environmental Management	1,168	418	1,586	13.9	2,217	
II. Social Development			**1,867**	**16.4**		30.0
A. Better Target and Improve Basic Services						
Safety Net/Nutrition	161	167	328	2.9	200	
Health	186	228	414	3.6		
Education	581	250	831	7.3		
B. Expand Income-Generating Opportunities		294	294	2.6	500	
III. Modernization of the State			**1,591**	**14.0**		10.0
A. Strengthen Underpinnings of Markets	422	200	622	5.5		
B. Modernize Public Administration	422	547	969	8.5		
Sub-Total	7,663	3,717	11,380	100.0	4,529	
Other		700				
Overheads	1,020					
TOTAL BUDGET	**13,100**					
Non-lending as % of Total (excl. overheads)		37				40.0

Note: Although the lending and non-lending program is allocated above against categories as discussed in the CAS, there are important interrelationships between these categories. Therefore, resources shown against one will in many cases also impact on the others.

Mexico: Bank Budget Allocation by Activity FY 97-99
(Direct Costs Only)

	FY 95		FY 96		FY 97	
	US $ m	%	US $ m	%	US $ m	%
Lending	2,667.8	48	2,266.6	38	1,996.5	31
ESW	1,123.8	20	1,023.4	17	1,990.5	31
Supervision	1,692.6	31	2,439.4	41	2,043.9	32
Other	64.7	1	245.1	4	338.6	6
TOTAL	**5,548.9**	**100**	**5,974.5**	**100**	**6,369.5**	**100**

(b) MEXICO: IFC Operational Budget[1/]

	FY95		FY96		FY97		FY98	
	Staff Years	Costs	Staff Years	Costs	Staff Years	Costs	Staff Years	Costs
Financial Sector	1.3	0.4	1.5	0.3	2.0	0.4	4.5	1.0
Manufacturing/Agribusiness	5.4	0.9	5.8	1.2	5.5	1.5	4.5	1.0
Infrastructure	1.8	0.3	2.4	0.4	4.0	0.8	4.0	1.0
Petrochemicals	1.1	0.2	1.6	0.3	1.0	0.2	3.0	0.6
Oil, Gas, Mining	0.8	0.2	0.3	0.1	1.0	0.3	1.0	0.3
Engineering, Legal, Others	4.8	1.0	4.3	0.9	5.0	1.0	5.0	1.0
Total	15.2	2.9	15.9	3.1	18.5	4.2	22.0	4.9

1/ Excludes Regional and Corporate Overheads, in $ million, inflation adjusted.

IFC's budgetary resources for Mexico have been modest with about 16 manyears and US$3.0 million for all operational departments plus legal and engineering support in FY96. An increase to about 19 staff years in FY97 is planned to support the entry into new sectors (infrastructure in particular) and the greatly enhanced advisory component (capital markets in particular).

The IFC Mexico budget may need adjustment in size and composition, since infrastructure and petrochemical projects depend partly on the pace of Government progress on privatization. Financial sector activity depends partly on Government actions as well. The infrastructure program could potentially require up to twice as much resources.

Annex 2: Mexico Country Assistance Strategy
Bank Portfolio Matrix

In the medium-longer term, we expect the Mexico portfolio to resume its status as one of the strongest in the Bank.

- As shown in the table below, a higher number of projects at risk in FY95-96 and lower disbursements in FY96 resulted from the crisis, reflecting Mexican budget constraints that have reduced counterpart funding in Bank projects and high domestic interest rates that have reduced demand for Bank funds onlent to state and municipal entities.

♦ *Risks/Rewards and the Bank's FY97-99 CAS.* The Bank's strategy for the next three years reflects a transition period as Mexico continues to deal with the impact of the crisis yet increasingly focuses on the longer term goals of reviving growth and reducing poverty. Overall, the proposed portfolio represents a balanced mix of risks and rewards. Investments in the financial sector, which remains fragile, carry a relatively high risk, but are a priority and promise a potentially high return in terms of contribution to restoration of financial stability and growth. The major risk in infrastructure is the Government's fulfillment of the ongoing privatizations and its subsequent ability to attract private participation in the provision of infrastructure services. Additional risks for infrastructure, environment and public sector operations, including an initiative in the Southern States, arise from the decentralization, resettlement and participation issues that are involved. Yet these operations are important to the long term viability of the development program. Human resource operations are concentrated in FY98-99 and reflect a lower risk profile.

♦ *Portfolio Management.* The Mexico Pilot with delegation of authority and increased field presence will allow the Bank to deal proactively in addressing the following issues:

- In response to the Government's decentralization policy, affected projects will be restructured. The roles of line ministries, state and municipal governments, and the development banks will be reassessed.
- A broad-based strategy will be adopted to promote sustainable development in the Southern States, in which the private sector and civil society will play a prominent role. The capacity and transparency of public sector management will also be strengthened.
- Environmental issues will be highlighted in the policy dialogue, and ongoing projects will be restructured to reflect new conditions.
- Problems predating the crisis will also need to be addressed, in particular the budgeting process affecting the Bank portfolio.
- Major implementation targets for end-FY98 include: % of problem projects < 10%, length of stay as problem project before restructuring or closing 3 months, and average time Board to effectiveness 3 months.

Portfolio Performance	FY93	FY94	FY95	FY96
Volume of Projects Under Implementation (US $ M) (end of year, disbursed plus undisbursed)	8,097	8,668	9,489	7,296
Number of Projects Under Implementation	45	43	41	35
Percent of problem projects (rated U or HU for past year)				
Development objectives	3	7	7	6
Overall status/Implementation Progress	5	7	17	23
Canceled during FY (US$M)	57.3	8.2	29.9	644
Disbursements (US $M)	1201	997	1,113	1,473 (o/w 675 investment)
Disbursement ratio (%) (investment projects only)	31.3	22.7	26.3	21.7
Completed projects rated unsatisfactory by OED	5	4	3	NA

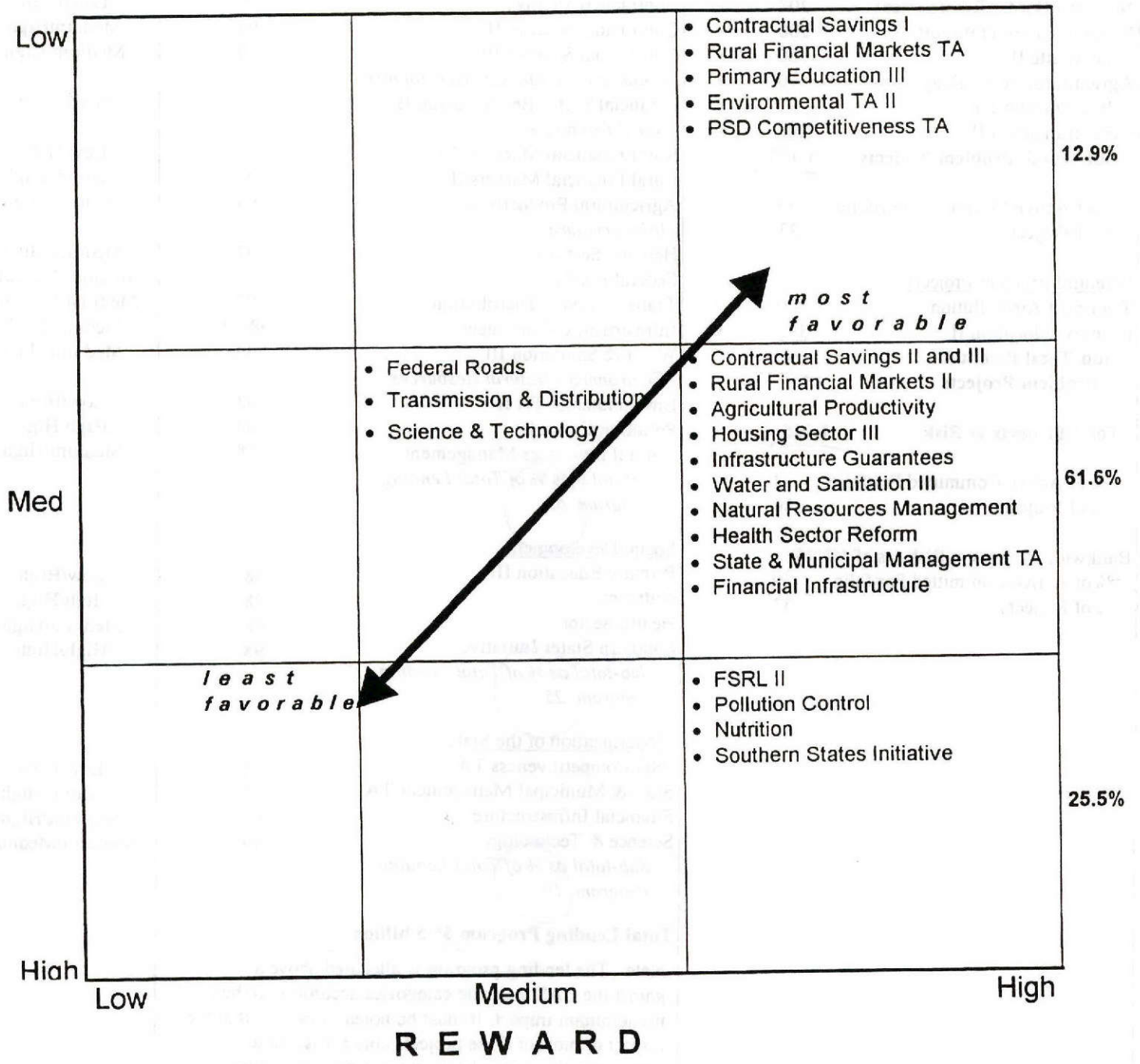
Projects at Risk			Proposed Projects FY 97-99		Risk/Reward (Low/Med/High)
lem Projects as of 6/30/96	US$M	Action	Growth with Stability	FY	
Envir./Nat. Resources	24	✓	*Pension System Reform*		
Northern Border Environment	208	✓	Contractual Savings I	97	Low/High
Medium Cities Transport	200	✓	Contractual Savings II	98	MediumHigh
Solid Waste II	60	✓	Contractual Savings III	99	Medium/High
Agricultural Technology	90	✓	*Finance/Cap. Markets Development*		
Urban Transport I	91	✓	Financial Sector Restructuring II	97	High/High
Decentralization II	500	✓	*Rural Productivity*		
Sub-Total Problem Projects	**1,173**		Rural Financial Markets TA	97	Low/High
			Rural Financial Markets II	99	Medium/High
% of Active Committed Portfolio	13		Agricultural Productivity	99	Medium/High
% of Projects	23		*Infrastructure*		
			Housing Sector III	97	Medium/High
Potential Problem Projects			Federal Roads	97	Medium/Medium
Transport Air Pollution	220	✓	Transmission & Distribution.	97	Medium/Medium
Primary Education II	372	✓	Infrastructure Guarantees	98,99	Medium/High
Sub-Total Potential Problem Projects	**592**		Water & Sanitation III	99	Medium/High
			Environment/Natural Resources		
Total Projects at Risk	**1,765**		Environmental TA II	98	Low/High
			Pollution Control	98	High/High
% of Active Committed Portfolio	24		Natural Resources Management	98	Medium/High
% of Projects	30		*Sub-total as % of Total Lending Program 65*		
Bankwide Projects at Risk (as of 4/5/96):			Social Development		
% of Active Committed Portfolio	30		Primary Education III	98	Low/High
% of Projects	33		Nutrition	98	High/High
			Health Sector	98	Medium/High
			Southern States Initiative	98	High/High
			Sub-total as % of Total Lending Program 25		
			Modernization of the State		
			PSD Competitiveness TA	98	Low/High
			State & Municipal Management TA	98	Medium/High
			Financial Infrastructure	99	Medium/High
			Science & Technology	99	Medium/Medium
			Sub-total as % of Total Lending Program 10		
			Total Lending Program $5.5 billion		
			Note: The lending program is allocated above a gainst the CAS thematic categories according to their predominant impact. It must be noted, however, that the impact of most of these projects cuts across these categories. For example, most projects listed under "growth with stability" and "social development" have institutional components that contribute to "modernization of the state."		

Projects at Risk include (i) projects categorized as "problem" projects and (ii) projects categorized as "potential" problem projects. The latter are defined as projects with satisfactory IP and DO ratings but which suffer from two or more of the following problems (see Prem Garg, EXCQA, Portfolio Improvement Program, Memo of April 10, 1996):

1. Counterpart Funding Constraints (rating 3 or 4)
2. Slow Disbursements (disbursement level < half of the original or revised forecast)
3. Effectiveness Delays (> 12 months after Board approval)
4. Financial Performance Problems (rating of 3 or 4)
5. Non-Compliance with Covenants (rating of 3 or 4)
6. Project Management Problems (rating of 3 or 4)
7. Extended Problem Status (> 2 consecutive years)
8. Procurement Problems (rating of 3 or 4)
9. Risky Countries (> 50% unsatisfactory commitments for operations closed during past 5 years) and no major change in economic management

10. Risky Instruments (>33% unsatisfactory commitments for operations closed during past 5 years)

CAS Decision: Balancing Risks and Rewards



Luis Muñoz
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Annex 3: Bank Lending and Non-Lending Program, FY 97-99

Lending/Guarantees		Non-Lending
FY97		
Lending Contractual Savings I Housing Sector III Federal Roads Transmission & Distribution Financial Sector Restructuring II	Technical Assistance Rural Financial Markets TA	CEM: Savings CEM: Restructuring and Productivity Fiscal Management/Decentralization Pre-School Education Review Training Assessment Financing Health Services Poverty Assessment Rural Poverty Industrial Pollution Prevention Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector Southern States Initiative Federal Budget Process Reform Informal Labor Markets Private Capital Inflows & Financial Integration Infrastructure Policy Notes Fiscal Costs of Health Insurance Reform PROCAMPO (Agricultural Policy) PROCEDE (Agricultural Policy) Gender and the Rural Economy
FY98		
Lending Contractual Savings II Southern States Initiative Nutrition Primary Education III Health Sector Reform Natural Resources Management Guarantees Infrastructure	Technical Assistance Environment PSD Competitiveness State & Municipal Management	CEM: Public Credit Programs Industrial Policy Agricultural Supply Response Land Markets in Rural Mexico Environmental Priorities and Decentralization Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector/Capital Markets External Debt/Asset Liability Management Infrastructure Policy Notes Southern States Initiative Follow-up Policy Notes on Poverty Studies PRODUCE (Agricultural Policy) Maize and Tortilla Policy Regulatory Issues in Water Sector
FY99		
Lending Contractual Savings III Water & Sanitation III Science and Technology Financial Infrastructure Pollution Control Rural Financial Markets II Agricultural Productivity Guarantees Infrastructure		CEM: Structural Reform and Poverty Alleviation Social Services for Marginalized Groups Education Decentralization Regulatory Issues in Rural Markets Ground Water Study Nonformal Reports/Policy Notes/Seminars Macro Monitoring/Policy Notes Financial Sector/Capital Markets Corporate Legal Framework/Judicial Reform Infrastructure Policy Notes Science & Technology (Others to be Identified)

Note: More nonlending tasks, especially nonformal tasks, will be added for FY98 and FY99. The above list does not include substantial analytical work supported by technical assistance loans. Two such TA loans are ongoing (FTAL, PTAL). Three TA loans (PSD Competitiveness; State and Municipal Management; and Environmental Decentralization) are being prepared, as shown above.

