Folder Title:	Background Files for Privatization - Lessons of Experience, Prepared by Kikeri - Mexico - Volume 2
Folder ID:	30451138
Series:	Background Materials Compiled by the Public Sector Management and Private Sector Development Division (CECPS), Country Economics Department (CEC) for Privatization: The Lessons of Experience
Dates:	04/09/1987 - 12/18/1991
Subfonds:	Records of the Office of the Vice President, Development Economics and Chief Economist and later Senior Vice President, Development Economics and Chief Economist (DECVP)
Fonds:	Records of the Office of the Chief Economist
ISAD Reference Code:	WB IBRD/IDA DEC-03-66
Digitized:	09/14/2023

MEXICO (2 OF 2)

Document of

The World Bank

FOR OFFICIAL USE ONLY

Report No. P-5254-ME

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

IN AN AMOUNT EQUIVALENT TO US$380 MILLION

TO

BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C. (BANOBRAS)

WITH THE GUARANTEE OF THE UNITED MEXICAN STATES

FOR A

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

MAY 3, 1990

CURRENCY EQUIVALENTS

Currency unit = Mexican peso (Mex$)

On March 30, 1990 the exchange rates stood at:

US$1 = MEX$ 2,719 (Controlled market)
US$1 = MEX$ 2,759 (Free market)

The controlled exchange rate is currently being devalued by one peso a day.

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

1 kilometer (km)	=	0.62 miles (mi)
1 ton (t)	=	1,000 kilograms (kg) = 2,205 pounds (lb)
1 liter (l)	=	0.26 gallons (gal)

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

BANOBRAS	=	Banco Nacional de Obras y Servicios Públicos (Government owned development bank)
DFI	=	Direct Foreign Investment
FHN	=	Federal Highway Network
GATT	=	General Agreement on Tariffs and Trade
ICB	=	International Competitive Bidding
IDB	=	Inter-American Development Bank
MULTIMODAL	=	A semi public company for transportation of containers
NDP	=	National Development Program, 1989 - 1994
PACTO	=	Economic Solidarity Pact
PECE	=	Pact for Stabilization and Growth
PEMEX	=	Petróleos Mexicanos (Government-owned National Oil Company)
SCT	=	Secretaría de Comunicaciones y Transporte (Secretariat of Communications and Transport)
SEDUE	=	Secretaría de Desarrollo Urbano y Ecología (Secretariat of Urban Development and Ecology)
SHCP	=	Secretaría de Hacienda y Crédito Público (Secretariat of Finance)
SPP	=	Secretaría de Programación y Presupuesto (Secretariat of Planning and Budgeting)
TELMEX	=	Teléfonos de Mexico S.A. de C.V. (Mexico's telephone company, 51% publicly owned)
TELECOMM	=	Telecomunicaciones de México (A decentralized state entity responsible for the basic transmission network and telex and telegraph services)

FOR OFFICIAL USE ONLY

MEXICO
TABLE OF CONTENTS

<u>ANNEXES</u>

MAP: IBRD 22252

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower:	Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS).
Guarantor:	United Mexican States.
Beneficiary:	United Mexican States.
Amount:	US$380 million equivalent.
Terms:	Repayable in 17 years, including 5 years of grace, at the standard variable interest rate.
Objective:	The proposed loan is part of a program of Bank support to the Mexican Government's plans to promote structural reforms so as to resume sustainable economic growth. The loan supports a comprehensive structural reform program in the road transport and telecommunications sectors which will improve their efficiency benefitting all users and, in particular, firms which conduct trade related business, for which communication services are an important input.
Description:	The proposed loan supports a program of deregulation in the trucking sector, and a program of privatization and regulatory reform that will promote competition in the telecommunications sector. Pricing and taxation distortions in the two sectors are being eliminated, and the public sector institutions responsible for the oversight of the sectors are being restructured. The loan also includes measures to improve highway safety, and to monitor compliance by trucks with air pollution standards. Under a parallel loan, technical assistance would be provided to strengthen the public sector agency responsible for the formulation of telecommunications policy and for sector regulation.
Benefits and Risks:	By providing an appropriate institutional and regulatory framework, the project is expected to spur private investment and competition, thus serving to increase the efficiency of communications services and--in the case of telecommunications--to greatly expand its coverage. Resource allocation would be improved through greater reliance on market forces for pricing and by a realignment of the fiscal treatment of the sectors. A project-related

risk relates to the Government's ability to fend off any internal political opposition to the terms or management of the deal for the privatization of the telephone company, TELMEX. Another risk is the lack of staff with experience in regulation and the chance of mistakes as a new regulatory framework for telecommunications is developed and put in place. On the macroeconomic front there is also a risk that the growth program may be put in jeopardy by declining oil prices, rising interest rates or protectionist trends in the trade policies of Mexico's major trading partners. Project related risks seem manageable, particularly since the significant upfront actions taken by the Government reflect a strong commitment to the reform process. The likelihood of derailment of the economic program is also felt to be small, given the success already achieved in economic stabilization, debt reduction and resumption of growth. In any case, the substantial conditionality of the Bank's adjustment loan portfolio provides for early warning signals on a worsening trend in domestic policy or in the country's external environment, and would thus enable the Bank to consider timely measures to protect its portfolio and longer term interests in Mexico.

Disbursements: The proposed loan would be disbursed against eligible general imports in two tranches of US$190 million each. The first tranche of the loan would be available upon loan effectiveness. The second tranche would be released after November 15, 1990 upon fulfillment of specific conditions in all key areas supported under the loan and verification of the consistency of the macroeconomic policy framework. Disbursement of the loan is expected to be completed by June 30, 1991.

Retroactive Financing: US$76 million would be made available for retroactive financing of eligible expenditures incurred from February 1, 1990.

Rate of Return: Not applicable.

Appraisal Report: This is a combined President's and Staff Appraisal Report.

Schedule of Disbursements:

US$ Million	FY90	FY91
Annual Amount	190.0	190.0
Cumulative Amount	190.0	380.0

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
REPORT AND RECOMMENDATION OF THE PRESIDENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT LOAN TO BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C.

INTRODUCTION

1. I submit the following report and recommendation on a proposed loan to Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), for the equivalent of US$380 million in support of a program for road transport deregulation and of privatization and regulatory reform in telecommunications. The loan would have a term of 17 years, including five years of grace, at the standard variable interest rate.

2. In the latter years of the de La Madrid administration (1983-1988) the roles assigned by Mexico to the public and private sectors underwent a significant change, which is being deepened further by the Salinas administration (1988-1993). The strategy of the seventies that relied on protectionism and public sector led growth has now been abandoned, and the Government has embarked on a wide ranging program of reforms that promotes competition and reduces public sector involvement in business activities. It has also divested itself of a large number of public enterprises, while implementing policies to increase the efficiency of those still under public ownership, and has moved very far in the deregulation of trade, foreign investment, the financial sector and industry, and on the elimination of subsidies. These reforms add up to one of the most substantive and comprehensive programs of reorientation of economic policy towards reliance on market forces that has been carried out in developing countries in recent years.

3. The Bank has supported these changes and has maintained a very close policy dialogue with the Government on these matters. In June 1989 three adjustment loans, for a total amount of $1.5 billion, were approved by the Board to support the Government's programs in the financial sector, public enterprise reform and industrial sector. The proposed operation is part of a follow-up stage of adjustment which focuses on sectors of strategic importance because of their linkages to most areas of economic activity. In addition to this project, the lending program also comprises operations to support deepening of reforms in trade, public sector enterprises, agriculture and, possibly, the financial sector.

4. The proposed project would seek to extend the process of adjustment to the transportation and telecommunications sectors by supporting policies that would improve their efficiency, benefitting all users and in particular firms which conduct trade related business, for which communication services are an important input through:

(a) changes to the regulatory framework: (i) by eliminating barriers to competition in road transportation, as there is evidence that such barriers have imposed heavy costs to the economy and have failed to achieve the objectives for which they had been designed, (ii) by defining the rules for private sector participation in the telecommunications sector, promoting competition and safeguarding the interest of consumers in those areas where a private monopoly operation is warranted;

(b) improving the allocation of investments by eliminating pricing distortions: (i) in road transportation, by allowing prices to be determined in the market and adjusting the price of competing modes to marginal costs, (ii) in telecommunications, by significantly reducing cross subsidies and introducing changes to the fiscal regime to align the tax treatment of the sector with the treatment now afforded to other economic activities;

(c) assisting the Government of Mexico to develop programs to attract private investment to the telecommunications sector, so as to achieve ambitious targets of sector growth and modernization; and

(d) promoting complementary policy measures that would, in general, enhance the efficiency of road transportation and telecommunications services.