Mexico - Bank Fact Sheet, FY 1994-1999

Category	Past			Current	Planned[a]	
	FY94	FY95	FY96	FY97	FY98	FY99
Commitments (US$m)	1530.0	2387.4	526.5	1930.0	2170.0	1400.0
Sector (%)[b]						
Agriculture	13.1	3.6	35.4	1.6	2.8	32.1
Education	26.9	11.1	0.0	0.0	12.9	0.0
Elec.power,oth.engy.	0.0	0.0	0.0	20.7	4.6	0.0
Environment	24.1	0.0	0.0	0.0	2.3	21.4
Finance	0.0	43.5	0.0	41.5	11.5	51.7
Multi Sector	0.0	0.0	0.0	0.0	18.4	0.0
Pop/health/nutrition	0.0	0.0	58.9	0.0	30.0	0.0
Public Sector Mgmt	0.0	20.9	5.7	13.0	3.7	32.1
Social Sector	0.0	20.9	0.0	0.0	0.0	0.0
Transportation	0.0	0.0	0.0	18.1	4.6	0.0
Urban Development	13.1	0.0	0.0	18.1	4.6	0.0
Water Supply & Sanit	22.9	0.0	0.0	0.0	4.6	14.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Lending instrument (%)						
Adjustment loans[c]	0.0	41.9	0.0	41.4	11.5	0.0
Specific investment loans and others	100.0	58.1	100.0	58.6	88.5	100.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
Disbursements (US$m)						
Adjustment loans[c]	197.0	0.0	500.0	1251.0	500.0	200.0
Specific investment loans and others	800.0	1112.9	973.2	1216.0	940.0	901.0
Repayments (US$m)	1007.1	1222.9	1461.4	1494.0	1533.0	1624.0
Interest (US$m)	907.4	959.0	951.1	1036.0	1038.0	1012.0

a. Ranges that reflect the base-case (i.e., most likely) scenario. For IDA countries, planned commitments are not presented by FY but as a three-year-total range; the figures are shown in brackets. A footnote indicates if the pattern of IDA lending has unusual characteristics (e.g., a high degree of frontloading, backloading, or lumpiness). For blend countries, planned IBRD and IDA commitments are presented for each year as a combined total.

b. For future lending, rounded to nearest 0 to 5%. To convey the thrust of country strategy more clearly, staff may aggregate sectors.

c. Structural adjustment loans, sector adjustment loans, and debt service reduction loans.

Note:

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

Annex 5: IFC Portfolio and Investment Program

Portfolio Status. As of June 30, 1996, IFC's Mexico portfolio involved 40 clients and stood at $652 million, of which $582 million (89%) related to loans and about $70 million (11%) to equity participation. Undisbursed amounts totaled $59 million. From a country exposure standpoint, IFC's Mexican portfolio is the fourth largest of the corporation after being the largest at the beginning of the 1990's. At year-end 1995, it amounted to 7.6% and 6.6% of total investments disbursed and held, respectively, by the Corporation worldwide. Sector-wise, IFC's outstanding investments are largest in general manufacturing (56%), chemicals/petrochemicals (17%), capital markets (15%), infrastructure (8%), and mining (4%).

Notwithstanding the difficult economic environment prevailing in Mexico, none of IFC's investee companies is in default and the collection rate on the loan portfolio remains firm at 100%. The financial yield and risk-adjusted financial yield[1] on the Mexican loan portfolio amounted to 4.2% and 5.1%, respectively, in FY96 compared with 3.8% and 3.2% for IFC as a whole.

Largely due to the devaluation of the peso, unrealized capital gains on the equity portfolio decreased sharply from a pre-crisis level of about $120 million to $68 million in August 1996. As the long-term fundamentals of the companies represented in IFC's equity holdings remain sound, this downturn may be viewed as temporary and reversible as the economy recovers. Profitability-wise, the equity portfolio ended FY96 with a return on average capital employed of 1.7% compared with 8.1% for the IFC's equity portfolio as a whole. This low performance resulted primarily form IFC's decision to hold on to its unrealized capital gains until fuller recovery of the local stock market. Over the FY92/FY96 period the average equity return in Mexico was 16.6% vs 13.0% for IFC as a whole.

Recent and Planned Investment Program. During FY96, IFC's Mexican activities included the processing of 10 transactions for which funds totaling $733 million were mobilized for the private sector.[2] Of this total, IFC's own-account approvals amount of $243 million of which $194 million related to loan operations, $38 million to equity and quasi-equity participations, and $11.1 million to interest and currency swaps.

Taking into account the emerging needs of the private sector and the development agenda proposed in this CAS, IFC intends to significantly increase its investment activities and portfolio exposure in Mexico in the coming years. Reflecting the sizable long-term financing needs of the private sector, IFC anticipates that through FY99 its activities could

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1 Income contractually due, dividends, capital gains and financial service fees, minus borrowing costs, if applicable.

2 In FY95, IFC's investment activities included 9 operations for which financial support of $189 million was extended, including $75 million for IFC's own account.

increase from 10 to 14 per year while gross approvals could reach $700 million and above, including $300-350 for IFC's own account. Such a program would result in the processing of 40-44 projects involving gross commitments of $2.2 billion through FY99, of which about $1 billion would be for IFC's own account. Sector-wise, over 50% of the program would go to financial market development and general manufacturing, and the balance to infrastructure, petrochemicals and agribusiness. The share of infrastructure could increase substantially with a comprehensive and fast privatization program in this sector.

Mexico: IFC Investment Activities

Category	Actual		Planned[a/]		
	FY95	FY96	FY97	FY98	FY99
IFC Net Approvals (US$m)	75	243	300	350	350
Sector (%)					
Financial Sector	14	42	30	30	25
Manufacturing	51	40	30	30	25
Agribusiness	0	0	5	5	10
Infrastructure	2	0	15	20	20
Petrochemicals	0	16	15	15	15
Oil/Gas/Mining	33	2	5	0	5
Total	*100*	*100*	*100*	*100*	*100*
Investment Instrument (%)					
Loans	84	84	85	85	85
Equity	16	16	15	15	15
Total	*100*	*100*	*100*	*100*	*100*

Notes
a/ Includes quasi-equity types of both loan and equity instruments.

The non-financing program is going to increase with additional resources devoted to joint advisory work with the Bank, in particular in the financial and infrastructure sectors.

Mexico - Key Economic Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
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	100.0	100.0	100.0	100.0
Agriculture[a]	9.1	8.9	8.4	8.2	8.0	8.2	..	..	..	..	..	..
Industry[a]	30.3	29.6	29.1	28.2	28.1	27.8	..	..	..	..	..	..
Services[a]	60.6	61.4	62.5	63.6	64.0	64.0	..	..	..	..	..	..
Total Consumption	78.3	79.7	81.0	81.0	81.6	77.7	78.7	78.0	77.3	76.7	76.3	75.1
Gross domestic investment	22.8	23.4	24.4	23.2	23.5	19.4	19.2	20.6	21.9	23.7	24.2	26.3
Government investment	4.8	4.5	4.1	4.1	4.2	4.1	3.8	4.1	4.3	4.6	4.6	4.8
Private investment	13.6	14.7	16.3	15.9	16.1	12.3	12.0	13.2	14.3	15.8	16.1	17.6
Increase in stocks	4.5	4.2	3.9	3.2	3.1	3.1	3.3	3.3	3.3	3.3	3.4	3.9
Exports (GNFS)[b]	15.6	13.6	12.4	12.2	12.7	24.0	26.2	27.8	29.2	30.1	30.7	31.3
Imports (GNFS)	16.7	16.8	17.9	16.4	17.8	21.2	24.1	26.5	28.4	30.5	31.1	32.7
Gross domestic savings	21.7	20.3	19.0	19.0	18.4	22.3	21.3	22.0	22.7	23.3	23.7	24.9
Gross national savings[c]	19.8	18.4	17.0	16.9	16.0	18.7	17.9	19.0	20.0	21.6	22.1	24.3
Memorandum items												
Gross domestic product (US$ million at current prices)	247,057	290,529	334,356	367,581	377,112	250,038	289,920	305,128	324,538	348,739	376,597	556,562
Gross national product per capita (US$, Atlas method)	2,450	2,981	3,490	3,810	4,090	3,320	2,964	2,897	3,223	3,445	3,658	5,100
Real annual growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	4.4%	3.6%	2.9%	0.7%	3.5%	-6.9%	3.0%	3.5%	4.0%	5.0%	5.0%	5.3%
Gross Domestic Income	5.6%	3.2%	3.2%	0.8%	3.4%	-11.1%	2.3%	3.1%	3.6%	4.7%	4.8%	5.1%
Total consumption	5.5%	4.8%	3.7%	0.4%	3.5%	-11.7%	0.4%	0.8%	2.1%	3.4%	4.0%	4.5%
Private consumption	6.1%	4.9%	3.9%	0.2%	3.7%	-12.9%	1.0%	1.2%	2.3%	3.5%	4.0%	4.5%
Real annual per capita growth rates (%, calculated from 1980 prices)												
Gross domestic product at market prices	0.5%	1.6%	0.9%	-1.2%	1.6%	-8.6%	1.1%	1.7%	2.2%	3.3%	3.4%	3.7%

(Continued)

Mexico - Key Economic Indicators
(Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Balance of Payments (US$m)												
Exports (GNFS)[b]	38,411	39,695	41,451	44,872	50,717	63,532	76,070	84,948	94,695	105,119	115,434	174,227
Merchandise FOB	30,390	30,905	32,259	35,453	40,416	53,362	65,047	72,923	81,138	89,896	98,781	148,078
Imports (GNFS)[b]	41,215	48,725	59,681	60,473	71,136	55,203	69,937	80,734	92,258	106,427	117,253	182,047
Merchandise FOB	31,272	38,184	48,193	48,924	58,880	46,274	57,816	67,574	77,065	89,197	98,405	152,521
Resource balance	-2,804	-9,030	-18,230	-15,601	-20,419	8,329	6,133	4,214	2,437	-1,308	-1,819	-7,819
Net current transfers (including official current transfers)	3,978	2,745	3,386	3,640	4,011	3,965	4,101	4,354	4,520	4,525	4,803	10,601
Current account balance (after official capital grants)	-7,451	-14,892	-24,438	-23,399	-29,419	-655	-3,563	-4,967	-6,276	-7,163	-7,735	-11,254
Net private foreign direct investment	2,633	4,761	4,393	4,389	10,973	6,964	5,800	6,000	6,400	7,100	9,600	9,700
Long-term loans (net)	9,224	4,171	51	3,227	4,271	7,817	354	1,836	363	1,749	78	-1,802
Official	4,181	1,392	620	20	-624	10,341	-7,113	-385	-2,718	-3,343	-1,088	-123
Private	5,043	2,779	-569	3,207	4,895	-2,524	7,467	2,221	3,080	5,092	1,166	-1,680
Other capital (net, including errors and omissions)	-1,175	14,099	21,168	21,724	-4,216	-3,275	-1,991	1,308	1,155	1,570	3,813	6,622
Change in reserves[d]	-3,231	-8,139	-1,174	-5,941	18,391	-10,851	-600	-4,177	-1,642	-3,256	-5,756	-3,266
Memorandum items												
Resource balance (% of GDP at current market prices)	-1.1%	-3.1%	-5.5%	-4.2%	-5.4%	3.3%	2.1%	1.4%	0.8%	-0.4%	-0.5%	-1.4%
Current account balance (% of GDP at current market prices)	-3.0%	-5.1%	-7.3%	-6.4%	-7.8%	-0.3%	-1.2%	-1.6%	-1.9%	-2.1%	-2.1%	-2.0%
Reserves in months of imports of goods	3.8	5.6	4.7	6.2	1.3	4.4	3.2	3.1	2.7	2.4	2.5	3.6

(Continued)

Mexico - Key Economic Indicators
(Continued)

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Public finance (as % of GDP at current market prices)[a]												
Current revenues	27.0	25.8	26.1	25.4	25.6	26.9	25.4	25.5	25.7	26.0	26.2	26.6
Current expenditures	26.3	22.5	20.6	21.8	21.8	23.1	22.6	22.8	22.5	22.4	22.2	21.6
Current account surplus (+) or deficit (-)	0.7	3.3	5.5	3.6	3.8	3.8	2.8	2.7	3.2	3.6	4.0	5.0
Capital expenditure	3.8	3.9	4.0	3.3	4.2	3.7	3.5	3.7	3.8	3.9	4.2	4.9
Overall Balance	-3.1	-0.6	1.5	0.3	-0.4	0.1	-0.7	-1.0	-0.6	-0.3	-0.3	0.1
Monetary indicators												
M2/GDP (at current market prices)	26.3	30.7	31.3	32.0	34.9	38.5	..	..	..	..	..	..
Growth of M2 (%)	46.2	47.1	20.3	13.4	21.3	38.7	..	..	..	..	..	..
Private sector credit growth / total credit growth (%)	83.7	105.2	161.5	193.3	139.9	43.1	..	..	..	..	..	..
Price indices(1980 =100)												
Merchandise export price index	87.3	82.3	84.9	86.4	95.8	110.6	112.1	115.1	118.7	122.1	125.1	139.8
Merchandise import price index	134.4	135.6	137.1	138.5	141.7	153.5	151.0	154.7	158.9	162.8	166.7	188.2
Merchandise terms of trade index	65.0	60.7	61.9	62.4	67.6	72.0	74.2	74.4	74.7	75.0	75.0	74.3
Real exchange rate (US$/LCU)[f]	128.8	117.5	107.4	101.5	105.3	152.8	135.0	135.0	135.0	135.0	135.0	135.0
Consumer price index (% growth rate) (period average)	26.7%	22.7%	15.5%	9.8%	7.1%	34.9%	39.0%	19.8%	10.8%	8.0%	6.0%	5.0%
Consumer price index (% growth rate) (end-of-period)	29.9%	18.8%	11.9%	8.0%	7.0%	51.3%	27.0%	12.5%	9.0%	7.0%	5.0%	5.0%
GDP deflator (% growth rate)	29.8%	21.8%	14.7%	9.9%	7.4%	35.4%	33.8%	17.8%	9.8%	7.2%	5.6%	4.9%

a. GDP components are at market prices.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Consolidated non-financial public sector.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Mexico - Key Exposure Indicators

Indicator	Actual						Projected					
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2005
Total debt outstanding and disbursed (TDO) (US$m)[a]	104,439	114,065	112,227	127,436	136,125	161,096	159,048	159,731	160,730	161,155	159,889	173,482
Net disbursements (US$m)[a]	17,637	10,117	2,162	4,798	7,475	16,466	-6,295	-2,629	-2,581	-3,107	-4,463	-410
Total debt service (TDS) (US$m)[a]	11,316	13,545	20,822	21,931	19,938	29,206	39,280	34,481	41,118	45,909	47,374	50,296
Debt and debt service indicators (%)												
TDO/XGS[b]	25.9	249.5	238.6	254.7	239.9	229.7	191.4	173.4	157.2	142.8	129.5	91.4
TDO/GDP	42.3	39.3	33.6	34.7	36.1	64.4	54.9	52.3	49.5	46.2	42.5	31.2
TDS/(XGS + current transfers)	26.7	31.9	46.4	45.2	36.4	43.3	48.9	38.6	41.4	41.9	39.4	27.2
IBRD exposure indicators (%)												
IBRD DS/public DS	16.2	16.6	11.2	15.5	15.1	13.2	8.4	11.0	9.1	8.2	7.8	8.3
Preferred creditor DS/public DS	39.3	36.5	22.9	33.3	31.1	24.1	21.5	25.9	26.2	31.0	24.9	14.6
IBRD DS/XGS	3.6	4.0	4.0	3.8	3.5	3.4	3.0	2.8	2.5	2.4	2.2	1.4
Share of IBRD portfolio	11.4	11.7	12.1	11.9	11.8	12.0	12.3	12.4	11.9	11.1	10.2	8.2
IFC (US$m)												
Loans	119	69	67	53	133	63	194	310	340	375	400	420
Equity and quasi-equity[c]	20	60	64	36	21	12	38	75	85	90	100	105
MIGA												
MIGA guarantees (US$m)	0	0	0	0	0	0	0	0	0	0	0	0