In addition, through a parallel Technical Assistance Loan, the Bank would support the institutional development of the agency responsible for the regulation of telecommunications, so as to improve its capability to discharge its functions (which would be reformulated).

5. The measures outlined above fit well with the development strategy of the Government of Mexico. As the success of Mexico's stabilization program progressively consolidates and the debt issue is being resolved, the priority of economic policy has shifted towards the attainment of sustainable growth. This objective, in the context of an economy that has been opened to external competition, will be assisted by the removal of barriers to efficiency in sectors, such as transportation and telecommunications, that play a vital supporting role to almost all business activities, particularly trade. Improved transportation and telecommunications should facilitate factor mobility, enhance competition and assist the development of new export activities. In addition, increased investment in these sectors, spurred by a framework more favorable to the private sector, will also contribute to economic growth.

PART I - THE ECONOMY

A. Background

6. Between 1950 and 1974, Mexico enjoyed a remarkable period of high growth, low inflation and moderate external debt accumulation. Real growth averaged 6.4%, and inflation was in single digits throughout the period. This era of fiscal conservatism came to an abrupt end in the early seventies. Rapidly expanding government involvement in the economy pushed up the rate of economic growth. However, increasing government expenditure was not matched by rising public sector revenues. As a result, the inflation tax and external debt became increasingly important sources of finance. At the same time, a decline in private savings incentives (real interest rates turned sharply downward) prevented a matching increase in private savings; external debt thus increased, the increased oil revenues notwithstanding. The period of single digit inflation ended in 1973, the real exchange rate[1/] started to appreciate and the accumulation of external debt accelerated above the GNP growth rate. A serious, but comparatively brief, financial and economic crisis in 1976 terminated following major oil discoveries in 1977. The ensuing prosperity lasted until 1982, when soaring domestic inflation, falling international oil prices, rising world interest rates, and massive capital flight led to a refusal by external creditors to roll over Mexico's short-term debt and forced a subsequent suspension of payments of interest on the external debt.

7. Over the 1982-88 period, economic growth ground to a virtual halt, accompanied by sharply falling living standards, deterioration of infrastructure, high inflation, and loss of investor confidence. To reverse Mexico's declining fortunes the most important changes needed were: (a) macroeconomic stability, (b) a rationalized set of incentives for private sector investment, (c) a reallocation of public spending, both to shore up a crumbling infrastructure in support of private sector-led growth and to alleviate the impact of adjustment on the poor, and (d) a medium-term financing plan capable of removing the specter of an unsustainable overhang of debt. In each of these areas, the Mexican Government has achieved notable progress.

B. Macroeconomic Stabilization

8. The onset of the financial and economic crisis of 1982 brought in its wake explosive inflationary and balance of payments difficulties whose effects had been largely repressed during the years leading up to the crisis. Initial strong fiscal and monetary adjustment efforts were alternately not sustained for a sufficiently long period (1983-85) or undermined by external shocks such as the collapse in international oil prices (1986). Inflation, rather than slowing down, accelerated,

---

1/ The real exchange rate is defined as the price of foreign goods relative to domestic goods. Appreciation means a decline in this relative price.

partially in response to the sharp real devaluation of the exchange rate necessitated by the 1986 downturn in the terms of trade. The subsequent de facto targeting of the real exchange rate, together with an increase in the frequency of wage and cost adjustments, introduced an element of inherent instability into the system, culminating in a run on the peso in the last quarter of 1987 and triple-digit inflation.

9. The Government responded with the "Economic Solidarity Pact" (Pacto), an agreement between business, labor, and government which called for accelerated structural reform, further tightening of fiscal and monetary policy, a freeze of minimum wages and of the prices of basic public and private sector prices and, the cornerstone of the "Pacto", a freeze of the nominal exchange rate against the U.S. dollar. This partial freeze was extended at three-month intervals through the end of 1988, and renewed, with some modifications, by the new Mexican Administration under the name of "PECE" (Pact for Stabilization and Growth) through March 1990. The main adjustments brought about under PECE were catch-up increases in selected public sector tariffs and in prices of key inputs, a two-stage 15% cumulative adjustment in the minimum wage, and a daily adjustment of the exchange rate of about one peso against the U.S. dollar. On December 1, 1989 fuel prices and some utility rates were increased, minimum (but not contractual) wages were raised by 10%, and the "PECE" was further extended to the end of June 1990. However, some further adjustment of public sector prices, including a major restructuring of the rates for telephone services (para. 63), took place during January 1990.

10. Performance under the "Pacto" and "PECE" has been highly satisfactory. Mexico has fully observed all of the adjusted performance criteria specified in its Extended Arrangement with the IMF for 1989 (excepting for fourth quarter targets on net domestic assets and net international reserves, for which waivers were granted) and obtained Fund approval for its 1990 macroeconomic program (para. 108). In trade, the Government had originally committed to a three-year program of reforms supported by the Bank. These reforms were designed inter alia to lower the maximum import tariff to 30% ad valorem by the end of 1988. In fact, during the first month of the Pacto, December 1987, the tariff was lowered to a 20% maximum, i.e., 10 percentage points lower than originally agreed and one year ahead of schedule. Such efforts were all the more noteworthy, given the negative budgetary impact of further declines in international oil prices and increasingly high real interest rates on foreign debt throughout much of 1988-89. The shift in exchange rate policy at the beginning of 1989 was instrumental in bringing about a small real depreciation of the peso during the first six months of the year, reversing a trend toward appreciation throughout much of 1988.

11. The fiscal measures, backed by the temporary exchange rate freeze and an array of formal and informal wage and price controls, have had a dramatic success in reducing the rate of inflation from 159% in 1987 to about 20% in 1989. At the same time, the economy has shown encouraging signs of economic recovery, led by a strong resurgence of private investment, which increased by around 10% in real terms. In 1989, GDP

is estimated to have grown by 2.9% in real terms, as manufacturing production rose substantially, while mining and agricultural output declined. During the first quarter of 1990 inflation rose beyond what had been planned. The selective liberalization of price controls on some intermediate and farm products, together with adjustments in public tariffs for gasoline, power, and water toward the end of 1989, led to this temporary resurgence of inflation. After rising to 3.8% in December and 4.8% in January, the rate of consumer price inflation receded to 1.8% in March and 0.8% during the first half of April. Thus, on the basis of current trends, inflation could return to a base level averaging around one percent monthly during the remainder of 1990. For the year, it is expected that inflation would range somewhere between 20% and 25%. Financial investors have already responded positively, bidding down the rates on Treasury bills from 47% annually in January (up from 35% in mid-1989) to around 43% currently. There is also evidence that the merchandise trade deficit has been declining as import growth during the first quarter slowed to a ten percent annual rate (from nearly 18 percent in 1989), while exports growth improved. The Government also recently announced that the extension of the PECE program would be negotiated with the private sector and implemented somewhat earlier than originally expected, perhaps by the end of June 1990.

C. Rationalized Private Sector Incentives

12. Mexico has transformed itself into one of the most open economies in the world through a trade reform supported by four Bank policy-based loans. Trade liberalization has lowered the percentage of domestic tradeable production covered by import quotas from 100% in 1984 to around 18% at present, and maximum import tariffs from 100% to 20%. Non-oil merchandise exports, which represented less than one -third of total exports in 1984, have doubled their share since then.

13. This "core" reform has been complemented by many others. Recognizing that the era of public sector-led growth had passed, the Government took a number of measures to stimulate greater private investment. In May 1989, foreign investment regulations were considerably relaxed and made more transparent. A long-standing prohibition against majority foreign ownership was removed, the fishing, petrochemical, and mining sectors were opened to foreign investors for the first time, the licensing of proposed investments under US$100 million was made automatic (so long as they satisfy newly-published criteria), and approval of larger investments became automatic following a 45-day waiting period, unless the Government interposed formal objection. In addition, since 1986 the tax system has undergone a series of reforms tending to reduce the previous biases against equity finance, adjusting assets and liabilities for the effects of inflation, bringing marginal tax rates more in line with levels in major industrial countries, encouraging the repatriation of flight capital, and increasing the sanctions for tax evasion.