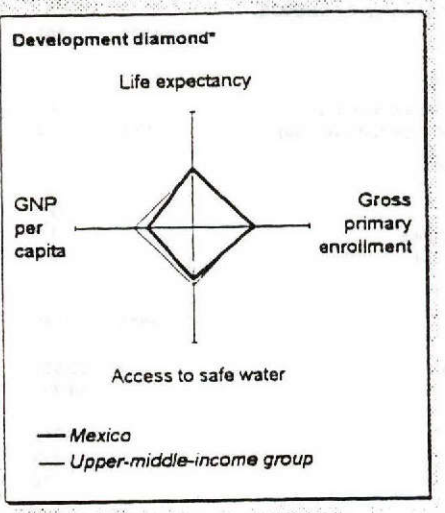
a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

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

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

Mexico at a glance

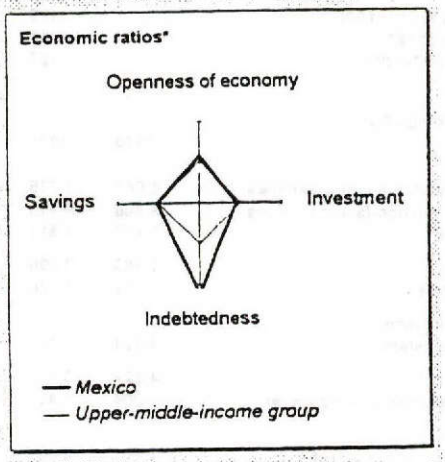
POVERTY and SOCIAL	Mexico	Latin America & Carib.	Upper-middle-income
Population mid-1995 *(millions)*	91.8	481	442
GNP per capita 1995 *(US$)*	3,320	3,320	4,300
GNP 1995 *(billions US$)*	304.9	1,597	1,901
Average annual growth, 1990-95			
Population *(%)*	1.9	1.8	1.7
Labor force *(%)*	2.9	2.4	2.1
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	34	..	..
Urban population *(% of total population)*	75	74	74
Life expectancy at birth *(years)*	70	68	69
Infant mortality *(per 1,000 live births)*	35	41	36
Child malnutrition *(% of children under 5)*	11	..	..
Access to safe water *(% of population)*	78	80	86
Illiteracy *(% of population age 15+)*	13	14	13
Gross primary enrollment *(% of school-age population)*	112	110	107
Male	114	..	..
Female	110	..	..



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

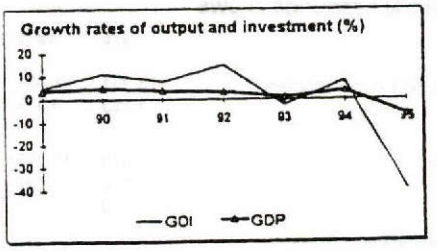
	1975	1985	1994	1995
GDP *(billions US$)*	94.4	183.6	377.1	250.0
Gross domestic investment/GDP	22.3	20.8	23.5	19.4
Exports of goods and non-factor services/GDP	5.7	15.5	12.7	24.0
Gross domestic savings/GDP	19.0	25.9	18.4	22.3
Gross national savings/GDP	17.1	22.1	16.0	18.7
Current account balance/GDP	-4.4	0.4	-7.8	-0.3
Interest payments/GDP	1.2	5.1	2.4	3.9
Total debt/GDP	19.3	52.8	36.1	64.4
Total debt service/(exports + current transfers)		52.4	36.4	43.3
Present value of debt/GDP	..	..	32.7	..
Present value of debt/exports	..	..	219.4	..

	1975-84	1985-95	1994	1995	1996-99
(average annual growth)					
GDP	5.1	2.0	3.5	-6.9	3.9
GNP per capita	2.0	0.3	1.2	-10.8	..
Exports of goods and nfs	12.5	5.2	7.3	28.4	10.3

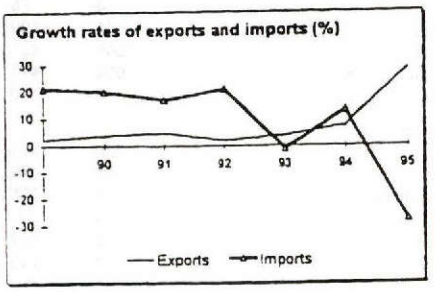


STRUCTURE of the ECONOMY

	1975	1985	1994	1995
(% of GDP)				
Agriculture	10.8	9.1	8.0	8.2
Industry	29.9	33.5	28.1	27.8
Manufacturing	21.9	23.5	19.7	19.8
Services	59.4	57.4	64.0	64.1
Private consumption	71.6	64.8	70.0	67.3
General government consumption	9.3	9.3	11.6	10.4
Imports of goods and non-factor services	9.0	10.4	17.8	21.2



	1975-84	1985-95	1994	1995
(average annual growth)				
Agriculture	3.2	0.3	4.2	-3.8
Industry	5.2	2.4	4.1	-8.0
Manufacturing	4.4	2.8	3.6	-6.4
Services	5.3	2.0	3.4	-6.7
Private consumption	4.1	3.8	3.7	-12.9
General government consumption	6.6	1.2	2.5	-4.1
Gross domestic investment	2.4	3.7	7.8	-39.5
Imports of goods and non-factor services	2.8	13.3	12.9	-27.6
Gross national product	4.5	2.2	3.1	-8.7

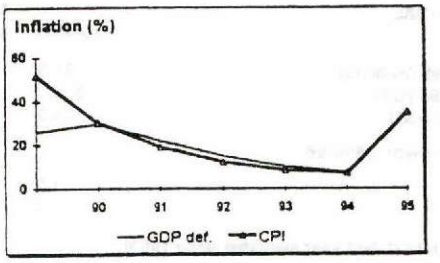


* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete

Mexico

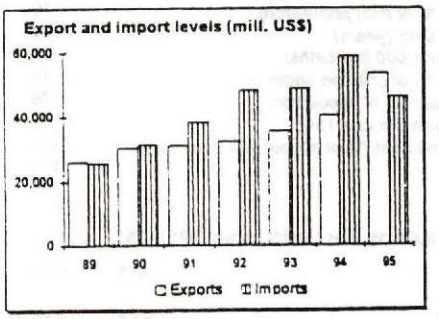
PRICES and GOVERNMENT FINANCE

	1975	1985	1994	1995
Domestic prices				
(% change)				
Consumer prices (period average)	..	57.7	7.1	34.9
Implicit GDP deflator (period average)	15.5	56.2	7.4	35.4
Government finance				
(% of GDP)				
Current revenue	..	31.5	25.6	26.9
Current budget balance	..	-1.6	3.8	3.8
Overall surplus/deficit	..	-6.2	-0.4	0.1



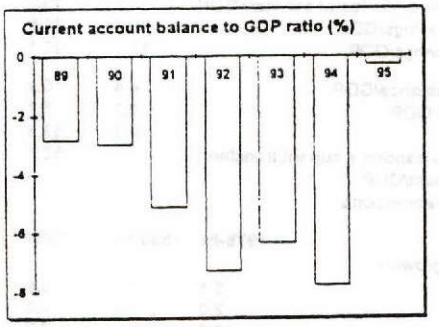
TRADE

	1975	1985	1994	1995
(millions US$)				
Total exports (fob)	..	22,931	40,416	53,362
Fuel	..	14,767	7,445	8,422
n.a.	..	..	..	..
Manufactures	..	6,245	29,936	40,379
Total imports (cif)	..	14,533	58,880	46,274
Food	..	1,082	9,510	5,335
Fuel and energy	..	..	..	..
Capital goods	..	3,165	13,322	8,697
Export price index *(1987=100)*	..	125	110	122
Import price index *(1987=100)*	..	99	119	123
Terms of trade *(1987=100)*	..	127	93	99



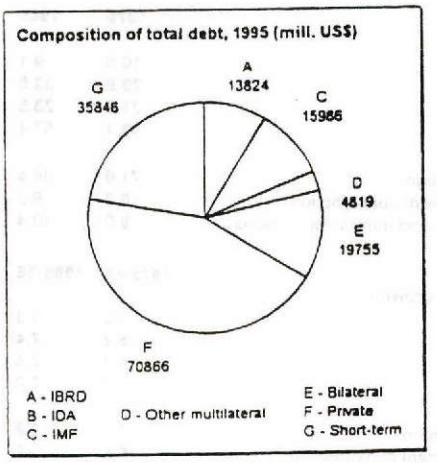
BALANCE of PAYMENTS

	1975	1985	1994	1995
(millions US$)				
Exports of goods and non-factor services	6,066	27,726	50,717	63,532
Imports of goods and non-factor services	8,466	19,915	71,136	55,203
Resource balance	-2,400	7,811	-20,419	8,329
Net factor income	-1,783	-8,996	-13,012	-12,948
Net current transfers	59	1,986	4,011	3,965
Current account balance, before official transfers	-4,124	801	-29,419	-655
Financing items (net)	4,327	-3,222	11,028	11,505
Changes in net reserves (- = increase)	-204	2,421	18,391	-10,850
Memo:				
Reserves including gold *(mill. US$)*	1,897	4,997	6,300	16,870
Conversion rate *(local/US$, period average)*	1.25E-02	0.3	3.4	6.4



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1994	1995
(millions US$)				
Total debt outstanding and disbursed	18,231	96,867	136,125	161,096
IBRD	1,123	4,034	13,038	13,824
IDA	0	0	0	0
Total debt service	2,613	15,293	19,938	29,206
IBRD	116	597	1,990	2,375
IDA	0	0	0	0
Composition of net resource flows				
Official grants	8	78	47	..
Official creditors	381	809	-623	10,341
Private creditors	3,365	-831	4,985	-2,424
Foreign direct investment	609	491	10,973	6,964
Portfolio equity	0	0	4,088	519
World Bank program				
Commitments	310	928	2,815	1,877
Disbursements	188	840	943	1,733
Principal repayments	39	335	1,065	1,411
Net flows	150	505	-123	322
Interest payments	78	262	924	964
Net transfers	72	243	-1,046	-642



Attachment 1

MEXICO
COUNTRY ASSISTANCE STRATEGY

PRIVATE SECTOR STRATEGY

I. INTRODUCTION

1. This Private Sector Strategy Paper (PSS) addresses selected issues that are relevant to Mexico's private sector development, as an important input to the country's overall strategy to recover from the recent crisis, reduce poverty and achieve sustained growth. The PSS is a supporting document of the Country Assistance Strategy (CAS), which attempts to provide a comprehensive assessment of the country's overall development needs and Bank Group assistance strategy.

2. Efforts to promote private sector development permeate virtually every Bank Group operation identified in the CAS. The PSS, however, focuses in more detail on five areas deemed important for private sector development at this stage: strengthening the banking sector, developing non-banking and capital markets, enhancing the competitiveness of Mexican corporations particularly in the SME sector, improving infrastructure and correcting regional development imbalances.[1] These areas reflect both the current priority needs of the Mexican private sector, as well as the proposed allocation of Bank Group resources for private sector development in Mexico over the FY97-99 period.

3. The PSS is organized in four sections: the next section describes the local private sector and presents an overview of the current business environment in Mexico. The third section summarizes Government actions to promote the private sector and the fourth section describes the Bank Group's strategy to assist the Government in removing the remaining constraints to private sector development.

II. THE PRIVATE BUSINESS ENVIRONMENT

General Profile

4. The macroeconomic reforms instituted by the Mexican authorities over the past decade have significantly elevated the role of the private sector. The sale of Government-owned enterprises and the re-privatization of the banking sector have played an important part, but most critical has been the opening of the economy to international competition.

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1 These sectors do not preclude active participation in other important areas such as agribusiness and small scale mining.

5. Characterized by a fairly diversified productive base, the Mexican private sector presently accounts for 70% of GDP and 86% of total employment. Data on output trends and productivity growth suggests a duality within the Mexican private sector. A large traditional sector, comprising mainly small and medium sized firms, employs a large fraction of the labor force but accounts for a much smaller portion of output and exports. Productivity improvements in this sector have been slow and output growth sluggish. In contrast, the modern sector has experienced faster productivity growth, and stronger output and export performance.

6. **Growth Patterns**. The evolution of private sector activity in Mexico mirrors the evolution of GDP in general. GDP growth has been moderate overall since the liberalization efforts began and has varied significantly across sectors, as productive activities have adjusted with differing degrees of success to structural changes. As shown in Table 1, agricultural growth remained flat while industry and services each grew by about 3.0% p.a. Within manufacturing, some industries experienced slow or even negative growth (e.g. textiles, clothing, footwear, wood products, agro-industry) while export-oriented industries (e.g. automobile assemblies and autoparts, electrical and electronic goods, petrochemicals and steel) showed the most dynamic performance.

Table 1
MEXICO
Gross Domestic Product and Sectoral Growth Rates

	GDP Share (%)	GDP Average Growth Rate	
Sector	*1995*	*1985-94*	*1995*
Agriculture	7.6	0.5	-3.8
Industry	32.7	3.1	-8.0
Mining	3.7	1.2	-0.7
Manufacturing	22.6	2.4	-6.4
Construction	4.6	2.0	-22.0
Electricity, Gas & Water	1.8	4.5	3.1
Services	59.7	2.3	-6.7
Trade & Restaurants	23.3	2.2	-14.4
Trans., Warehouse & Comm	7..9	4.5	-1.9
Finance, Insurance & Fixed Assets	12.4	3.5	0.4
Community, Social & Personal Services	16.1	1.4	-2.4

Source: Calculations based on National Accounts series. INEGI

7. The recent economic recession has had strong repercussions on sectoral developments. Mexico's overall index of industrial production declined in 1995, as did agricultural output and services. Within the industrial sector, the construction industry experienced the most severe contraction as a result of a sharp decline in public infrastructure projects and private investment. Output of all major manufacturing sectors declined with the exception of basic metal industries which grew by 9%. Notwithstanding a flat growth performance within the mining sector as a whole, iron ore and other non-metallic metals experienced real growth rates between 13% and 15%, reflecting the positive role of direct and indirect exports in these mining activities.

8. The past decade also witnessed a significant shift in the nature and distribution of exports. As detailed in Table 2, manufactured exports have replaced oil as Mexico's main

source of export earnings. In addition to the dynamism of manufactured exports growth, this evolution also reflects a halving in world oil prices since 1982. Agricultural exports have remained constant at around 5-6% of the total, with rising sales of fresh fruit and vegetables offsetting declining revenues from traditional export crops such as cotton and coffee.