14. To encourage improved mobilization of domestic savings, the Government initiated a process of liberalization of the financial markets, supported by a Financial Sector Adjustment Loan from the Bank. Interest rate ceilings and credit allocation formulae were removed on commercial bank lending and credit subsidies through official development banks were reduced significantly. At present, the principal development and agricultural banks in the public sector are in the midst of significant managerial and financial restructurings, designed to consolidate these institutions, clean up their balance sheets, and reform their lending practices.

15. To reduce the role of the public sector, over 750 state-owned enterprises have been sold, transferred, or liquidated from 1983 to the present and 42 more are expected to be sold or closed during 1990. In March 1990, the Government announced the privatization of two large steel companies. The country's largest airline has been privatized and the Government has also placed in receivership, for eventual sale or liquidation, the country's largest mine. Under the Industrial Sector Policy Loan the Government has already moved far ahead in the deregulation of various sectors, such as petrochemicals, pharmaceuticals, microcomputers and automotives. Attention is now centering on liberalizing the transport and telecommunications sectors since their services are a vital input to all economic activity, particularly industrial production and exports. Liberalization will be useful not only in its own right, but also as a means of increasing the efficiency gains from industry and trade reforms.

D. Reorientation of Public Spending

16. Since 1982, a retrenchment of public expenditure has occurred, of a dimension unprecedented in Mexican terms, if not for most developing countries. Non-interest spending declined by 36% in real terms. However, the composition of the cutbacks was not ideal from the standpoint of growth. Investment expenditures were cut more deeply than current expenditures, posing the risk, now that growth seems to be underway once again, that infrastructure bottlenecks in areas such as roads, communications, and urban services, and lack of skilled manpower availability could impose severe constraints on potential growth.

17. Also, some of the gains in reducing illiteracy, infant mortality, and nutrition during the seventies are threatened by the sharp cutbacks in public expenditures for social programs. The social sector's budgetary share declined from 20% or more in the years preceding 1982 to around 13% currently. This trend seems unsustainable, given the already sharp reduction in real wages, widespread unemployment, and worsening inter-personal and inter-regional income disparities, and for the first time in many years the 1990 budget provides for a significant increase in the social sector's share.

18. In recent years, two successive administrations have sought to soften the blow of reductions in social expenditures. Global consumer subsidies for basic food items have been replaced by less expensive, but more targeted, subsidies to the poor. In 1989 a new "National Solidarity Program" has set aside US$400 million to coordinate the activities of existing agencies and to provide limited additional budgetary support for agriculture, infrastructure and social programs in Mexico's ten poorest states.

19. As for the environment, it is widely recognized that the cumulative effects of past growth, combined with generations of public indifference about ecological issues, have resulted in severe degradation of Mexico's air, soil, water, and forestry resources. Mexico City is now one of the world's most seriously polluted cities, but many other Mexican medium-sized cities suffer from significant problems too. The Salinas Administration is the first to recognize the urgency of broad-based efforts to clean up the environment and, following up on the reformulation of an urban transport project (Loan 2824-ME) to start addressing the pollution caused by vehicle circulation, the Bank is currently involved in the preparation of a free-standing project to address the air pollution problem in Mexico City.

20. Given the severe fiscal constraints, the task of rebuilding roads, bridges and other infrastructure is being met in limited ways. The greatest room for improvement lies in shifting resources at the margin away from support of activities, such as telecommunications, which could be better carried out by the private sector. This will permit increased financing of activities, such as transport infrastructure, where the state's role traditionally has been predominant, even though this is an area where private investment is also being sought. The restoration of sustainable growth will require a gradual increase in public investment over the next few years (para. 25), particularly for agriculture infrastructure, the environment, transportation, energy, and the social sectors.

E. <u>External Debt Reduction Agreement</u>

21. On September 13, 1989, the Government of Mexico and the Bank Advisory Committee representing the commercial bank creditors reached agreement on a financing package covering the period 1989-92, restructuring approximately US$48.4 billion of Mexico's external debt. The agreement consists of a menu of financing options which includes two debt and debt service reduction facilities and four new money facilities. The debt relief package was signed at the end of March 1990. It is estimated to reduce Mexico's annual net transfers abroad by almost US$4 billion per year over the 1989-94 period. This reduction will have a direct beneficial impact on Mexico's fiscal situation and on output growth. At least as important will be the indirect effects through renewed confidence. Lower net external transfers mean reduced pressure on the exchange rate; this should reduce the risks associated with peso-denominated public sector debt, thus taking pressure off

domestic interest rates. Indeed, within days of the announcement of the terms of the agreement in July 1989, nominal interest rates fell from 56 percent to 36 percent on an uncompounded basis. At the same time, the maturity structure of foreign public debt widened considerably and repatriation of over US$2 billion in private foreign capital rebuilt the Government's foreign reserves, which are further indications of a recovery in private confidence.

22. Nominal interest rates have rebounded since September to around 45 percent currently, a reflection of uncertainties about what form the extension of the PECE program (para. 9) will take beyond its June 1990 horizon, as well as uncertainties stemming from the sizeable growth in the current account deficit (US$5.6 billion in 1989, compared with US$3 billion in 1988). The change in the size of the current account deficit was largely due to the increased imports drawn in by accelerating private sector investment, fast growing consumer imports (though starting from a relatively low base), and a drought-induced decline in net agricultural exports. Manufactured export growth during 1989 also slowed substantially to around 8.5 percent. However, with signs of a slowdown in the growth of private investment and a strong recovery of agricultural net exports and output already underway, the current account deficit is expected to fall substantially in 1990, even before taking into account the favorable impact of the debt agreement. This agreement is expected to reduce the current account deficit by US$2 billion in 1990, and by US$1.3 billion annually in subsequent years. Thus, external developments look set to improve in the near future.

F. Macroeconomic Projections[2/]

23. The substantial improvements in macroeconomic performance and in structural adjustment are expected to lead to greatly improved prospects for sustained growth and improving standards of living. The base case starts from an assumption that the 1989 current account deficit, equivalent to nearly 3 percent of GDP, will taper to deficits of around 1.4 percent of GDP over the next five years (see Annex V). These moderate deficits should be easily financeable, and are consistent with a projected decline in the foreign debt-GDP ratio from 49 percent in 1989 to 34 percent in 1994.

24. It is also assumed that the fiscal stance will continue to be consistent with inflation targets, which means that the non-interest fiscal surplus would by assumption remain at around 6-6.5 percent of GDP. This assumed fiscal outcome would be in line with the FY90 budget, but significantly below the 8.4 percent of GDP primary surplus actually achieved in FY89. From the standpoint of consistency with macroeconomic growth and inflation targets, this level of fiscal effort would fall somewhat short of what is needed in 1990-91, when domestic real interest rates are likely to remain high, but exceed what is necessary in 1992-

---

2/ Macroeconomic tables are attached as Annex V.

94, when real rates, are assumed to drop to a more reasonable risk premium over foreign real rates.

25. Per capita consumption is expected to decline slightly in real terms through 1992, before experiencing a sharp recovery in 1993-94.[3/] As for public investment, it is assumed to recover gradually from 4.2 percent of GDP in 1989 to around 6 percent of GDP in 1994, enabling the Government to address the accumulated bottlenecks in the economy's physical and social infrastructure which might otherwise constrain growth. Private investment, which rose from a low of 11.6 percent of GDP in 1986 to 15.8 percent in 1989 would continue to grow over the next several years, attracted by the newly-enhanced investment climate and, later in the sexenio, by the steady decline in real interest rates. By 1994, it is projected to reach around 18 percent of GDP.

26. As a consequence of the rise in total investment from 18.5 percent of GDP in 1986 to nearly 24 percent projected in 1994, real growth would accelerate to a projected 5 percent by 1994. Stronger investment growth under a smaller current account deficit target requires, of course, higher private and/or public sector savings. Private consumption is likely to grow faster than GDP over the sexenio. As a consequence, virtually all of the growth in investment would have to be financed out of increased public sector saving (defined as public investment less the operational fiscal deficit), which would rise sharply from 2.1 percent of GDP in 1989 to a projected 9.1 percent in 1994. The already completed reforms in tax administration and in the structure of personal income and property taxation, combined with continued assumed improvements in public sector pricing, offer solid underpinning for the projection of strong growth in public sector revenues. Substitution of public investment for public consumption and the drop in domestic real interest rates (projected to lower the domestic public debt service 4.4 percentage points of GDP between 1989 and 1994) will also contribute to higher public savings.

27. In conclusion, with foreign financing now in place, the program of internal reform well-advanced, and the economy in a moderate growth mode for the past year, a cautiously optimistic prognosis for Mexico's recovery in growth seems justified. Moreover, Mexico's debt indicators are projected to decline substantially. With a continuation of the Government's reform program, investing in Mexico would offer prospects of a high pay-off. Under the proposed project we would intend to closely monitor the evolution of economic events and to carry out an assessment of the medium term macroeconomic framework prior to second tranche release.

3/ The projections discussed in this chapter have been generated with the help of an econometric model described in Growth, External Debt, and the Real Exchange Rate in Mexico, S. van Wijnbergen, Working Papers, August 1989.

PART II - SECTORAL CONTEXT

A. Introduction

28. In the past two decades there has been a growing awareness all over the world of the negative effects of excessive regulation on private investment, productivity and growth. The original rationale for regulation had stemmed from the concern that economies of scale led to natural monopolies and that such monopolies would result in an inefficient allocation of resources. In addition, it was feared that unregulated competition could negatively affect quality and reliability (or safety) of service. However, by the seventies greater concern was being expressed that regulation limited innovation, sheltered inefficiency and led to resource misallocation. In addition, questions on the appropriate role of the state were brought up, in many cases prompted by generalized concerns about the financing of public sector budget deficits. This has been reflected in a move towards the liberalization of markets previously not open to competition, and in enhanced private sector participation in activities that had before been reserved to the public sector.

29. Mexico has been taking important steps to spur privatization and to adjust the regulatory framework in line with the considerations outlined above. Most important has been the liberalization of trade, reflected in a significant elimination of quantitative restrictions and reduction in the level and coverage of tariffs (para. 12). The Bank has supported this process through several loans and progress has exceeded the targets agreed therein, as well as commitments under GATT, which Mexico joined in 1986. Another important area of policy reform has been direct foreign investment (DFI). The rules governing DFI were liberalized in May 1989, opening new areas for DFI, allowing majority foreign ownership and simplifying the procedures for licensing (para. 13). A third area of policy reform has been the banking system, which had been subject to quantitative credit controls that now have been lifted (para. 14). Finally, reforms in the industrial sector in general (such as reduction of domestic content requirements and investment incentives) and in some subsectors in particular (i.e.: petrochemicals) also deserve to be highlighted, as they underscore the coherence and sense of direction of the overall program.

30. Within the above general policy framework, the Government has embarked on a program to expand the role of the private sector to areas previously reserved to the public sector. The de la Madrid and Salinas' administrations have made substantial progress in the divestiture of public enterprises (para. 15), and a program to continue the disengagement process has been agreed with the Bank under the Public Enterprise Reform Loan (Loan 3086-ME). In a number of sectors hitherto reserved exclusively to government ownership, new initiatives are being undertaken to attract private sector participation and investment. For example, the Government is considering cogeneration alternatives which would attract private capital to the power sector. In water supply, private provision of water services is being tried on a pilot basis in

Aguas Calientes. In urban transportation, the public bus lines serving Mexico city may be turned into cooperative enterprises. In highway construction, concessions are being given for the construction and operation of privately financed toll roads.

31. The two sectors on which the proposed project focuses (road freight transportation and telecommunications) would also be the subject of major policy changes in line with, and supportive of, the broad reform processes discussed above. Transportation and telecommunications are services on which all business activities rely, and their timely availability, quality and cost have important effects on a wide range of products and services and play an important role in facilitating trade. The proposed loan would support the Government's programs in these two sectors and would promote institutional changes to ensure the success of the program. In addition, through a parallel loan, the Bank would provide technical assistance to the telecommunications sector regulatory body.

B. Road Transport

32. The regulation of road freight transportation is a common practice. It is normally justified on grounds of safety, reliability of service and stability of rates. Competition in the sector is feared to be ultimately destructive of the ability of the industry to offer good service. However, there are many countries where the industry is free from most Government regulation and operates in an efficient manner. The costs of trucking regulation arise from inefficient provision of services, shifting of traffic to less economical modes, higher costs of transportation and reduction in total transportation volumes. A study conducted in the USA in 1975, before deregulation, had estimated that these costs could amount to as much as one third of the income generated in road transportation.4/ As we discuss below, the Mexican regulatory framework involved an even higher degree of interference with market forces than in the US, so that its cost could well be in such range.5/

33. Besides freight transportation (trucking), which--together with telecommunications--is the focus of the proposed project, road transport also includes bus passenger and tourism services. Currently, buses are given permission to operate only on specific routes, and entry to the market is highly restricted. In order to provide a permit for a service, SCT consults existing providers, which has led to a very concentrated market structure. The Goverment now intends to deregulate

---

4/ T. Gale Moore "Deregulating Surface Freight Transportation" in A. Phillips (ed), Promoting Competition in Regulated Markets, The Brookings Institution, Washington, D.C. 1975.

5/ The Mexican Government conducted a preliminary study on the welfare cost of regulation in trucking, which estimates that it amounted to 1/2% of GNP.

entry, requiring minimal formalities to change routes. Transport services for tourism were deregulated in March 1990. Before then, these services were provided through a Government monopoly and the level of service was generally considered to be very poor. SCT has now eliminated this monopoly and will issue permits to all interested operators. Route and tariff restrictions have been eliminated and tour operators are free to contract transport services. Foreign vehicles bringing in tourists from abroad are now allowed into Mexico, which could be an important measure to promote tourism and improve the balance of payments. While outside the scope of this proposed project, the policy measures outlined above highlight the breadth and coherence of the Government's reform program.

34. While in the past regulation may have helped the development of the road freight transport industry, the Government has now reached the conclusion that the regulatory framework has been defeating the purpose for which it had been conceived. The Bank's sector dialogue with Mexico during the last two or three years has been increasingly focused on this issue, developing awareness of the problems and promoting discussion on alternative ways to address them. In mid-1988 the findings of a study conducted by the Bank among industrial users, showed generalized concern with the poor quality of trucking services. The main issues to be addressed in the trucking industry and the Government's policies and actions are outlined below.

<u>Trucking Entry Restrictions</u>

35. In the past many restrictions to entry into the trucking industry have limited competition and reduced efficiency:

(a) <u>Federal trucking concessions</u>. In order to provide public trucking services, trucking firms were required to obtain a concession to operate from the Ministry of Communications and Transport (SCT). The concessions, by law, were given primarily to existing concession holders and the administrative procedures for determining the need for additional service depended on the opinion of existing service providers. These procedures strengthened the position of existing firms and led to the formation of cartels.

(b) <u>Corridor Assignments</u>. The country was divided into eleven corridors and each trucker needed a permit to operate within a specific corridor. As a result, both truckers and shippers experienced increased costs. For the truckers, down time increased and load factors reduced as the restrictions constrained their options for backhauling and made it more difficult to match their supply with available demand. For the shippers who wanted to send cargo across corridors, indirect routing was necessary or special arrangements with higher tariffs had to be made. Furthermore, the corridor system tended to favor existing spatial concentration, since the corridors tended to radiate from Mexico City.

(c) Freight centers: Truckers, especially small operators, were originally encouraged to form freight centers so that they could take advantage of economies of scale for common services (such as the provision of spare parts, insurance and paperwork), and facilitate cargo movements. While these services are supportive of the industry, the freight centers, partly as a result of their market knowledge, in recent years limited entry and tended to form cartels in the assignment of cargo. Some freight centers adopted a roll call, first-come first-serve queuing system for truckers to be given access to cargo. As a result, shippers had little say in the selection of the trucker and the benefits of either competition or a close working relationship were foregone. Moreover, the centers were increasingly reluctant to allow return load facilities to other centers even on the same route, and opposed allowing vehicles from other routes to operate within their service area, even when transport was in short supply.

(d) Container Movements: Regulations also inhibited the efficient circulation of containers. To optimize the handling of international container movements, Multimodal, a semipublic company, was created by SCT in 1981. The company was expected to perform the role of a national freight forwarder, undertaking a host of complex services, ranging from packaging to arranging insurance and delivery. However, in practice, as a result of Multimodal's monopoly status and partly because of its lack of expertise, which requires a detailed knowledge of shipping markets and costs, international container shipments were not handled in an efficient manner. Instead, collusion between Multimodal and the freight centers led to a system of surcharges and unofficial payments which often far exceeded the stated tariffs. More important than the shipping costs, service standards were low and deliveries often delayed. As a result, there has been a strong tendency for container traffic to be confined to the port area, thus foregoing the large potential benefits of door-to-door delivery, which is the main advantage of the intermodal technology. In addition, customs regulations did not permit containers that were temporarily brought into the country boxing imports to be used to transport domestic cargoes, which resulted in empty movements of containers and in an uneconomic utilization of their transportation capacity.