Table 2
MEXICO
Structural Changes in Mexican Exports
(percentages)

Year	Manufactured Exports/ Manufacturing GDP	Manufactured Exports/ Total Exports (excluding in-bond)	Petroleum Exports/Total Exports (excluding in-bond)
1982-83	10.5	17.5	74.5
1986-87	23.6	37.7 *	50.9 *
1994	32.0	68.9	21.2
1995	53.8	73.2	17.4
1985-87*			

Source: El Indicador Bursatil

9. The *peso* crisis has reinforced the above trends, as exports have taken up the slack in domestic demand. In US dollar terms, total merchandise exports increased by 31% in 1995, with manufacturing exports experiencing a 47% surge and the "*Maquiladora*" (in-bond) industry growing by 18%. This high export growth continued through the first half of 1996, facilitated by the sharp improvement in Mexico's price competitiveness and strong diversification into non-traditional exports.

10. **Recent Performance.** Following a major recession in 1995, the country's prospects for faster growth and lower inflation have improved in 1996. The disciplined fiscal and monetary policies required to stabilize the economy, however, have limited the credit available to the private sector. Uncertainties about the future performance of the Mexican economy also have led to a significant contraction of international credit and have forced companies to become more resourceful in their search for overseas funding. Medium to long-term external financing today for private entrepreneurs is largely limited to the securitization of export receivables. The foreign syndicated loan market remains largely closed, while the bond market is only starting to recover with limited issues involving a few premier companies. This situation has severely complicated the private sector's capacity to meet its investment needs.

11. The *peso* crisis has caused widespread corporate distress as Mexican enterprises have been hit within a relatively short time with high real interest rates and weak domestic demand. Unprecedented declines in output and difficulties experienced in passing raw material cost increases to customers have depressed operating profits. The domestic credit crunch and the closing of foreign credit markets have caused severe financing shortfalls and consequent liquidity difficulties as well. Resulting losses have further eroded already over-leveraged balance sheets.

12. Payment delays within the private sector have resulted in a "domino-effect" accumulation of receivables, while lower sales have caused an undesirable build-up of

inventories. Both have led to dramatic declines in liquid assets at a time when credit to finance current assets is not readily available. Even among companies that have managed to show positive net incomes, there are many examples of firms which cannot meet payments to suppliers and creditors alike and which continue to face inadequate liquid balances, depressed cash flows, and pressing debt service obligations. With the dramatic reduction in conventional domestic and foreign credit, lenders have become increasingly reluctant to refinance existing debt, leading many companies to bankruptcy. This widespread corporate problem has forced many companies to focus on continuing debt servicing and rollover issues rather than in addressing the operational and asset restructuring needs of their businesses. Private investment fell 34% in 1995, the most pronounced fall in the last 15 years.

13. The above operational strains have widened performance differentials within the private sector. Large productive concerns have weathered the crisis better than their smaller counterparts and companies that serve the domestic market have been more seriously affected than those which diversified into exports.[2] The small and medium scale enterprise sector (SME) has been particularly hard pressed. The non-tradable sector has been hurt the most due to the combined impact of a sharp decline in domestic demand, production cost increases, and limited access to international capital markets. On the brighter side, commodity and other basic import substitution industries have been helped as their foreign competitors have been effectively priced out of the market. The incipient recovery and decline of market interest rates observed in mid-1996, also are expected to improve the overall financial situation of both private corporations and banks.

14. The liberalization effort in Mexico has improved the environment for foreign investment. Foreign direct investment increased from $US2.6 billion in 1990 to US$11 billion by 1994. Even in the midst of the recession of 1995, foreign direct investment continued at US$7.0 billion. Foreign direct investment has introduced many modern technologies and management practices, particularly in manufacturing. Portfolio equity investment also increased significantly, rising from US$2.0 billion in 1990 to a peak of US$10.7 billion in 1993. The political and economic uncertainties associated with the financial crisis reduced net equity inflows to US$0.5 billion in 1995. Net bond placements showed a more exaggerated pattern with net redemption in 1995 of US$14.4 billion.

III. THE GOVERNMENT AND THE PRIVATE SECTOR

15. Over the last fifteen years, Mexico has pursued a long process of economic reforms directed at promoting private sector-led growth and shrinking the role of the state. As part of that agenda, the Mexican authorities have engaged in fiscal reforms

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2 Detailed information illustrating the impact of the above crisis on enterprise performance by size category is scarce. The available evidence, based on electricity sales as a proxy for industrial activity, suggests that micro, small and medium sized firms have been the hardest hit. Electricity sales to this particular group dropped by 20% in 1995 while they increased marginally by 1% among the largest Mexican corporates.

accompanied by trade liberalization. This effort was formalized in the NAFTA agreement which came into effect in January 1994. The competitive atmosphere was enhanced by liberalization of the law on foreign investment, which permits majority foreign ownership in certain sectors. The reprivatization of the commercial banks, elimination of credit controls, and reduction of the role of government development banks and trust funds were meant to allow the private sector a greater role in allocating resources. Tax reform, industrial deregulation, improved intellectual property rights, a privatization program in mining and steel, telecoms, roads and ports, and extensive agricultural reforms provide further evidence of Mexico's adjustment.

16. In addition to launching a comprehensive economic stabilization program, the Government has taken a number of actions over the past year to maintain public confidence in the banking system. The Laws of Credit Institutions, Brokerage Houses and Financial Groups were amended to permit greater foreign involvement and participation in the financial sector. The National Securities and National Banking Commissions were merged to strengthen bank supervision and ensure the application of uniform accounting and regulatory standards among financial institutions. Finally, a number of legal reforms were introduced to facilitate the securitization and sale of bank loan portfolios to third parties, lift banking secrecy to provide potential purchasers with detailed information on credit risk, and clamp down on the practice whereby banks lend money to themselves and to members of groups to which they belong.

17. The Government also launched various programs to contain the deterioration of banks loan portfolios and maintain adequate capitalization within the banking system. FOBAPROA, the banking support fund administered by the Banco de Mexico, intervened in ten banks and provided assistance to other banks through various support mechanisms. Reflecting the critical role which the banking sector must play in the economic recovery process, these support programs have thus far primarily addressed the risk of systemic bank failure. Now, increasing attention is being given by the Mexican authorities to establishing a base for recovery of the corporate sector. In recent months, the Government initiated programs to facilitate the restructuring of financially distressed enterprises on a case-by-case basis. The UCABE program, designed to resolve stalled debt negotiations, has targeted companies with roughly US$150-500 million of bank debt.[3] A second program would provide equity to distressed small-and medium-scale enterprises through NAFIN.

Constraints to Private Sector Development

18. While recent Government actions and initiatives will contribute to the ongoing economic recovery process, additional reforms are needed to induce a broad-based modernization of the economy and private sector. Key areas that need to be addressed immediately are banking and corporate restructuring. Over the longer term, major constraints include: infrastructure bottlenecks, underdeveloped capital markets, regional

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3 UCABE's financial instruments include: (a) a debt swap mechanism that allows a debtor to obtain a 22.5 percent reduction in the amount owed, without causing a corresponding 22.5 percent book loss to the creditor; (b) and debt swap alternatives to enable banks to swap exposures among themselves on a one-for-one basis.

imbalances, continuing regulatory barriers to trade and investment particularly at state and municipal levels, low skill levels, and inadequacies of the commercial legal framework and judicial system that especially disadvantage SMEs and contribute to a concentrated industrial structure.

19. In those key areas where the Bank Group plans to collaborate in assisting the Government, the following Government actions are required:

- **Banking.** Some liquidation and consolidation of Mexico's banking system may be necessary. While every effort to resist bank failure is appropriate, ultimately the health of the overall system will call for some adjustment to avoid contaminating potentially salvageable banks. The basis for this adjustment ideally should be market-based, i.e., voluntarily sought by shareholders and creditors. The authorities need to both (a) place a cap on the financial relief provided and (b) establish a termination date on the period of forbearance with respect to failure to honor contractual obligations. Problems of "willingness to pay" need to be eliminated so that "ability to pay" can be effectively addressed.

- **Corporate Restructuring.** Mechanisms need to be put in place to enable the timely and impartial enforcement of contracts. This is a *sine qua non*. Otherwise, perverse market expectations will thwart the best efforts of the authorities in other areas. A specific set of actions in this regard would include improvement of title registry and recordation, measures to enable the perfection of security interest, the strengthening of bankruptcy provisions and the strengthening of legal and administrative procedures regarding asset foreclosures. In addition, special financing facilities need to be established, aimed at financing the transfer of assets from distressed enterprises and financial institutions. Once borrowers are convinced that the authorities are not likely to encourage contractual leniency after the current relief has been exhausted, such facilities will help them realize at least partial value for distressed assets—an outcome that has been unavailable to date.

- **Capital Markets.** Actions are needed to strengthen and diversify Mexico's capital markets in order for them to contribute over the longer-term to improved stability and efficiency in the process of resource allocation

- **Infrastructure**. The legal and regulatory framework for private provision of power, and water and sanitation needs to be improved. While much privatization has taken place in these sectors, the largest enterprises have not been fully privatized. Also, stalled petrochemical privatizations need to move ahead. These sectors provide the most important infrastructure services for private sector activity, and if they are not reformed, will stymie private sector growth.

- **Regional Development**. Mexico's uneven regional development remains a severe obstacle to sustained and balanced growth. Government initiatives are needed to reduce poverty in these areas by accelerating private sector led growth and improving the delivery and management of basic social services.

IV. THE BANK GROUP STRATEGY

Strategic Framework

20. Since the devaluation of the *peso*, the Bank Group's assistance to the Mexican private sector has been of a crisis-response nature where efforts have been primarily aimed at containing the financial crisis and stabilizing the environment for corporate development. As Mexico is likely to remain in a difficult state of transition for much of the next three years, the Bank Group's private sector strategy will continue to focus on the immediate priorities of the Mexican private sector. At the same time, however, the Bank Group will begin to focus on those areas that need to be strengthened to ensure sustained private sector growth in the medium to long-term.

21. Given its critical importance to the economic recovery process, the *financial sector* will continue to account for a significant part of the Bank Group's economic and sector work program, investment and lending activities, and policy dialogue with the Mexican authorities. While the *banking sector* will remain the top immediate priority, the Bank Group's support will increasingly shift to strengthening the regulatory and institutional framework needed to ensure the future development of the banking system and diversify further the range of financial institutions and financial products. Beyond the financial sector, high priority will also be assigned to assist the *corporate sector in restructuring* its troubled enterprises, in particular SMEs.

22. Medium to long term issues to which the Bank Group will assign high priority relate to the general constraints to private sector development predating the crisis, particularly *infrastructure* deficiencies and excessive *regional concentration* of productive activities. While infrastructure development will remain a key area of Bank Group involvement, the focus of support will shift to promoting increased and more efficient private participation. Activities to achieve more balanced regional development will feature a new Southern States Initiative which aims to foster growth and poverty reduction in the poorest two states through an enhanced role of the private sector.

23. The above strategic areas for Bank Group intervention are key to sustained growth, employment generation, and poverty alleviation. The rationale behind their selection and details of the Bank Group's strategy to be pursued for each through FY99 are presented in the subsequent sections. Matrices relating to each strategic area and providing summary information on the objectives, actions, benchmarks, and instruments which will be part of the proposed Bank Group's agenda are included at the end of each section.[4]

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4 IFC's involvement in each individual transaction will need to be tested against IFC's project selection criteria as described in Annex 1.

1. The Banking Sector

24. The *peso* devaluation of December 1994 has had both immediate and long-term adverse effects on the capacity of the system[5] to respond to the needs of the private sector. The Government has currently intervened in 10 banks and the 12 largest banks still in private hands are struggling to meet adequate capital adequacy levels.

25. The systemic weaknesses from which the banking sector currently suffers were already evident when the banks were privatized in 1991-92. The new bankers inherited unprepared personnel and weak internal systems and controls, particularly in the area of credit analysis. In some cases, banks were sold to controlling shareholders lacking lending experience and access to technical expertise. Moreover, the new owners were under considerable pressure to record high earnings, having paid multiples of between three and four times book value for their ownership interests. In the rush to compete for market share, lending exploded to levels many times the economy's growth rate, with much of the credit expansion in consumer lending. Consumer lending was already growing in the three years proceeding privatization. Not surprisingly, portfolio quality suffered, becoming particularly evident toward the end of 1994.

26. The *peso* devaluation accentuated the above portfolio trends and weaknesses of the banking system. Mexico's commercial banks posted a net loss of N$37.9 billion (US$6.0 billion equivalent) in 1995 and of N$16.3 billion (US$2.0 billion equivalent) through March 1996. Past due loans increased by 74.4% from N$57 billion to N$98.7 billion in 1995. Available data also reveal that during the first half of 1996 the commercial banks' loan portfolio deteriorated further with the ratio of past due loans to gross loans reaching an estimated 15% as compared to 7.3% at year-end 1994, and 14% at year-end 1995 (excluding FOBAPROA purchases).

TABLE 3
Mexico
Structure of Commercial Banking System
(N$ million as of end-March 1996)

Bank Groups	Number of Banks	Assets	Gross Loans	Direct Funding	Equity	Net Profit or Losses
Intervened Banks	8	136,897	142,318	98,795	-40,127	-13,975
Privatized Banks	12	886,189	553,388	506,934	54,767	-2,995
New Local Banks	15	36,062	18,742	14,335	6,421	293
Subs. of Foreign Banks	16	41,524	6,981	9,859	5,249	326
Banking System	51	1,100,672	720,429	629,923	26,310	-16,351

5 Fifty-four institutions comprise the Mexican commercial banking sector. Twenty are established banks (18 of which were privatized in 1991/2). The remaining banks in the system operate under charters issued since 1993. The Mexican banking system is characterized by extreme concentration and little foreign participation. Three large banks -Banamex, Bancomer and Serfin- represent about 46% of total system assets, the seventeen other established banks represent about 48% of the system and the newly chartered banks, 6%.

27. Since early 1995 the Government has tightened banking supervision and provided financial support to the banking system. While these actions contributed to an improvement in the banks' capitalization, the deterioration in their loan portfolios—as stated earlier—has not yet been firmly contained. Further actions need to be taken in the following areas:

- *Accounting and Reporting Practices.* There remains a lack of unbiased, transparent and timely financial reporting. Accounting and loan classification practices continue to overstate profitability and obscure the true condition of banks. The practice of "quick-fix" restructuring to eliminate arrears and avoid reclassifying troubled loans of major debtors also results in overstatement of loan quality and inadequate provisioning. Finally, Mexican GAAP encourages the overstatement of profits and thus capital adequacy calculations[6].

- *Legal and Regulatory Framework.* Laws governing commercial transactions are no longer adequate to meet the complex requirements of a global economy. The Bankruptcy Law, in particular, needs improvement. It has proven to be an ineffective instrument for managing orderly workouts or liquidation of troubled companies. Its complicated procedural requirements, together with certain of its substantive provisions, have impeded the ability of lenders to force debtors into bankruptcy and have contributed to delay enterprise restructuring agreements and the disposition of impaired banking assets needed for a comprehensive rehabilitation of the banking system. Additionally, the Law on Negotiable Instruments and Credit Transactions limits the financing options available to companies through banks and non-bank intermediaries, and thus prevents private sector entities from entering into mutually beneficial contracts.

- *Liability Protection.* Through FOBAPROA, the Government currently provides an implicit guarantee of all unsubordinated bank liabilities. As part of the rehabilitation of the Mexican banking system, such coverage should be limited to retail deposits below a certain threshold so as to encourage banking efficiency by subjecting banks to greater scrutiny from inter-bank lenders, rating agencies, large depositors and bond investors.