(e) Cargo Handling Concessions. SCT granted concessions for handling cargo movements at the railroad stations and border customs facilities, as well as for the drayage services to cross the border. In most cases goods could not be removed without the services of the concessionaire. As with the federal trucking concessions, entry was limited and cartels were formed, which tend to increase costs and reduce service quality.

(f) International trucking. While cargo trailers are allowed to cross the international borders and proceed to their final destination with unloading and loading, the tractors (power units) are not permitted (neither by Mexico nor by the U.S.) to cross. To undertake the exchange of trailers at the border, drayage services have developed. The regulations for these services vary depending on the cities and states involved on both sides. In most cases the Mexican drayage firms (which often operated as cartels) are allowed to bring and take trailers across the US border within a commercial zone which is usually limited to the urban area at the border. The US drayage operations, on the other hand, are generally more restricted; sometimes they are not allowed to cross the border areas or to pickup return loads. Besides the increased costs of exchanging power units and drayage services, customs delays in the clearance of goods are often experienced on both sides. An additional difficulty has been that the high-growth "maquiladora" (in-bond assembly) industries have not been permitted to transport their own products in their own private fleet, which led to inefficiency and higher costs.

(g) State Restrictions. Besides the Federal regulations, some states have restrictions which affect intrastate movements of cargo. In some cases, concessions are required for specific cargo and/or route movements on state highways. A review of state regulations in Chihuahua, Jalisco, Puebla, Veracruz and the state of Mexico generally indicates that state regulations do not, in general, pose major issues as intrastate traffic is not very significant in comparison to interstate transport. However, state regulations do affect the movement of some agriculture, forestry and construction industry products.

The Government Program to Eliminate Trucking Entry Restrictions

36. The recently issued National Development Program (NDP) for 1989-1994 outlines the general policy framework under which the Government expects to achieve its objective of modernization in the road transport industry, so that the quality of services may be improved and costs reduced. The basis of the program is that private investments and competition would be encouraged and the development of multimodal transportation would be pursued. In accordance with the NDP, on July 6, 1989, the Government signed an agreement with the private sector which spelled out sector objectives and mutual commitments to modernize the road transport industry. Subsequently, on July 7, 1989 new regulations governing trucking and inter-modal transport were approved by decree.

37. The main points of the new regulations, that address the entry issues raised above, are:

(a) Federal trucking Permits: The public service notion, which was behind the concept that trucking operations require a concession, has been abandoned. Entry requirements have been eliminated and clear guidelines have been provided for obtaining permits. The trucker need only to prove his identity and vehicle ownership to get a permit, which is easy to obtain. This will allow an increase in the number of truckers that may engage in public transport and allow the legalization of an estimated 20,000 truckers that were operating outside the previous system. From August through December 1989 over 8500 permits have been granted (i.e.: about three times the number issued during 1986-1988). Also, own-account operators are now allowed to transport third party cargo.

(b) Route assignments. The corridor restrictions have been eliminated and trucks have been freed to transport interstate cargo throughout Mexico. Direct shipments between former corridors are permitted without additional costs and truckers are free to offer their services throughout the country.

(c) Freight centers. Truckers do not have to belong to freight centers to obtain cargo and shippers are free to use the trucker of their choice. The freight centers no longer control cargo shipments and certify the shipment bill of lading.

(d) Container movements. The new regulations allow containers to be transported without Multimodal's services and entry into the provision of inter-modal services (under which the transporter is fully responsible for door-to- door shipments) has been opened up. Six new firms have already obtained permits to provide these services and applications from six additional firms are currently being processed. In addition, in January 1990 restrictions on the use of international containers for the transport of domestic cargo were lifted. This is expected to increase container utilization and, hence, efficiency.

(e) Cargo handling concessions. In January 1990 new regulations were issued to allow open entry to the provision of cargo handling services at railroad stations and customs facilities. These regulations forbid giving exclusive rights for the provision of these services and provide flexibility for rate charges. Operators with federal trucking permits will automatically be allowed to provide cargo handling services in federal areas (railroad stations, customs and border crossings).

(f) International trucking. Discussions under GATT are taking place between the USA and Mexico on border trade issues and a fourth meeting was held in January 1990. The new regulations issued in January 1990 allow open entry for the provision of drayage services (which also includes border crossings) so that the present cartels are being broken. In addition, the "maquiladoras" are now allowed to transport their own products in their own trucks across the border.

(g) State Restrictions. SCT has developed a plan of action to sign agreements that will cover road transport in the areas of freight, passenger and tourism with every individual state where this is warranted, in order to eliminate state transport restrictions. The Federal Government will provide state licenced carriers with permits to operate on the Federal network and, in exchange, the States will adjust their regulatory framework to the deregulated Federal one. While the states have autonomy to regulate intrastate transport, the elimination of state regulations would be in line with federal policy. All agreements are expected to be finalized by March 31, 1991.

Official Trucking Tariffs

38. In the past, the official trucking tariffs were set by SCT. While formally the tariffs were not negotiable, in practice some flexibility existed, especially in the form of discounts for large powerful users and, conversely, surcharges by powerful truckers. Furthermore, the tariffs, which were classified into five rate categories and fixed on a countrywide basis, often bore little or no relationship with the costs for a specific shipment. Thus, supply tended to be more available in some areas and less in others, depending on the relationship of the tariffs to costs.

39. In July 1989 regulations were issued which allowed "official" tariffs to be regarded as maximum rates. It then became legal to negotiate individual rates taking into account the specifics of the goods to be transported, provided they did not exceed the maximum official rate. Also a 15% surcharge on rates on imported goods was eliminated. More recently, in January 1990 the tariff ceilings were also eliminated, as well as the application rules that set values for, among other services, pick up-delivery, cargo insurance, exclusively served customers, empty back-hauls and warehouse spaces. Thus, rates may now be freely negotiated between the trucker and the customer.

Automotive Industry

40. The automotive industry, consisting of auto, truck, and bus and parts producers, faces numerous regulations which greatly increase the

effective costs of vehicle purchase and maintenance. In line with the government's previous import substitution policies, protection in the form of high tariffs and numerous import quota restrictions exist. For automotive production, the effective protection is currently estimated at about 50%, compared with the 15% average for the manufacturing industry as a whole. In addition, all producers must comply with domestic component restrictions which vary depending upon whether production is for the domestic or export market. Furthermore, the number of lines and models which producers may manufacture is limited. Foreign ownership of domestic auto parts firms is also limited to 40%. Only the "maquiladoras" which produce auto parts for export are exempted from the above regulations.

41. The automotive industry issue is being addressed under the Industrial Sector Policy Loan (ISPL), approved in June 1989, under which the Bank and the GOM agreed on an action plan to deregulate the automotive sector. In compliance with this commitment, on December 11, 1989 the GOM published two decrees which represent a major step forward in the liberalization of the sector and which exceed substantially the actions required under the ISPL. The regulations governing the automotive industry have been changed to ensure that truckers will be able to purchase units of international quality at international prices and starting with model year 1991 the import of tractor trailers will be allowed (starting in 1992 also heavy trucks) if domestic prices exceed the international level. In addition, restrictive regulations on the organization of truck production, such as national integration requirements, compulsory incorporation of domestic components into vehicles and the majority national ownership requirement have been eliminated. The plan also calls for:

(a) opening up the import of buses (which has already taken place), and of automobiles, light and medium trucks, beginning with the 1991 model year; and

(b) gradual reduction of domestic content requirements for the vehicles listed above and for auto parts, and progressive removal of quantitative restrictions on auto part imports.

<u>Highway Safety and Environment</u>

42. While on economic grounds a convincing case may be made that most regulations which restrict entry and limit price competition should be eliminated, there is an economic rationale for safety, environmental and vehicle loading controls, based on the externalities that they cause. The total number of road fatalities in Mexico is estimated to be about 15,000 per year and a rough estimate made by the Bank in 1987 indicates that the proportion of the number of persons killed on Mexican highways to the number of accidents was six times higher than in Sweden.