- *Regulation and Supervision.* Prudential regulatory norms and supervisory capacity are still inadequate. Although the authorities have introduced capital adequacy criteria more in line with BIS (Basle Accord) requirements, the inadequacies in accounting and reporting standards weaken the positive impact that capital adequacy criteria were designed to achieve.

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6 As part of the banking reform package supported by the ongoing IBRD's Financial Sector Restructuring Loan, the authorities will require banks to switch to international accounting standards starting with their year-end 1996 financial statements. However, private sector analysts believe it may take as long as a year thereafter before individual bank accounting systems fully implement the new system.

- *Financial Infrastructure Services.* The poor quality and lack of para-financial services constrain the modernization of the financial system. Improvements in this area would provide both regulators and financial sector participants with objective information necessary for sound evaluation of loans, borrowers and financial institutions.

28. **Bank Group Strategy - Banking Sector.** Through its Financial Sector Technical Assistance Loan (FTAL), the Bank Group has thus far contributed to the introduction of important improvements in regulation, supervision and institution building in the area of bank and non-bank intermediaries. Similarly, through the Financial Sector Restructuring Loan (FSRL), it has also addressed the most important short-term threats facing the banking system. Both of these efforts have encouraged reliance on market based solutions, greater incentives for market oversight of financial intermediaries, the introduction of new financial instruments, and the modernization of the legal/regulatory framework for lending.

29. To complement the above efforts, the Bank Group will, in the short-term, deepen its support of the banking sector with the objective of: (i) further improving accounting, reporting, and disclosure standards in the banking industry; (ii) bringing prudential regulations in line with international standards, and (iii) providing technical and financial assistance sufficient to assure the enactment of needed banking reforms. As part of that agenda, the Bank intends to process a second Financial Sector Restructuring Loan (FSRL II) in FY97. Through that new operation as well as a planned Financial Infrastructure Loan, it would build upon the progress achieved thus far in the banking system by assisting the economic authorities in:

- Operating an RTC type facility to divest bank assets held by the Government through FOBAPROA;
- Upgrading and modernizing public registries and credit bureaus;
- Updating the laws pertaining to credit and collateral, and undertaking needed reforms in bankruptcy laws and processes; and
- Improving the technical and supervisory capacity of regulators across the financial sector.

30. In addition to supporting the Bank's technical assistance and policy dialogue activities, IFC will seek to further expand its presence in the banking sector beyond the recent Banamex operation (FY96) through a combination of loans and equity investments. As part of this increased portfolio exposure, IFC would use commercial banks as vehicles through which to channel restructuring finance to the SME sector. The use of the country's strongest and largest banks will allow for wider distribution of IFC finance throughout the country, and IFC's equity participation should encourage foreign banks to

increase their investment in Mexico at this time. In addition to providing much needed financing, this instrument will aim to reinforce the use of strict financial discipline both in the banking and corporate sectors. Financial assistance will be completed by assigning a senior person to the field to actively transfer IFC's restructuring experience.

31. Over the medium-term, the Bank Group's assistance will aim to (i) bolster market discipline by reducing deposit insurance; (ii) broaden the use of international accounting standards; (iii) reduce arbitrage by closing loopholes within the financial regulatory framework; (iv) promote the development of private financial information gathering and reporting institutions; (v) deepen asset securitization through the establishment of private specialized financial institutions; and (vi) further develop micro and small enterprise lending.

MEXICO PRIVATE SECTOR STRATEGY: BANKING SECTOR DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Return of intervened banks and assets to private sector (Bank Resolution).	• Resolution (sale/merger/liquidation) of banks under government control, transfer of banks and assets to private management. • Adequately equip bank resolution agency (VVA) to manage and sell assets acquired by the government.	• Bring majority of currently intervened banks to point of resolution by year-end 1996; resolve remaining banks by end-July 1997. • Begin operations of VVA in July 1996; disposition of assets in accordance with annual targets over next five years.	• Technical assistance through financing of international experts, seconded staff of RTC-type entities (FTAL). • Banking System ESW. • FSRL I, II.	• Technical assistance and advisory role to help authorities strengthen banking framework and establish RTC-type institution.
Strengthen prudential regulations, accounting and disclosure framework (rules and regulations).	• Introduction of revised bank accounting for year-end 1996 statements based on international GAAP. • Limitations on qualification of subordinated convertible debt as Tier I capital. • Revised capitalization rules, including market risk. • Revised loan classification rules.	• Prudential regulations and capital rules more comparable with OECD countries. • Accounting rules for banks and other financial institutions consistent with international standards (US GAAP). • Evidence (based on visits to banks) that banks are applying new standards.	• Technical assistance through financing of international experts (FTAL). • Advisory role to assist authorities to conform to international (Basle) standards (FTAL). • FSRL I, II. • Financial Infrastructure Loan.	• Technical staff participation.
Strengthen banking supervision.	• Further improvement in the staff, systems, equipment and permanent training programs of the CNBV. • Continued annual on-site inspection of major banks, diagnostic audits and better analytical use of examination and audit results.	• Evidence (through monthly reviews by IBRD) of tighter CNBV control of banking activities, including application of penalties/sanctions.	• Technical assistance, including seconded examiners from OECD countries (FTAL).	• Technical staff participation.

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Encourage market-based discipline through limitation of FOBAPROA coverage of bank liabilities.	• Development of a timetable for removing implicit government guarantee for securities, interbank lines and eventually large deposits of banks.	• Announcement in 1996 of plans to phase out certain coverage.	• Advisory role. • FSRL I, II.	
		• Implementation of phase-out, beginning with interbank liabilities in 1997 and progress in accordance with agreed timetable.		
Modernize lending/securitization framework.	• Introduce changes in lending laws, particularly regarding secured transactions, title transfer and asset-backed securities.	• Evidence of greater reliance on loans secured by movable property, whole loan sales and asset-backed securities transactions taking place.	• Financing of domestic and international expertise (FTAL). • Financial Infrastructure Loan.	• Institution -building (equity finance) role for (a) banks at the Financial Group (FG) level, bank level and in other corporate entities of the FG within a multibanking context; (b) securitization institutions; (c) institution-building role at the regional level for microlending allowing IFC to "wholesale" its experience in this area; and (d) information generating institutions (e.g., rating agencies, financial publications, financial news and data networking ventures).
Reform the bankruptcy and work-out framework.	• Introduce laws and supporting regulations for bankruptcy, suspension of payments as well as voluntary work-outs.	• New legislation and rules drafted.	• Financing of domestic and international legal expertise (FTAL).	
Strengthen private commercial banks.	• Attract foreign equity financing for banks and the transfer of banking technology and systems. • Establish an RTC-type institution for the purchased loan portfolio and for insolvent banks. • Provide "financial work-out" expertise . • Rationalize prudential regulations across all activities spanned by financial groups and strengthen accounting and reporting requirements for financial groups, particularly the requirement to publish both consolidated and individual financial statements. • Accelerate measures to allow securitization of bank assets. • Mobilize resources for term finance and equity injections.	• Majority of commercial banks operating with improved capital adequacy and stronger financial and operating performance indicators. • Significant reduction in number and size of intervened banks. • Evidence of banks undertaking more secured lending and asset sales/ securitization.	• FTAL (ongoing). • FSRL I, II.	• Funds mobilization and catalytic roles regarding (a) credit lines to banks for restructuring finance (Banamex FY96 and Probursa FY97); (b) subordinated debt to banks to strengthen Tier II capital; (c) syndication of loans to banks (Banamex FY96); and (d) asset (loan) securitization (Banamex FY96). • Institution-building role (equity finance) for selected banks during the transition. • Technical assistance role for strengthening long-term financial system framework across all activities of financial groups. • Funds mobilization and catalytic roles for (a) lending to selected banks; and (b) securitization of bank assets.

2. Capital Markets and Specialized Financial Institutions

32. Mexico's financial markets have not yet attained the level of diversification and sophistication expected for such a large liberalized economy. Note from Table 4 below the extremely small share of total financial assets accounted for by specialized financial institutions in such areas as leasing, factoring, venture capital and insurance.

33. Given the nature and extent of existing capital market constraints, various tasks need to be addressed on a priority basis if local financial markets are to be developed and play a leading role in the ongoing recovery process. In addition to restoring the health of the banking sector and raising domestic savings, these tasks include: (i) securing an orderly transition to a funded pension system; (ii) strengthening the institutional framework for housing finance; (iii) rapidly expanding the financial services available to SMEs through such institutions as leasing and venture capital; and (iv) remedying the inefficiencies and lack of transparency of the equity and bond markets.

Table 4
MEXICO: Assets of Mexican Financial Institutions
(Millions of New Pesos and % of Total)

Type of Institution	Dec-93	%	Dec-94	%	Sep-95	%
Commercial Banks	556,678	50	799,880	47	872,554	52
Brokerage Firms	210,814	19	399,244	24	251,657	15
Development Banks (Gov't.)	195,424	17	336,488	20	409,727	24
Mutual Funds	80,481	7	61,234	4	61,611	4
Insurance	29,651	3	35,408	2	42,236	3
Others[1]	47,911	4	61,561	4	46,073	3
TOTAL	**1,120,959**	**100**	**1,693,815**	**100**	**1,683,857**	**100**

Source: CNBV
1/ "others" includes credit unions, factoring companies, leasing companies, warehousing companies, bonding companies and exchange houses.

34. ***Pension Reform and the Contractual Savings Industry.*** Without understating the other financial market constraints, the most pressing capital market issue involves the reform of the *Sistema de Ahorro para el Retiro* (SAR) into a privately-managed system. Indeed, with a current base of 10 million affiliates, such a reform could potentially create the single largest financial industry in Mexico within a decade. For a vibrant private sector-managed contractual savings industry to be established, the current reform program will have to address key issues pertaining to: (i) transition costs; (ii) fiscal implications; (iii) system coverage; (iv) fee structure; and (v) competition.

35. As it stands, further work is required to encourage efficiency, economies of scale and public confidence. Mexico also needs to replace the Pay-As-You-Go (PAYG) system for public employees. Furthermore, pension contribution rates must be raised preferably through the transfer of the current INFONAVIT contributions to the funded pension system. Competition and efficiency in asset management must be encouraged by offering greater choice to workers regarding investment assets, vehicles, and providers. Finally, greater specialization is required with respect to investment objectives with commensurate

flexibility regarding admissible investment options. Concurrently with this last task, Mexico should eventually dismantle the artificial segmentation between the management of mandated savings (managed by AFOREs) and voluntary savings (managed by insurers, mutual funds, banks, etc.).

36. ***Housing Finance.*** Due to the flows of real assets involved, housing finance also has the potential to significantly influence the development of domestic financial markets. However, the persistent lack and high cost of such finance has remained an important social concern in Mexico by putting home ownership beyond the reach of most people. The main problem here is that Mexico does not have a coherent national housing policy. To the extent that the housing framework is marked by inefficiencies, the introduction of new financial products and creation of greater asset liquidity are impeded. The state has attempted to provide both housing and housing finance through multiple institutions and programs as well as through the *ad hoc* diversion of specific taxes. This has resulted in enormous fiscal costs, significant institutional failures, and sharply segmented markets.

37. ***Other Non-bank Financial Services.*** Sources of medium and long term funding from non-bank financial intermediaries are very limited. Although during 1995, 54 companies in Mexico were engaged in *leasing* with the 10 largest companies accounting for 72% of the total leasing portfolio, lease financing has not developed much beyond the consumer automobile market. The *factoring* market is served by some 31 factoring companies of which the top 10 companies account for 73% of related assets. In the cases of both leasing and factoring, companies belonging to large financial groups account for a large share of the respective markets. Payment performance is deteriorating in these markets as with commercial bank lending, causing many of the independent companies to disappear. Furthermore, given that senior financial group management is currently concerned with strengthening banks under their ownership, this is likely to divert attention away from other financial services. This is particularly detrimental to SMEs given the important role that leasing and factoring have in this sector. (In leasing, security enforcement is relatively easy, whereas the enforcement of a lien in a traditional bank loan can take a long time.) A competitive *venture capital* industry has not developed in Mexico and venture capital companies of the larger groups have not worked well. Years of directed credit by the development banks seems to have undermined the private equity culture in Mexico.

38. ***Stock Market.*** Although it has always been a "thin" market and not an important source of new equity capital (company listings declined from over 200 in recent years to 184 today), the Mexican Bolsa had, prior to the 1994 devaluation, achieved international recognition as an important stock exchange among emerging market countries. The crisis, however, revealed a number of shortcomings in the legal and regulatory framework.. Despite an efficient, open "out-cry" trading system for most listed securities and the imminent move to T+1 clearing and settlement, trading systems remain inadequate in the second-tier market. Illiquidity is a problem for many issues as well, given that the average float of any issue traded on the Bolsa is about 30% of its market capitalization. Market capitalization is currently about one-third of GDP but this masks the thinness of the equity market, which represents only 5% of the volume of securities traded. Also, the stock

market is dominated by 33 brokerage firms, of which four account for 40% of total trading. About 40% of average daily trading is dominated by trading in the shares of 5 companies. These inadequacies significantly hinder the development of pension and mutual funds, the restructuring of enterprises and privatizations.

39. ***Bond Markets.*** Mexico's private bond markets—which had been attractive to international investors prior to the *peso* crisis—have since tumbled and virtually dried up. While the main reasons for this situation are to be found in inflation and interest rate uncertainties, they have also been compounded by structural problems, including the existence of multiple interest-rate bases (dollar, inflation linked, and nominal). Public debt management in the past was dominated by the pursuit of very short-term goals leading to large year-to-year fluctuations in interest rates. Also, the way public debt has been issued has not helped to create or maintain a full interest-rate spectrum, thereby hampering the development of private markets in interest-bearing securities. A private pension fund system would greatly enhance the development of the medium and long-term bond markets.

40. **Bank Group Strategy - Financial Institutions and Markets.** Building upon the advisory services it has thus far extended on ***pension reforms***, the Bank will encourage the formulation of an appropriate regulatory strategy. As it has done over the past year, IFC will continue to assist the Bank in remedying specific deficiencies of the regulatory framework. It will play also an institution-building role in private sector pension management companies and act as an "honest broker" in helping project sponsors enter into long-term arrangements with suitable technical partners.

41. Regarding ***housing finance***, the Bank Group will focus its support on three broad areas. *First*, the Bank will assist the Mexican authorities in articulating long-term national housing priorities and policies. *Second*, the Bank will assist the Government in redefining the role of existing housing finance institutions. This assistance would extend to formulating and implementing plans for the restructuring, phasing out or privatization of existing public institutions. *Third*, the Bank would support this program with appropriate financial assistance, including selective provision of Bank guarantees to enhance the funding capability and functions of public housing finance institutions. To the extent that the concerned entities are restructured and reoriented within a private sector framework, IFC would play institution-building, technical assistance, and "honest-broker" roles in helping these institutions become established market-driven players in the secondary housing finance market.

42. The Bank Group's strategy for development of Mexico's ***equity markets*** will initially entail in-depth analysis of the causes of underutilized use of stock markets. Such assistance will also involve identifying necessary reforms to improve: (a) second-tier market trading systems; (b) company reporting and disclosure requirements; (c) institutional investor guidelines; and (d) the regulatory and technical requirements associated with derivatives markets, securities lending, short selling, margin accounts and minimum margin requirements. While the Bank will focus on the technical aspects of the regulatory environment, IFC will: (i) promote the development of more efficient non-bank financial service institutions, particularly in leasing and factoring, as well as a more efficient and effective over-the-counter (OTC) market; (ii) promote a strong venture capital and private equity industry; and (iii) provide equity underwriting facilities.