43. SCT's road safety policy, outlined in the 1989-1994 national program for transport modernization, seeks to substantially reduce the number of traffic fatalities and injuries. However, although much good

work is being done by various agencies to improve road safety, coordination is weak and policy objectives are not clearly defined. To address this problem, the Government has strengthened the interagency group that is responsible for these areas. An expanded interagency group will bring to bear the views of all affected parties, and is perceived as the first step towards effective coordination. While an accident data collection system exists, collection, storage and analysis require improvement so that the data for the entire country is presented in a consistent way and subsequent action programs formulated.

44. At present, Mexico lacks an adequate inspection system to monitor vehicle safety. The present system allows potentially dangerous vehicles to use the public roads, and at least 7% of the accidents are due to vehicle factors, such as bad tires and brakes. However, it would be of little value to invest in expensive testing facilities and to employ a large number of inspectors if there is no confidence on the results that such system would deliver. Furthermore, at a time when the size of the public sector is being reduced, the merits of such an option become questionable. Hence, an alternative which would be better suited to present circumstances would be to promote insurance against third party claims, which over time should result in better monitoring of the conditions of vehicles and of driver behavior; this is the course that the Government intends to follow.

45. A particular safety concern is the size and heavy loads of the cargo truck fleet. Overloaded axles of trucks cause severe damage to highway pavements, which increases the risk of accidents and results in shorter road life and high maintenance costs. The cost of the resultant damages caused to bridges and to pavements is borne by the highway authority, and the increased cost of accidents have to be met by the community. While little data is presently available, axle overloadings are suspected to be most serious on roads connecting major port areas, where cargoes are concentrated and heavy industries are located. This problem is to be addressed, in a first stage, by a study that has already been contracted which will first collect information on vehicle sizes and loadings and, in subsequent stages, analyze policy options and recommend measures to enforce vehicle size and weight regulations.

46. Another problem related to security, and which business firms report to be a major concern, is loss and damage to cargo. At present, the trucker's responsibility for cargo loss is limited to only Mex$ 800/ton (US$0.31) and provides little incentive to care for the cargo. Until January 1990, a further regulation indicated that the shipper could insure his cargo by paying the trucker a fixed rate of 3 mills per declared value. The fixed rate did not take into account the type of product shipping risks, which are independent of the cargo value. While now the rate for incremental insurance may be negotiated freely, the limit on the trucker's responsibility has not been updated. The Government is now reviewing the limit and a decision is expected soon.

47. Regarding the environment, the key concern is with air pollution, particularly in the Mexico City metropolitan area. At present SEDUE and

SCT are drafting norms to control bus and truck noise and air pollution, requiring periodic inspections which would be conducted by private service stations. In addition, programs to improve the quality of fuels are under way. The Bank will also provide assistance to address the specific problem of Mexico city through Loan 2824-ME (which was amended in January 1990 for this purpose) as well as through a proposed free standing project which is now in an advanced stage of preparation.

Pricing, Cost Recovery and Taxation

48. Sector cost recovery: If transportation is to be used in the most efficient way, users should face charges that adequately reflect the true cost of the mode chosen. In this context, a study conducted by the Bank indicates that while overall road costs are being recovered there are cross-subsidies between automobiles and trucks. By late 1989 trucks were only paying for a small fraction (about 15%) of the costs which they caused to the highway network. This result was essentially due to the relatively low domestic price of diesel fuel, which in November 1989 was Mex$ 445/lt (US$0.65/gallon), above the international border price but not enough to allow adequate cost recovery. On December 1, 1989 the price of diesel was increased by 5.6% and this increased cost recovery from trucks to about 50%. Further measures would still be required to raise cost recovery to an acceptable level. These could involve some additional increase in the price of diesel and/or an increase in direct taxes or license fees paid by truckers. The Government's development policy letter confirms its commitment to the objective of full cost recovery.

49. Railroad tariffs. Also related to the issue of market pricing, is the present structure of railroad tariffs, since trucks compete with the railroads for traffic. In general, the tariffs charged by the railroads for the transportation of key commodities fall short of long run variable costs. This should be corrected to avoid a misallocation of traffic between trucks and the railroads. This issue is being addressed under the Railway Sector Loan (Loan 2575-ME) but the constraints placed by the ongoing stabilization program to public sector price adjustments have resulted in a build-up of distortions over the past two years. The Government has now decided to substantially increase FERRONALES' rates within the next few months, so as to realign them with economic costs. In addition, under the Public Enterprise Reform Loan (Loan 3086-ME) a study of railway rates has been initiated and, upon its completion in September 1990, it will provide an improved data base for relating railway rates to economic costs. Lastly, on January 26, 1990 the Government passed a decree which provides general guidelines for the operation of all public enterprises. The decree highlights the objective of fostering managerial autonomy, establishes that public sector prices should reflect opportunity costs or should be based on economic criteria, and assigns freedom to the enterprises to periodically adjust their prices based on these criteria, subject only to a five day prior notification to the Government. Thus the decree provides an excellent framework for the future.

50. Taxation. Because of a special provision, the Mexican transport sector was exempt from income taxes as well as from value added and ownership taxes. Instead, since 1966 truckers were required to pay a direct tax which was a fixed amount per operated vehicle. The amount varied according to the type of vehicle and the kind of service it provided but on average was very small and, as a result, revenues obtained from this tax were minuscule. Not only did this cause a distortion in the pricing and allocation system, it was a major loss of tax revenue since the transport sector accounts for about 7% of GDP and the Bank estimated that a large revenue potential from taxing truckers under the general income tax regime was not being tapped. The exclusion also presented an avenue for tax evasion, since a manufacturer could start a trucking operation to escape corporate income taxes. Within the 1990 budget that was approved by Congress, the exemption of the trucking industry from income taxes, value added and ownership taxes was eliminated. This action thus closes a large loophole in the tax structure.

Road Maintenance and Efficiency

51. Closely related to the pricing and taxation issue is the amount of expenditures on road maintenance, since the condition of the roads directly influences costs and tariffs. About 20% of Mexico's 45,000 km long Federal Highway Network (FHN) is badly deteriorated, mostly due to inadequate maintenance over the past several years. The backlog of deferred maintenance is estimated to be over 50% of the federal highway network (i.e., about 25,000 kms). The problem is expected to increase in severity, particularly as the funds currently allocated to maintenance fall short of estimated needs. During the 1987-89 period routine maintenance was carried out only on about 20% of the FHN. Furthermore, to add to the difficulty, for budget management reasons the funds released to SCT often arrive during the second half of the calendar year while the main maintenance and construction period during the dry season occurs during the first half of the year.

52. An analysis of SCT's expenditures during the 1983-88 period indicates that only about half of their budget was spent on maintenance and rehabilitation activities. The remainder of SCT's resources was spent on new construction and on widening existing roads. While new construction and widening can provide acceptable returns, numerous studies both in Mexico and other countries have indicated that maintenance activities (preservation of the existing roads) show the highest returns and are the best use of limited resources. The Government's development policy letter underscores the priority it assigns to highway maintenance and this has been reflected in its recent decision to increase the originally proposed 1990 budget for maintenance by about 40%.

Reorganization of SCT

53. As a result of the steps already taken, many of SCT's regulatory functions in the transportation sector are being eliminated or reduced,

particularly within the General Directorate of Land Transport and Tariffs. To ensure the efficient use of personnel SCT conducted an internal reorganization (including reductions in personnel, suppression of a department and reassignment of its staff, and reformulation of the functions of two other departments) to align its structure with its revised role in the sector. This reorganization is substantially implemented, and only some fine tuning is likely to be needed in the months ahead.

C. The Telecommunications Sector

54. In recent years the telecommunications sector has been the focus of worldwide attention. The success of a recent Bank seminar in Asia[6/] testifies to the growing interest in management and restructuring options for the sector. Following the break-up of AT&T in the USA, and the move towards privatization and a more competitive environment (as well as innovative concepts in regulatory practice) in the UK and other large industrialized countries (such as Japan, France, Germany, Netherlands and Australia) there has been a widening interest in the potential of sector reforms. The underlying technological and economic forces of change are by now clearly visible in developing countries.

55. As noted in the IBRD book mentioned above, in most developing nations telecommunication services are provided by the public sector. Often quality of service is poor and there is a large unmet demand. Sector investments, constrained by overall ceilings on total public sector investments, fall short of needs and charges tend to be influenced more by political factors than by financial and economic considerations. At the same time, technologies are in a process of constant change, costs are dropping and the uses of telecommunications in business are expanding. The inability of the sector to respond to demand is a major challenge faced by the developing world, and Mexico is no exception.

The Mexican Telecommunications Sector

56. TELMEX has a monopoly on telephone service. Until 1972, TELMEX was controlled and managed by the private sector and still today 49% of its stock is publicly traded (both in the Mexico and in the New York stock exchanges), while the other 51% is held by the Government. TELMEX is run as a government enterprise, and its tariffs, investment decisions, finances and management are constrained by the same factors as in other parastatal enterprises. SCT is responsible for telecommunications sector policy and regulation. The latter includes licensing of private networks, approval of customer premises equipment, and planning, administering and monitoring the use of the radio spectrum. Until late 1989, SCT also had direct operational

---

6/ B. Wellenius, P. Stern, T. Nulty and R. Stern (editors), Restructuring and Managing the Telecommunications Sector, The World Bank, Washington D.C., May 1989.

responsibility for the provision of some services (mainly telex, data transmission, operation of a sizable, but antiquated, microwave network, a modern but underutilized domestic satellite system, and a network of maritime coastal stations).

57. Mexico's present telecommunications system is a major constraint to economic growth, particularly industrial production and export activities. There are over 1.5 million applications for telephone service awaiting installation (and many more potential subscribers that do not bother to apply given known long delays in obtaining service)[7/]. Telephone service is also of poor quality, unreliable, and heavily congested (it is virtually impossible to get through during peak business hours). In the recent past, TELMEX has installed about 230,000 lines per year, which barely keeps up with the growth of demand. More advanced services (e.g., facsimile, data transmission, cellular telephony, access to time-shared data processing and data banks) are only in their infancy. Given Mexico's drive to open its economy, it is becoming increasingly important to ensure that business firms operating throughout Mexico have access to state-of-the-art telecommunications and information services, and that households gain access to markets and business activities through a more effective basic telephone infrastructure.

Sector Issues

58. Senior government and TELMEX officials have given much careful thought to the four key sets of issues that need to be addressed in order to overcome the above deficiencies:

(a) What role should the private sector play in telecommunications? In particular, how can the huge investments required to expand and modernize services be funded? And what functions should remain with the government?

(b) To what extent, and how, should competition be developed?

(c) What would be an appropriate regulatory framework? In particular, what should be the price and tax regime? How can the required regulatory capacity be developed? And,

---

7/ Mexico's 5.3 connected telephone lines per 100 inhabitants is somewhat less than the average for Latin America (about 6) and well below other newly industrialized countries (e.g., Korea 15, Singapore 30). Only 18% of Mexican households have a telephone (compared with about 40% in Spain). Furthermore, there are large imbalances among states (e.g. 11 lines per 100 inhabitants in the Federal District compared with 3 lines per hundred in the states of Mexico, Veracruz and Michoacan) and between urban and rural areas.

(d) How can the conflict of interest between the government's regulatory functions and its operating responsibilities be reduced or eliminated?

These issues are linked to broader aspects of the Government strategy which, as noted earlier, seeks to spur private sector development and non-traditional exports and reduce public sector participation in business activities where the public sector does not have a comparative advantage or very clear rationale for its involvement.

59. Private Sector Role. There is now a widespread perception, which the Bank shares, that under private ownership TELMEX would face less constraints in mobilizing funds and operating as an efficient business than it does as a parastatal enterprise. In addition, in the context of appropriate sector policies it would be more responsive to changing market requirements and technological opportunities. There is also the idea that ownership of a substantial proportion of TELMEX stock by a foreign operating company would bring in expert telecommunications management to steer TELMEX towards more efficient commercial operation. In order to prepare TELMEX for sale, in October 1989 the Secretary of Finance (who is responsible for handling the placement of TELMEX shares) was appointed as chairman of the Board and a new director general took over as chief executive. Furthermore, in January 1990 a Mexican investment bank, "Banco Internacional", was appointed to handle the sale.

60. Competition. The Bank also shares the view that new private service providers should be allowed to enter the market under a regulatory framework which limits Government intervention as much as reasonably feasible. Such competition would help meet outstanding and new demands, particularly for advanced business services where innovation and responsiveness, rather than scale and scope, are the key determinants of performance. Competition would also press TELMEX to accelerate network growth, improve the quality of its services, and contain costs.

61. Policy decisions are required, however, on the competitive supply of services, participation of monopoly entities in the competitive segments, and relations between both. Unfettered competition would result in wasteful duplication of facilities, loss of benefits due to excessive network fragmentation, and dilution of surplus funds needed to complete the basic national telecommunications infrastructure required for economic development reasons.

62. Regulation, Pricing and Taxation. As the state moves out of the business of providing telecommunications services, it becomes necessary to revise the policy and regulatory framework and build up a public regulatory capability. First, regulatory objectives suited to a mix of private competitive and monopoly services need to be clearly established. Second, the role of pricing as a means to ensure efficient allocation of resources must be recognized and principles developed to set prices in such cases where market mechanisms may be inadequate.

Third, areas where disagreement between affected parties may arise must be identified and processes established to resolve disputes and ensure fairness in decision making. Finally, transparency and accountability must be brought into the picture to attract public trust and support for the proposed changes. The extent and pace at which Mexico can build up effective, trustworthy regulation will be a key factor in the success of privatization and competition.

63. A critical area for regulatory improvement is that of pricing. Until January 1990, installation charges were very high, monthly network access and local usage charges were very low, and tariffs on international calls (especially to the USA, which accounts for about 90% of the traffic) were extremely high. These price distortions induced excessive use of some facilities while penalizing others (especially burdening international business activities with prices that were significantly higher than those of Mexico's foreign competitors or partners). In January 1990 cross subsidies were significantly reduced, with some charges for domestic calls increasing as much as twelve times and rates for international calls dropping by about 35%. As TELMEX is privatized, it becomes increasingly important to establish a process for the periodic adjustment of tariffs that reflects the objective of promoting efficiency, while ensuring an adequate level of profitability[8/]. Considerable progress has been made in this regard and the Government has now decided to rely on price-cap mechanisms, which is in line with the prevailing thinking in the USA, UK and other countries that have moved towards privatization.

64. Until recently, taxation was also a major issue. Telephone users had to pay a tax (inclusive of VAT) which ranged between 22% and 72% (depending on the type of service). On average, TELMEX suscribers paid more than 50% in taxes, which was the highest of a group of 76 countries studied by the Bank. Over the past several years, while the Government did provide funds for investment to TELMEX, the sector remained a net contributor of funds to the Treasury. It is estimated that in 1989 the net transfers (all taxes minus funds provided for investment) from TELMEX to the Government amounted to the equivalent of about US$640 million. It was increasingly felt, however, that as the sector was opened to competition, telephone taxes had to be reconsidered to avoid misallocation of resources. Applying VAT to telephone services is perfectly justifiable (indeed necessary to avoid distortions). So is taxing income under the same rules and applying the same rates as for other business activities. On this basis the tax regime was substantially realigned in January 1990. The new regime does provide for a tax on revenues (in additon to VAT and income taxes), but this new tax (which replaces the old tax on telephone users) is a major

---

8/ Often the marginal cost of providing telecommunications services is lower than average cost (mainly due to economies of scale and technological innovation). Thus deviations from efficient prices may be required to ensure full cost recovery and generation of operating surpluses to sustain rapid expansion and modernization.

improvement. It allows for a substantial investment credit and may be deducted from income taxes, so it may reasonably be expected that its financial impact on TELMEX will be negligible but it will serve to reduce accounting profits, and hence avoid a large increase in employee participation in profits. The recently enacted price and tax changes, coupled to a phasing out of Government contributions to investment by the time that TELMEX is privatized, are expected to result in TELMEX payments to the Government of about US$754 million in 1990.[9/] In the medium term, increased private participation in the sector will result in system growth and increased fiscal revenues, so that by 1994 these would rise to about US$1,460 million.

65. There are also areas of essentially technical (as distinct from economic) regulation that need attention. Management of the radio spectrum, a scarce natural resource, is already antiquated and ineffective; with the advent of more private networks and service providers, this may prove an intractable bottleneck unless extensively modernized. Under a proposed Technical Assistance Loan that is being processed in parallel to this operation, the Bank would assist TELMEX in this field. Also, maintenance of national fundamental technical plans (for signalling, numbering, etc, required to facilitate interconnectivity among national network segments and with international standards) is currently the responsibility of TELMEX; as TELMEX is privatized, and competition develops, responsibility for this function must be taken over by an entity that is independent of the operator.