43. In ***debt markets***, the Bank will play a technical assistance role to help rationalize the structure of the public debt, remove interest-rate segmentation of debt securities markets and eliminate hindrances in the issuance of private debt securities and structured finance. IFC will support the development of orderly long-term credit markets through a two-pronged approach involving: (i) the selective use of bond underwriting facilities; and (ii) the promotion of markets for asset backed securities and the provision of equity finance, as well as technical assistance for asset securitization vehicles.

MEXICO PRIVATE SECTOR STRATEGY: FINANCIAL MARKETS DEVELOPMENT FY1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Ensure retirement with dignity through improved competition and efficiency in pension fund management and lower government liability	• Replace PAYG system for public employees, transfer INFONAVIT contributions to AFORES, greater competition in mandated savings management between banks, mutual funds, insurers and AFORES, and greater accountability through independent directors, education, and performance comparison.	• Coverage of public employees; phaseout of INFONAVIT; entry of foreign managers, banks, mutual funds and insurance companies in retirement savings management; liberal investment guidelines to encourage long term risk-taking; modifications of certain minimum guarantee provisions.	• Contratural Savings Loans I, II, III.	• Policy advice including TA on regulations, investment management guidelines and corporate governance. • Institution-building through participation in AFORE.
Lower cost of and improved access to housing finance.	• Determine long term housing finance strategy, target population, cost and fiscal affordability. Derive a consistent role for public housing finance institutions (phaseout, privatization, expansion, etc.)	• Preparation of housing finance strategy, determination of affordable subsidy/resource transfer to the housing sector, action plan and implementation for FOVI, INFONAVIT, and other housing finance institutions.	• Housing Finance Loan. • Guarantee. • Policy Analysis.	• Policy advice. • Equity investment in mortgage insurance company. • Multi-line reinsurance corporation. • SOFOL (mortgage securitization).
Develop markets for mortgage- and asset-backed securities.	• Reform of registries and notaries, suasion by Central Bank for product standardization, sensible capital guidelines for ABS transactions, regulatory reforms to simplify vehicles, products, and transactions.	• Improved laws/regulations relating to notaries, registry, borrowers' consent, and issuance of typical ABS implemented across most states. Capital adequacy guidelines for ABS deals. Simpler and automatic approval of ABS issuance by banks and SOFOLs.	• Financial Infrastructure Loan. • Ongoing FTAL. • Policy Analysis.	• Policy advice. • Equity investment in asset securitization company.
Improve capacity to raise capital through stock markets, reduce cost of new capital, create exit mechanism for banks, government, and NAFIN.	• Increase number of listings; improve trading, liquidity, and self-regulation; targeted marketing to listable companies. Encourage listing of all large businesses (subsidiaries) rather than just the holding company. Rationalize investment guidelines of pension funds and insurance companies.	• Higher number of listings, market capitalization, and new equity offerings. Pension fund guidelines that encourage equity investment and liquidity.	• CEM on Savings.	

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Develop a long term domestic bond market and lower cost of capital.	• Develop a long term public debt issuance strategy. Homogenize government debt, extend yield curve, and create benchmark interest rate structure. Facilitate ABS/MBS markets. Allow institutional investors to develop bond markets.	• Adoption by market of uniform domestic interest rate benchmarks. Improved efficiency of bond markets in terms of new issuance, liquidity, maturity and interest rates.	• CEM on Savings	• Credit Lines for Board underwritings. • Asset backed securities.
Improve efficiency of and mobilization of savings by insurance companies and mutual funds.	• Permit them to manage mandated retirement savings. Greater harmonization/supervision of similar operations of mutual and pension funds. Increase number of independent directors. Greater foreign competition.		• CEM on Savings. • Ongoing FTAL. • Seminars, study tours.	• Policy advice. • Equity investment in domestic insurance firm, mutual fund company.
Improved financial market infrastructure.	• Improved bankruptcy code and process, adoption of GAAP standards, improvements in collateral law and registries, development of credit bureaus and rating services, technical upgrading of principal regulators.	• Implementation of legal and market reforms.	• TA and sector work to identify more specific measures. • FTAL (ongoing). • Financial Infrastructure Loan.	• Policy advice. • Equity investment in registry companies, rating agencies, credit bureaus.

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September 29, 1996 1:50 PM

3. Corporate Restructuring and Small and Medium Scale Industry

44. Extensive financial restructuring of the corporate sector represents a key determinant of economic recovery and future growth for the private sector in Mexico today. Financial restructuring is primarily required for the recapitalization of over-indebted companies which have become uncompetitive as a result of high financial expenses, and which are thus unable to raise new financing for adjustment and growth.

45. Mexico's *peso* crisis and ensuing recession also have created the need for important structural changes among Mexican corporates. Significant increases in the cost of imported and local inputs require the restructuring of installed capacity. Trade liberalization and increased international competition similarly require significant alterations in existing production facilities. While the devaluation of the *peso* has opened up new export markets, significant re-deployment of existing capacity must now take place to take advantage of new opportunities.

46. The need for operational and financial restructurings is particularly relevant in the SME sector. Even before the *peso* crisis, this sector lagged in modernization, product quality and production efficiencies. Lack of professional management in these largely family owned enterprises is a major problem. The crisis worsened the operating conditions across this sector, and in addition the banking system directed new credits towards the larger corporations.

47. Although critical for the success of the ongoing economic stabilization efforts, the corporate restructuring described above has not yet taken hold within the Mexican private sector. The main reasons are the illiquidity of the banking system, the associated unavailability of corporate credit and the inadequacy of Mexico's legal and regulatory framework. This has led to unprecedented "asset paralysis" within the private sector. While the Government has engaged in several debtor arrangements that have avoided a cascade of wholesale corporate defaults, the corporate expectations of further government sponsored assistance also have delayed negotiations between debtors and creditors.

48. **Bank Group Strategy - Corporate Restructuring.** Strengthening the competitiveness of the private sector forms the core of the Banks Group's strategic agenda in Mexico. This entails responding to both the immediate financial restructuring needs as well as to the systemic problems of low productivity growth, asset redeployment and technological obsolescence.

49. To achieve the above objectives, the Bank—in cooperation with IFC—will provide the Government with the technical support needed to remove the legal and regulatory obstacles to the corporate restructuring process. Through the ongoing ESW program and Financial Technical Assistance Loan (FTAL) it will seek to both reform the regulatory and legal framework for bankruptcy, liquidation and foreclosure, as well as develop the legal environment required to expedite infusion of capital and redeployment of assets. Additionally, through a new Financial Restructuring Loan (FSRL II), the Bank intends to support the development of financial infrastructure and enterprise restructuring. In the

medium term, the Bank is supporting the Government in promoting assistance through ESW work on industrial policy and a PSD Competitiveness project, involving promotion of quality standards at the enterprise level and a more client oriented R&D infrastructure.

50. Building upon its earlier financial restructuring experience in Mexico, IFC's strategy will focus on providing tailored assistance to individual Mexican corporates. While it is impossible to generalize about the specific components of each restructuring in which IFC will participate, each effort will seek to reduce unsustainable corporate debt and liquidity burdens while improving resource utilization. Incremental investments in fixed assets and inventories as well as organizational and technological changes would be implemented to improve cash flow and secure long-term viability. Long term debt and equity needs would be addressed to both recapitalize poorly structured balance sheets and to finance incremental investments in fixed and working capital.

51. Because small and medium enterprises have been the hardest hit by recent economic events, IFC will devote greater resources to identifying economically sound SMEs that need special support to weather the current crisis and prosper under NAFTA. Its efforts will center on a two-pronged approach involving both wholesale and direct assistance.

- *Wholesale Approach*. As part of its overall financial sector and capital market development activities, IFC will work with local financial intermediaries or will help establish specialized institutions capable of providing restructuring assistance to medium and smaller enterprises. On the equity side, it will support private equity/venture capital funds such as the imminent Mexican Partners Fund and the Fondo Chiapas, while on the lending side this will be achieved through credit lines for on-lending or the provision of leasing services such as the recently approved BANAMEX and PROBURSA operations. Leasing and factoring operations will also be supported as a means to broaden the availability of equipment and working capital finance for SMEs.

- *Direct Assistance*. IFC will increase its direct assistance to promising "second tier" companies that need restructuring, to improve their competitiveness and access long-term capital. IFC will favor those situations where financing needs cannot be met purely from local sources and where its presence is catalytic in persuading parties to agree to a successful restructuring package. In such direct transactions, emphasis will be placed on providing restructuring assistance to firms with whom IFC does not have existing investments.

- Although IFC's strategy will give priority to second tier companies, the special circumstances facing Mexico also dictate that it provide selective support to those larger companies which face unusual adjustment and investment financing constraints. Operations will be limited to those cases where IFC's support is essential to reaccess the international financial markets, or where innovative financial engineering or other forms of IFC value added and role are required to firm up project restructuring or project financing packages.

MEXICO PRIVATE SECTOR STRATEGY: CORPORATE RESTRUCTURING AND DEVELOPMENT FY 1997-1999

Development Objectives	**Strategy/Actions**	**Progress Benchmarks**	**IBRD Instruments**	**IFC Instruments**
Promote debt workouts - return SMEs and other companies not covered by UCABE companies to a sound debt footing - at minimum government cost.	• Further develop the existing proposal for an RTC-type entity. Require it to farm out management of or auction off all loans and other assets in government hands to private sector. • Facilitate provisions of TA to enterprises in preparation of debt workout/reorganization plans.	• Non performing loan portfolio of Banking sector to be brought down to reasonable level after 3-5 years.	• Financial Infrastructure Loan.	• Direct financial and real restructuring support to individual companies. • Participation in SME venture capital funds. • Enterprise restructuring lines of credit involving local financial intermediaries..
Improve legal/regulatory framework for workouts and bankruptcy system.	• Focus on key legal/regulatory obstacles, such as asset-backed securities, secured transactions, etc. and related components of bankruptcy law .	• New legal frameworks with implementing regulations and institutional capacity to implement.	• FTAL (ongoing) • FSRL II.	• Participation in IBRD technical and advisory assistance.
Promote demand driven SME assistance.	• Backward linkage programs with larger firms to SME suppliers • Facilitate TA to enterprises to build financial management and general business skills.. • Improve technology level of enterprises through promotion of quality standards at enterprise level, in client-orientation of R&D infrastructure.	• More financial flows to SME sector, greater indirect participation in exports, more long-term subcontracting relations. • Number of enterprises with ISO-9000/14000 certification, productivity growth in technology intensive SME sectors.	• ESW on Industrial Policy • PSD Competitiveness • Additional support to CIMO (to support efficiency improvements in private companies). • Support of collective action (horizontal networking between enterprises).	• Participation in venture capital companies directed at SMEs. • Loan transactions with larger firms sponsoring financial/technical support programs to SME suppliers.. • SME credit lines to local financial intermediaries. • Equity and loan transactions involving individual larger SMEs.

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4. Infrastructure

52. Mexico has the weakest infrastructure of all countries in Latin America with similar income levels. Many of the observed infrastructure deficiencies could be overcome through innovations in regulation, competition, and private ownership, as in Argentina and Chile. The Mexican Government has until recently monopolized infrastructure and prevented private investment in a number of critical infrastructure services. This has compounded Mexico's infrastructure constraints especially since the *peso* crisis, as Mexico had to scale down pubic expenditure for infrastructure projects due to the overriding importance of maintaining fiscal discipline and correcting critical macroeconomic imbalances in the economy. Government ownership of infrastructure also has been a major reason underlying the weak development of the Mexican equity market.

Table 5
MEXICO
Infrastructure Comparators for Latin America

Country	Income (per capita) 1993 Dollars	Electric Power (kwh/person) 1992	Telephone Mainlines (per 1000 persons) 1992	Population with access to safe water 1991 (% of total)
Venezuela	$2,840	3,404	91	89
Brazil	$2,930	1,570	71	96
Chile	$3,170	1,646	94	86
Mexico	$3,610	1,381	80	78
Argentina	$7,220	1,670	123	64

Source: World Development Report (1995).

53. Having recently acknowledged its inability to meet all of Mexico's infrastructure needs, the Government is recognizing the importance of privately owned and managed infrastructure services. Reflecting a renewed commitment to accelerate the privatization of such services, the Government took a number of positive steps in that direction over the past year. A Privatization Commission was created and the Constitution was amended to allow for private and foreign investments in telecommunications, satellite communications, gas distribution and storage, ports and airports, and railways. Bids were issued and some 92 concessions were awarded involving the country's leading port facilities and ports, including VeraCruz, Acapulco and Altamira. Strategic decisions concerning market structure and regulations were also taken in the railway sector where 12 investor groups have since registered for concessions to be awarded later this year. The opening of Mexico's long-insulated natural gas market took a major step forward with the unveiling of 11 metropolitan centers—including the critical Mexico City market—to privately owned pipeline distribution. Privatization of telecommunications has proceeded well as witnessed by the eight concessions for long distance communications, and the 158 applications for paging services and paging channels approved by the Government since September 1995.

54. Notwithstanding the above achievements, the Government's intentions and direction remain unclear in the power, petrochemicals, water and sanitation sub-sectors, where privatization has fallen short of expectations. Besides a firm political commitment and the development of transparent legal and regulatory frameworks, a range of other issues—relating principally to market structures, concession design, public procurement

rules, government guarantees, and tariff policies—need to be urgently resolved if the pace of private investment in these infrastructure activities is to be accelerated and adequate levels of financing are to be mobilized. A summary of these particular sub-sectors follows:

- In ***power,*** private generation and co-generation have not yet taken place although reforms to allow for such privatization were introduced in 1992. Causes for this situation include a lack of political will to privatize CFE, the absence of incentives for private investments and, most importantly, difficulties encountered by prospective investors in reaching critical contractual arrangements with the National Electricity Commission;

- In ***water***, despite the fact that Mexico remains critically short of basic water treatment and distribution systems, large scale privatization has been hampered by restrictive state regulations, inadequate water tariff structures, the generally poor financial condition of most municipalities and weak technical capacity of local water authorities;

- In ***petrochemicals***, the privatization of Premix Petrochemicals—which had been announced in early 1995—has encountered serious opposition from the Mexican Congress and is presently stalled. Authorities originally involved in the sale of the targeted 10 chemical complexes have been overtaken by political pressures.

55. **Bank Group Strategy - Infrastructure.** The principal challenge for the Government in expanding private infrastructure services is to promote effective competition, especially in those sub-sectors that exhibit natural monopoly characteristics. Within this strategic framework, the Bank Group and the Government have come to share the common view that the greatest opportunity for improving the quality and efficiency of infrastructure services lies in increasing private sector participation within an appropriate regulatory environment and removing statutory restrictions on competition. There is also agreement that more efficient public investment and more effective operating modalities are required for those services which will not attract private financing (e.g. secondary roads, urban traffic management, and low income housing) or which are to remain within the purview of the public sector at least during a transitional period (e.g. electricity transmission and distribution, road maintenance, and urban transport infrastructure).

56. In line with the above, the Bank will seek to further improve the planning, financing, and management of public infrastructure projects in those geographical areas and among those services which are unlikely to attract private sector support in the short run. To correct existing regional development imbalances, such efforts will be predominantly oriented towards the Southern States and will involve the processing of a number of infrastructure projects in power transmission, road maintenance, rural roads, water systems and sanitation. As part of the ongoing Privatization Technical Assistance Loan (PAL), the Bank will also assist the Mexican authorities in further strengthening the

legal/regulatory framework for privatization. While the Bank is already extending such technical assistance to the National Water Commission and the Energy Regulatory Agency, its efforts will be further broadened to include telecommunications and transport agencies.

57. The Bank, with IFC assistance as appropriate, is proposing to review jointly with the Ministry of Finance the range of reforms that are necessary to attract private financing and the implications for public financing. This would include evaluating investment considerations and risk perceptions across the various sectors, focusing on sector specific policy and regulatory risks and the terms available in the financial markets for projects in Mexico. This assessment should reveal which sectors could benefit from policy reforms and which would continue to require direct public support. This proposed task would be reinforced by ongoing work on concession design, bidding strategies, and pricing policy which the Bank is currently supporting with the sectoral agencies through the Infrastructure Privatization Technical Assistance Loan. The Bank would be prepared to back up the Government—through its guarantee authority—where, despite appropriate sector reforms, Government related risks and project size and gestation would prevent the structuring of a complete financing package without Government guarantee.

58. Within this framework, IFC will work with private investors to expand its infrastructure pipeline, consistent with market demand and policy reforms, particularly in the sub-sectors cited above. IFC will undertake promotional work to ensure that investors and Government officials are fully aware of the range of products and services it offers. IFC will also assist the private sector in remedying some of the regulatory and financing constraints which have thus far held up the pace of privatization, mostly in the context of specific projects (as it is currently doing in the case of the Cancun water project in cooperation with Banobras). IFC can also advise Government officials, where appropriate, on the likely market response to alternative sectoral reforms.

59. IFC will also seek to complement and mobilize the resources of both local and foreign investors by offering the appropriate financing and capital market products to attract adequate equity investment as well as long term debt financing for the infrastructure sectors in Mexico. In this context, the establishment of one or more independently managed specialized funds to finance private sector infrastructure projects will be pursued. Bank support to these funds will be considered as appropriate. IFC will also seek to develop local capital markets to provide crucial domestic financing for infrastructure projects.

60. IFC's success in expanding and diversifying its infrastructure activities will depend heavily on the steps the Government will take to establish the regulatory framework required to attract domestic and foreign private investors in the sector. While the immediate opportunities lie in the sub-sectors where liberalization is the most advanced, IFC will also seek to initiate private power generation and assist in the privatization of water/sanitation and transport services as well.

61. *Petrochemicals.* When privatized, IFC will work with local and foreign investors to design sound project structures. IFC's role would be to give confidence to those partners (as many contractual arrangements on the input and output side will still be with Pemex) as well as to help in major funds mobilization.

Guarantees for Private Sector Participation in Infrastructure

Because of the newness of private participation across the infrastructure sectors in Mexico, there is a lack of precedents from successful projects on which lenders can evaluate credit and policy risks. Most projects proposed for private financing are of long gestation, requiring substantial amounts of long term debt, at maturities which far exceed those available in local financial markets and from international sources.Depending upon the market response to sectoral reforms, private financing may initially require some official support, particularly where Government remains directly involved (e.g. gas, power, water, municipal services), but also where new sector structures and regulations do not require direct government involvement but lack a proven track record (rails, airports, toll roads). The Bank, through its recently expanded guarantee authority, is prepared to back up Government if this leads to easier access to financing sources and better financing terms. At the same time, such support should be designed to minimize the government's risk exposure. The guarantee would be justified where the policy related risks are of a nature and projects of a size and gestation period that would prevent the structuring of a complete financing package even with support from other official financing and insurance agencies. The Bank would thus assume the role of guarantor of last resort, similar to its role as lender of last resort. Guarantees would be considered as a temporary measure to facilitate financing and execution of a few landmark transactions.

Based on discussions with prospective private sector lenders, judicious application of the Bank's guarantee authority will have a significant impact on direct investment in the infrastructure and energy sectors as: (i) commercial bank guarantee-covered resources can be additional to their normal country limits and (ii) guarantees are partial, leveraging more uncovered medium/long term debt than would otherwise be available. Guarantees could be developed on a project by project basis in those sectors deemed priority by the Government or on a sector-wide basis where a sectoral guarantee framework would be prepared and projects within the sector identified as eligible for guarantee coverage based on the attractiveness of the winning bidders offers.

A number of target sectors have now been identified in which Bank support in form of partial risk guarantees could be instrumental for attracting private investment.

- ***Gas Transport and Storage***. Distribution has been deregulated and opened for private participation, and third-party access was introduced in April 1996. However, PEMEX remains the monopoly producer, and, within most of Mexico except for the border areas, the monopoly source of supply in southern and central Mexico. On the users' side, Government entities, such as CFE, are among the primary anchor customers. Moreover, the regulatory framework is new and untested. The Bank has been closely monitoring developments in the gas sector and see good possibilities for the realization of several gas pipeline projects in the northern border states which could be candidates for Bank guarantee support, as well as concessioning Mexico City.

- ***Power.*** The regulatory framework for private participation has yet to be worked out. After further deregulation and demonopolization of CFE, at least in power production, there is good potential for private sector involvement and for guarantee support.

- ***Toll Roads and Other Transport***. Provided the Government implements a regulatory framework that is based on a more equitable risk sharing with private sector parties, the Bank envisions good potential for private toll roads and for Bank guarantee assistance in the future. There may be scope for other transport projects on a stand alone basis, for example with concessions negotiated specifically for the project, i.e. urban transport.

- ***Water Supply and Treatment, Waste Disposal***. These have proven to be the politically most sensitive sectors for privatization. The main issue is whether a regulatory framework can be designed and implemented that provides the basis for full cost recovery and adequate risk sharing between the public and private sectors.

MEXICO PRIVATE SECTOR STRATEGY: INFRASTRUCTURE DEVELOPMENT FY 1997-1999

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Reduces infrastructure deficiencies which have posed a serious bottleneck to economic growth and international competitiveness by increasing private sector participation within an appropriate regulatory framework.	• Support the ongoing privatization process in telecommunications, ports, airports, railways, electricity and water and sanitation as well as secondary petrochemicals.	• Process completed in ports, railways , telecommunications. • Process underway in airports, water and sanitation, electricity and secondary petrochemicals.	• Sustained policy dialogue via: (i) supervision of PTAL; (ii) non-lending services; (iii) " just-in-time" ESW	• Equity and loan support to specific projects in privatized infrastructure sectors.
	• Support the development of legal, regulatory and financing frameworks that are transparent and predictable and would efficiently attract private investment.	• Strengthened energy (CRE) and water (CNA) agencies. • Establish transport and telecommunications regulatory agencies. • New instruments and investors resulting from pension reform.	• Sustained policy dialogue via: (i) supervision of PTAL and FTAL; (ii) non-lending services; and (iii) "just-in-time" ESW.	• Support for IBRD technical and advisory assistance.
	• Attract more non-recourse, private finance for the provision of infrastructure services.	• Planned project interventions in gas, electricity, ports and water and sanitation. • Possible restructurings in toll roads and airlines. • Concession designs for water and municipal services piloted at state and municipal levels. • Implement infrastructure finance facility.	• Advice on concession design. • Infrastructure Guarantees (FY98) for specific sectors/ projects. • Dialogue on infrastructure finance facility.	• Equity and loan transactions involving specific projects in privatized infrastructure sectors. • Promotion of new financing instruments and facilities. • Technical and/or financial support to specialized infrastructure financing facilities.

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5. Regional Development

62. Mexico's uneven regional development remains a serious obstacle to sustained and balanced private sector growth. Industrial activities are primarily concentrated in Mexico City and Monterrey and, to a lesser extent, within the triangle formed by these two cities and Guadalajara. Altogether the Central region—of which the Federal District is part—accounts for nearly 50% of GDP and 59% of commercial bank lending despite the fact that it covers only 8% of the national territory. Although a program intended to boost employment in the northern border area has in recent years led to the creation of a flourishing in-bond industry in the states of Baja California, Chihuahua, Coahuila, Sonora and Tamaulipas, overall government efforts to decentralize productive activities and foster more balanced regional development have thus far had modest results. With foreign investors seeking potential projects opened up by NAFTA, there are today renewed and promising opportunities to correct regional imbalances by promoting private sector development outside Mexico's major industrial centers. Given that the *maquiladora* sector is gradually moving away from the border areas, special emphasis should be also given—as part of these regionalization efforts—to identifying means to integrate more effectively the expanding *maquiladora* industries into the Mexican economy.

63. Although offering promising growth potential, a number of states severely trail the rest of the nation on basic social and economic indicators. This is particularly the case for the states of Chiapas and Oaxaca in southern Mexico, While rich in natural resources and climatic conditions, and strategically located next to Central America and the Gulf of Mexico, these states are the poorest in Mexico. GDP per capita is less than half the national average (US$1450 in Chiapas and US$1230 in Oaxaca in 1990, compared to US$3030 in Mexico), and social indicators are significantly lower than in the rest of the country. Population growth is more than double the national rate (4.5% in Chiapas vs. 2% for all of Mexico), infant mortality is about 50% higher, population per physician about double, and 62% of the population has not had elementary schooling compared to 29% for Mexico as a whole.

64. Social, economic and political conditions in the South have also deteriorated over the past decade. While the Mexican economy overall has grown, the real incomes of the Southern States have declined. In the northern region of the country, real expenditures were roughly constant from 1984 to 1989 for most households, then rose from 1989 to 1992, leading to positive growth between 1984 and 1992. In contrast, for the South there was a decline of 15-20% in the living standards of most households between 1984 and 1989, and then a further decline between 1989 and 1992 leading to an overall decline of about 30% between 1984 and 1992. The decline in the South held for almost all households.

65. Besides a lack of basic infrastructure, this unbalanced growth record can be largely attributed, on the one hand, to the different structure of the Southern States and, on the other hand, to the disappointing results of centrally controlled government programs implemented in these regions. These states are more dependent on agriculture than other regions and consequently have been relatively more afflicted by stagnating agricultural

prices in recent years. Highly fragmented land ownership and polarized political, social and economic structures have also resulted in few opportunities for advancement. Compounding this problem has been the fact that the federal interventions to assist the region --although significant in recent years[7]-- have failed to support sustained economic growth and employment. Recurrent problems in the selection, design, management, and implementation of centrally controlled government programs have led to disappointing results on the ground. The main contributing factors to this situation have been: lack of integrated approach to regional development, excessive sectoral fragmentation of investment projects, lack of resource allocation transparency and project accountability at federal and state levels, weak local project implementation and supervision capabilities, and limited public administration and institutional capacity at the state levels.

66. **Bank Group Strategy - Regional Development.** In line with the Government's regional development objectives, the Bank will support a special initiative in the Southern States of Chiapas and Oaxaca, the two poorest states in the country. This initiative aims to reduce the level of poverty in the region by stimulating the acceleration of private-sector led growth and improving the delivery and management of basic social services. Under this initiative, the Bank--in cooperation with--IFC will assist the Government in setting up a task force that will work with the local and foreign business community and civil society to identify and tackle specific constraints to the development of local productive private sector activities. Further, the Bank will support this endeavor in several ways, including (a) funding complementary infrastructure for private sector investment initiative and (b) providing technical assistance for public sector capacity building at state and local levels (see Box next page).

67. IFC will supplement the above Bank actions through targeted interventions in the region. Besides the structuring of a potential micro-enterprise project in Oaxaca, IFC will contribute towards alleviating the scarcity of long-term financing through funding of a small and medium scale enterprise credit line with one of the leading national banks represented locally. Additionally, it will help improve the private sector's access to equity finance by providing the Fondo Chiapas, a venture-capital fund investing in small and medium enterprises in the State of Chiapas, with the financial and technical assistance it presently needs to strengthen its long-term operational and institutional capabilities in that State. In association with Mexican corporates it will also seek to channel long-term financing in support of *ejidos* and indigenous communities participating in agricultural activities. Finally, with FIAS it will assist the State authorities in improving the local regulatory regime and incentives framework needed for the local private sector to operate on a competitive footing with the rest of the nation.

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7 Nationally, transfers from the federal government represent some 77% of consolidated expenditures of the states (85% and 93%, respectively, for Chiapas and Oaxaca). The majority of federal expenditure in Chiapas and Oaxaca are carried out under the Programa Nacional de Solidaridad (PRONASOL), a country-wide program that includes over 30 sub-programs.

The Southern States Initiative (SSI) Action Plan

The proposed SSI Action Plan consists of five broad elements:

- The Government will create a coordinating mechanism to establish a strategic plan to guide the development of the SSI, and to select, implement and monitor specific investments.
- The Government and the Bank will refocus ongoing projects relevant to the states of Chiapas and Oaxaca, to facilitate the immediate implementation of the SSI. Some eleven operations could be restructured, with a total value of approximately $360 million. In addition, the IDB has recently approved a program for small productive projects of $15 million.
- An agreement will also be reached to include specific components for the Southern States in new operations. Bank investment lending will be targeted to support infrastructure that complements private sector investments. Some eleven new investment operations will include specific components focused on Chiapas and Oaxaca.
- The Bank and the IFC, in partnership with the Government, will organize a task force to work with the business community and civil society to identify and tackle specific constraints to the development of productive activities.
- To ensure that funds are transferred to priority programs, civil society will participate in the design and implementation of the regional strategy, as well as the selection, financing and implementation of specific activities. These activities will be targeted geographically at areas with strong potential for the development of productive activities, and at priority areas, such as highly impoverished communities of small family farms.

MEXICO PRIVATE SECTOR STRATEGY: REGIONAL DEVELOPMENT FY 1997-99

Development Objectives	Strategy/Actions	Progress Benchmarks	IBRD Instruments	IFC Instruments
Foster productive activities in the least developed regions of the country.	• Work with government and private enterprise to identify and tackle constraints to development of productive sector in Southern States. • Decentralization of industrial promotion through (I) introduction of system of matching grants to cofinance state industrial programs and (ii) creation of information system to coordinate federal, state and local level promotion efforts. • Support private sector development in the State of Chiapas by: (i) improving the local investment climate, (ii) strengthening the capabilities of local financial institutions; (iii) increasing financial support to SMEs. • Provide microenterprise support in the State of Oaxaca.	• Actions initiated to address identified constraints to productive sector development in Southern States, relying predominantly on private initiative. • Strengthened fiscal and regulatory framework for private investments, including enforcement of land ownership and property rights. • Strengthening of Fondo Chiapas financial resources and project development capabilities. • Structuring of agribusiness project involving indigenous communities. • Development of microenterprise project with ADMIC.	• PHRD grant to: (i) identify constraints to private investment through workshops with private sector and government; (ii) support feasibility studies of public infrastructure identified to complement private investment. • Southern States Initiative (SSI), ESW. • PSD Competitiveness TA • Bank loan for state and municipal government. • Policy analysis on incentive framework.	• Technical assistance including IFC and FIAS. • Establishment of IFC-backed line of credit for SMEs. • Line of credit to leading financial intermediary. • Loan Transaction in Agribusiness.. • Private Venture Capital Fund (Fundo Chiapas) • Line of credit/equity participation in ADMIC.

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Annex 1.

IFC's Project Selection Criteria

The Group strategy leads to a number of IFC advisory and investment transactions as shown in the IFC instruments column in the matrices at the end of each strategy subset. These transactions have to be tested against generally applied criteria of Development Impact, IFC role and Profitablility (of the project as well as for IFC as an investor and lender).

- The Development Impact Test is straightforward: the whole thinking behind the strategy design has been geared to developmental impact enhanced through close cooperation between the Bank and IFC in the design and implementation phase. The ERR as part of the Development Impact Test will eliminate most commercially unviable transactions.

- The IFC Role Test is more complex and can actually force IFC to withdraw from some very developmental projects. The IFC role test is the test of "no alternative domestic or foreign financing available" and the proactive involvement of IFC in several ways. In Mexico, this proactive involvement will come in particular through:

  - Funds mobilization from the international syndicated loan markets on maturity terms only IFC can achieve.

  - Transfer of international technical and financial expertise and complex project design experience: demanded from IFC mainly by the medium scale sector. However, new financial products often need to be introduced first in larger corporations.

  - Partner of the foreign direct investor, who has not been exposed to Mexico in the past such as mid-size US, European and Japanese companies.

  - IFC as co-investor/lender in the newly privatized sectors joining domestic and foreign lead investors. IFC as generator of confidence is important for even strong partners due to untested regulatory environment. Role concentration in infrastructure, oil, petrochemicals, gas.

  - Agent of change in corporate governance actively including reporting and auditing, separation of the interest of owner and shareholder, opening of share capital to the public.

  - Creation of environmental awareness and assisting the client to meet the Bank Group environmental standards.

- The Profitability Test has to assure that IFC can achieve an adequate return on its equity investments and loans together with sound credit security arrangements. This requires first commercially viable transactions and second an adequate risk/reward profile for IFC. These requirements can often delay the project structuring process, especially in the newly privatized sectors. It is not only for IFC's protection, but also for establishing best practices for future financing from the market.

Lessons from
the Mexican Crisis

Attachment 2
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THE MEXICAN CRISIS: LESSONS FOR THE WORLD BANK

SUMMARY[1]

i. The Mexican crisis in 1994 presented a major challenge to policymakers in Mexico and the international financial community. A lot has since been written about the policy lessons for Mexico and other countries. The purpose of this internal review is to focus on the design and implementation of the World Bank's country assistance strategy: both in the lead-up to the crisis and the subsequent response. The objective is to draw lessons for the management of the Mexican program and, more generally, the role of the Bank in crisis situations.

ii. The basic conclusion of this review is that Bank staff did a good job prior to the crisis in highlighting the exchange rate problem. Given the political situation in Mexico, and genuine differences of view on how the macro situation would evolve, there was little more the Bank could have done to avert a crisis. Nor could we have accurately predicted the timing or size of the crisis. However, given the growing warning signs of potential trouble, the Bank should have been better prepared to respond. It took some time for the Bank to decide what its role should be. Once this was sorted out, the Bank's financial response was rapid. This signal of support, especially in the financial sector, was appreciated by the Mexicans. However, the Bank's performance on policy analysis and advice has been less satisfactory. Some of the much-needed analysis of the economic and social impact of the crisis is still to be completed. The main lessons and recommendations arising from this assessment—in terms of defining the Bank's role in crisis situations, gearing up to handle crises, and managing the crisis response—are summarized in paras. xii and xiii below.

The Bank's role before the crisis

iii. During the early 1990s, the Bank's program in Mexico was shaped by a strongly positive view of the Mexican strategy and the successful stabilization it had achieved. As private capital flows became more important, the lending program was scaled back and refocused away from adjustment lending toward overcoming longer-term development constraints (especially infrastructure and human resources). This lending and the Bank's policy dialogue were supported by an expanded economic and sector work (ESW) program in FY93-94 on the major development issues facing the Mexican economy. This culminated in a series of topical policy papers discussed with senior Mexican officials in mid-1994.

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[1] Based on a review commissioned by EXC and prepared by the Office of Senior Vice President, Development Economics, in mid-1996.

iv. In the area of *macro policy*, the Bank did good analytical work, which correctly identified that the overvalued exchange rate would become a major obstacle to growth, if Mexico did not take corrective action. However, like most observers, the Bank did not fully appreciate the shift in monetary policy during 1994 or the rapid change in the composition of debt (i.e., toward U.S. dollar-indexed *tesobonos*). These two factors turned out to be crucial determinants of both the occurrence and the severity of the crisis. In the *financial sector*, Bank staff highlighted weaknesses in the prudential regulatory system for banks and helped develop an action plan to improve bank supervision. However, in general, financial sector work was not a central element of the Bank's program in the pre-crisis period. This reflected a number of factors, including weak information on the health of the banking system, resistance from the Mexicans to Bank involvement in the financial sector, and an overly-optimistic view on what had been achieved by earlier reforms in the sector.

v. The exchange rate issue figured prominently in the Bank's policy dialogue with Mexican officials in the pre-crisis period. Although the Bank's warnings intensified during 1994, they went unheeded. There were several reasons for this:

- There were honest differences of opinion between the Bank and the GoM regarding the extent of overvaluation and the threat of an exchange rate crisis. These differences were exacerbated in the run-up to the 1994 elections, when the Mexicans wanted a buoyant economic situation and were reluctant to adopt deflationary policies.

- The IMF would normally be expected to take the lead on exchange rate issues. However, this did not seem to be high on the Fund's agenda in 1994 and, in the absence of an IMF program with Mexico, its own influence was rather limited during this period.

- The Bank's policy dialogue focused primarily on the exchange rate rather than on the overall consistency of macro policy or on second-best policy options more acceptable to the Mexicans. Stronger financial sector work might have also increased awareness of the vulnerability of the economy (via the banking system) to a crisis.

- In the absence of adjustment lending, the Bank lacked a formal vehicle for advice on macroeconomic management. Under these conditions, the dialogue might have benefited from greater use of world-class experts, respected by senior policymakers in Mexico, to work with them on developing a local consensus for policy change.

vi. Given staff concerns about the exchange rate in 1994, and the failure of the Mexicans to respond, why wasn't more attention given to revisiting the Bank's strategy in Mexico? Part of the answer obviously lies in the fact the Bank could not accurately predict the timing or size of the crisis. However, in addition, the motivation for the Bank to adjust was constrained by the fact that there was not a single perception of the Mexican

situation within the institution. The macro concerns of staff were not well-known to top management, who were debating whether or not to upgrade Mexico's creditworthiness rating in mid-1994. While both the Region and FRS argued against upgrading, and management agreed, there was little discussion of the short-term warning signals—already evident at this time—of a pending crisis. And, within the country department, many staff and even some managers working on sectoral issues were unaware of the macro concerns of their colleagues. As a result, their policy dialogue continued to be based on the assumption that the stabilization program would stay on track, with a smooth transition to longer-term growth and development. This inevitably sent mixed signals to the Mexicans, and diverted attention from looking at how to respond to a crisis situation (e.g., restructuring failed banks or providing social safety nets).

The Bank's response to the crisis

vii. Despite its pre-crisis warnings on the exchange rate, the Bank was ill-prepared when the crisis hit in December 1994. Insufficient effort was devoted to developing "what if" scenarios, examining alternative combinations of exchange rate, fiscal and monetary policies, and financing requirements. This was due in part to the poor flow of data, especially on reserve changes and *tesobonos* placements, which made it difficult to assess the risks ahead of time. While some information was available through informal channels and market sources, the Bank (and the Fund) should have made it clear that timely provision of official data is a prerequisite for an effective country relationship and assistance program. There was also too much willingness to accept the assertions of the Mexican authorities at face value (e.g., the Central Bank's assurance in April 1994 that they would not defend the exchange rate band if it became unsustainable, and that they were shifting to a monetary anchor). This reflected respect for the competence of the Mexican technical team, but there was probably also some element of "intimidation" from such a large and important client country.

viii. The Bank's initial response was also constrained by cautious signals from the top. Top management, including the President, believed that the Fund should take the lead in responding to the immediate liquidity crisis and the Bank should continue to focus on underlying structural and social issues. The hesitant response from the Mexicans, when asked what the Bank should do, tended to confirm this view. Combined with concerns over the level of Bank exposure in Mexico and the Region's preparedness to provide the policy underpinnings for a quick response, this led to a reluctance to consider another round of adjustment operations. As a result, the Region spent much of January examining possibilities for restructuring the portfolio with a view to creating headroom for new lending and to expediting disbursements under ongoing operations. The Region also shifted attention to getting the already negotiated Financial Sector Technical Assistance Loan to the Board.

ix. The pace picked up after a request from the U.S. Treasury for Bank assistance in the rescue operation it was orchestrating. Senior managers met on January 31, 1995 and agreed that the Bank should provide up to US$2 billion in the form of quick-disbursing loans to support reforms in the financial sector and basic social programs. Following this

decision, the Region moved ahead quickly with loan preparation and appraisal. Two of the three operations were ready by the end of May, but Board presentation was delayed until June 22 at the request of the Mexicans in order to benefit from the impending Bank decision on single currency loans. A third technical assistance loan for infrastructure privatization was approved in August. The commitment amounts were relatively small in the overall package of international support, and disbursements have been slower than expected. But, even so, the Bank's financial support was appreciated by the Mexicans, primarily as a signal of confidence in their approach to financial sector reform.

x. The advisory role of the Bank in response to the crisis was less satisfactory. As noted earlier, Bank staff were not well prepared in terms of how to respond to a crisis situation. Although the Bank had just negotiated a technical assistance loan for the financial sector, it lacked detailed knowledge and analysis of the banking system. Similarly in the social sectors, while the Region had worked on developing a pipeline of investment projects, this was of little use in a situation where the immediate priority was how best to cut the fiscal deficit while minimizing the impact on the poor, provide social safety nets for the poor and newly unemployed, and monitor the impact of the crisis on vulnerable groups. Some of the much-needed studies on the fiscal and financial impact of the crisis, and the longer-term impact of the crisis on the economy and social conditions, have not yet been completed. Of course, this is due in part to the inevitable short-run focus on managing the crisis itself. But it also reflects the run-down of technical resources deployed for ESW on Mexico (from an average of 11.2 staffyears in FY93-94 to 8.9 staffyears in FY95). Turnover of staff on the country team has also been high, with key departures on macro and financial sector work over the past year. By the end of 1995, there was only one country economist working full-time on the Mexican program; down from three in the early nineties.

xi. The Region was able to draw on staff resources from elsewhere in the Bank, especially the Central Vice Presidencies (CVPUs), to assist with the crisis response. For example, staff from FSD and DEC were involved in preparation of the Financial Sector Restructuring Loan. The Program of Essential Social Services and the work on infrastructure privatization also counted on the assistance of central staff. However, the Mexican experience also suggests that mechanisms for coordinating CVPU inputs, especially in a crisis situation, are far from perfect. Central staff often complain that they are called on at short notice, with little control over the overall design of the work or the final product. The Region, on the other hand, feels that central staff do not always share the urgency or commitment of people working in operations. Solutions to these problems lie beyond the scope of this review. However, it is to be hoped that they will be addressed by the ongoing work on professional networks. In addition, special Bankwide mechanisms may be needed to improve coordination in crisis situations.

Lessons and recommendations

xii. This review suggests the following issues to be addressed:

- vertical and horizontal communications within the Bank did not foster a shared perception of the Mexican situation prior to the crisis
- ESW was not adequately geared to thinking through the possible impacts of crises and the implications for the Bank
- the role of the Bank in crises was not clearly defined and communicated to the Region by top management, and no mechanism was in place to respond to crises
- follow-up on policy issues has been constrained by staff turnover and insufficient use of world-class experts to interact with the Mexicans
- the Bank's capacity to analyze financial sector issues and their links to the macro-economy remains inadequate
- the traditional focus of the Bank's debt monitoring on longer-term external debt is inadequate in view of the increasing integration of capital markets and the holding of shorter-term and domestic debt by foreigners

xiii. The main lessons and recommendations concern the Bank's role in crises, preparedness to respond, and response management and execution:

- *The Bank needs to clarify its role in crisis situations.* In practice, there are good reasons to stay actively engaged in the policy dialogue during these critical periods in a country's development. Depending on the circumstances, provision of financial assistance can either facilitate or distract from this role. Accordingly, it would be better to establish clear operating guidelines for such events, with triggers for action, rather than being pushed reluctantly into a delayed and *ad hoc* response. It is therefore recommended that a policy note on this issue, laying out alternative options for the Bank, be prepared for review by the Executive Committee. The note should clarify the preconditions for using adjustment lending in crisis situations (including how to handle exposure concerns) and suggest what new instruments, if any, are needed for liquidity financing and to sustain engagement on longer-term institutional reforms (especially in the financial sector).
- *ESW should analyze potential causes and consequences of crises.* Particular attention should be given to sources of vulnerability to external and domestic shocks, and the political determinants of the country's policy response. The IMF normally takes the lead in providing advice on macroeconomic matters. But the 1989 Concordat is clear that the Bank should also maintain its own analytical capacity in this area. Events in Mexico underscore the importance of the Bank's right to be heard, especially when our own views—on the urgency of the situation and the policy options—may differ from those of the Fund. In addition, the Bank brings a critical micro perspective to the macro dialogue,

including issues of financial sector reform and public spending on basic social programs. Prior work in these areas may help prevent a crisis and is essential to prepare a quick response once a crisis occurs.

- *The Bank needs to do a better job of monitoring vulnerable economies.* Macro surveillance is primarily the responsibility of the Fund. The Bank should establish clear procedures for accessing their enhanced surveillance of macro indicators. But, as evidenced by the Mexican situation, this cannot substitute for the Bank's own monitoring activities, including of external and domestic debt, financial sector performance and social conditions. Current efforts by FPI to put a Bankwide monitoring system in place—to provide an independent assessment of short-term developments and early warning signals to top management—warrant top priority. High-level lines of communication should also be established with the Fund, so that critical information can be exchanged quickly and confidentially.

- *Monitoring should be linked to contingency planning.* "What if" scenarios are useful for the dialogue with country officials on policy options. But they are also useful to consider options for the Bank's response to a crisis. We cannot predict a crisis any better than country officials or financial markets. But we can assess risks and make contingency plans. This should become standard practice for all high-risk countries identified by the Bankwide monitoring system. This will ensure that preparatory work is in place and that the Bank is ready to move fast if and when the crisis hits. This work should also feed into the country strategy. Where it involves sensitive information, the essential elements should be conveyed separately to Bank management and the Board, possibly through an oral statement.

- *The Bank must use its best people in responding to crisis situations.* There is no substitute for a cohesive and well-staffed country team. Credible interlocutors—able to gain the respect of their country counterparts and work alongside them—are essential. Institutional priorities should take precedence over personal preferences in staffing decisions, to ensure that the right people are working on the right issues. But even the best country teams cannot embody all of the expertise needed to respond effectively to crisis situations. Nor can one afford to assimilate this knowledge through time-consuming and costly review processes. CVPU staff and consultants must be fully integrated into the crisis response teams. Priority must be given to strengthening the Bank's financial sector expertise through recruitment, training and access to outside experts.

- *The Bank must establish clear lines of responsibility for crisis management.* Front-line responsibility obviously lies with Regional management and the country department. But Bankwide coordination is also essential to harness staff resources quickly, reach agreed positions on how the Bank will respond, and send clear signals to country authorities and world markets. For this, a

higher-level crisis response group, possibly chaired by the relevant Managing Director, is needed. With good monitoring and contingency planning, this group should be in place before the crisis hits or at least up-and-running immediately thereafter.