66. Lastly, there is the need to concentrate in a single agency a number of regulatory functions now dispersed between several. In particular it would be advisable to consolidate the tariff oversight function, in which SCT, SHCP and, in some way SPP, are now presently involved. This would automatically take place once TELMEX becomes private, as the role currently played by SHCP and SPP, arises from the "public" nature that TELMEX now has. The need to strengthen SCT's

---

9/ The windfall effect on Government finances of the sale of its shareholdings in TELMEX should also be taken into account. TELMEX's net book value is about US$3.3 billion. Based on the current market price of TELMEX shares in the Mexican stock exchange, the Government's holdings in the company would be worth over US$2 billion, but now that tariffs have been substantially aligned with economic costs it is expected that such value will rise. In this context the pace of divestiture is likely to have significant financial implications. One of the key objectives of the strategy that the Government, with the assistance of investment bankers, is now developing is to obtain the best possible deal, while meeting the other objectives of the divestiture process. To achieve this, the Government will initially sell about 20% of the shares (i.e.: less than 40% of the Government's holdings) which will provide the purchaser with a controlling interest (because of the higher voting rights that will be attached to these shares).

telecommunications regulatory capability is based on TELMEX' significant monopoly power, and is addressed by the Technical Assistance project being proposed in parallel with this operation.

67. Divestiture of SCT's Operations. An essential element of sector reform must be separating operational activities under SCT from its policy and regulatory responsibilities. This would substantially reduce the risk that SCT would seek to protect its own business activities at the expense of overall sectoral development. It is also essential to give adequate assurances to private investors (particularly those expected to buy TELMEX) that state operations will not be used as a tool for arbitrary interference in the market. To achieve this, the Government has decided to reorganize SCT's operations under an autonomous state enterprise, TELECOMM, subject to the same rules and regulations as any private operating entity, and without further Government financial support.

The Government's Telecommunications Program

68. The Government has decided that a major effort to step up the pace of telecommunications development is required, and has set as a goal an investment program of about US$10 billion over 6 years (1989-1994), which would allow increasing the telephone density from about 5.3 lines per 100 inhabitants (end 1988) to 8.5 (1994). The Government is willing to take action on the issues outlined above and is quite advanced in implementing a far reaching program of reforms, of which the following key aspects deserve to be highlighted:

(a) Privatization: Privatization of TELMEX, announced by the President several months ago, is the center piece of the Government's telecommunications reform plan and is well underway. A satisfactory program and timetable have been furnished to the Bank; under them in early 1991 "Banco Internacional" expects to transfer administrative control of TELMEX to private owners and to initiate the sale of remaining Government-held shares in the national and international markets. To achieve this, "Banco Internacional" has finalized an agreement with a foreign investment banker that will coordinate efforts in placing shares abroad; for which purpose other foreign investment banks are also to be engaged soon.

(b) Competition: Concurrent with the sale of TELMEX shares, competition will be widely encouraged, including development of private user networks interconnected to the public network, cellular telephony (mainly for mobile service but also as an alternative to TELMEX's fixed telephone service), supply of customer premises equipment (e.g., telephones, PABXs, fax and telex machines), provision of information services, and eventually long-distance and international voice and data transmission. Franchises for cellular services in Mexico City and in eight regions covering the rest of the country have already been awarded (with a large response from prospective suppliers, as over 100 bids had been received for the country's eight regions).

(c) Regulation, Tariffs and Taxes: A new franchise contract for TELMEX has been prepared, for discussion with TELMEX's prospective shareholders. Rules and regulations for licensing telecommunications networks and services, which would define the rules of the game to all firms interested in competing in these markets have also been drafted. TELMEX tariffs have been substantially restructured (January 1990) increasing on average by more than 70% and significantly reducing cross subsidies (para. 63) and, while there is still room for some fine tuning, the present tariff structure would allow TELMEX to internally finance about 80% of its 1990 investment plan. And;

(d) Divestiture of SCT's Operations: While SCT will retain and develop its policy and regulatory responsibilities, all its telecommunications operating functions have now been transfered to a new decentralized state enterprise, TELECOMM[10], and a competent management team has been appointed to run it.

69. Finally, the collective contract with TELMEX's union was successfully renegotiated in April 1989, overcoming long standing problems that had limited management's freedom to run the company as a business. However, while in the case of road transport most of the important steps have already been taken, in the telecommunications sector some important reforms still have to be implemented.

PART III - BANK STRATEGY

A. Government Strategy

70. After six years of falling per capita income and a protracted stabilization and adjustment process, the Government's main objective is the restoration of sustainable economic growth. To achieve this objective, macroeconomic stability had to be consolidated and the burden of the country's external debt overhang had to be credibly reduced so as to restore investor confidence. The ongoing stabilization program has brought down inflation from an annual 159% to about 20% in 1989. The debt rescheduling was also satisfactorily concluded in March 1990 (paras. 21-22); the debt package has been supported by the IMF and the

---

10/ Presidential decree of November 17, 1989. Some of the services taken over by TELECOMM may be privatized, e.g. the small packet-switched network and the telex service. SCT's reservations network, also small, established in 1985 as a decentralized agency, would be privatized directly; a decree to this effect is being drafted.

Bank (an interest support loan for US$1.26 billion was approved by the Board on January 30, 1990; see report No. 5235-ME which discusses in detail the debt agreement between Mexico and the commercial banks).

71. The Government has stated that growth must be private sector based, with the Government playing a supportive role by providing incentives for private sector investment and reallocating public spending to improve public infrastructure, alleviate poverty and solve long-neglected problems of the environment. To eliminate the anti-agriculture bias in the incentive and trade regime, the Government has resolved to adjust sector policies in agriculture, where reforms in the past have been lagging behind industry. To prevent inadequate service levels from becoming a bottleneck for renewed growth, infrastructure policies will assign priority to the rehabilitation and maintenance of existing infrastructure (power, water, transportation, irrigation, etc.) and, where feasible, private sector investment will also be sought. The Government is also committed to equitable development and is emphasizing social sector programs, including health, nutrition, education, and rural development, and the budget for 1990 already includes a sizeable increase in the share of resources assigned to these sectors. These programs would be targeted to the truly needy, to reduce the social cost of adjustment and to address issues of structural poverty. On the environment, the Government has launched a major initiative to tackle high priority problems which have been affecting increasingly the health and living condition of the country's people and its economic growth potential.

B. Country Assistance Strategy

72. Given such a comprehensive and balanced Government strategy, the Bank has a major role to play. Our assistance strategy is based on the highly successful partnership that the Bank has built up with the Government over the last few years. Through adjustment lending in support of structural reforms and increased sector investment lending, the Bank is giving a signal of confidence so that the inflow of external capital necessary for growth will be forthcoming. At the same time, adjustment lending and credit enhancement by the Bank in support of the 1990 debt package are helping relax Mexico's resource constraint that is stifling growth, thus playing a major role in helping the country break out of the macroeconomic and financial bind in which the country finds itself. That is the main rationale for sustained high levels of Bank lending with a robust conditionality. After FY91, as the conditions for growth have been restored, lending would shift away from adjustment lending to growth-oriented sector investment lending and to social and environmental projects.

73. In support of the Government's program to consolidate macro economic stability and to restore growth, the Bank's strategy would pursue the following objectives: (a) consolidation of the stabilization effort; (b) support of incentives for efficiency/private sector led growth, including the necessary infrastructure investments, particularly in transport, power, agriculture and urban services; (c) poverty

alleviation/improved social services; (d) environmental protection; and (e) secure continued access to external resources.

74. The above outlined assistance strategy and sectoral objectives will be implemented with the help of sustained high levels of Bank lending to Mexico over the medium term, which would be maintained at US$2 billion per year. Such high levels of new commitments would, of course, hinge on the maintenance of a consistent macroeconomic environment and on the depth and quality of Mexico's further structural reforms. As 61% of Bank lending to Mexico has been in support of adjustment and debt reduction in FYs88-90, it is the Bank's intention to cut back on quick-disbursing adjustment operations and, in a manner consistent with the requirements of the recovery of economic growth, focus on sector investment operations which are designed to support agreed investment programs in high priority sectors. To keep resource transfers at adequate levels, the Bank and the Government are currently reviewing the requirements of time slice financing, which would be an essential feature of the sector investment operations. To help achieve the stated objectives of the Bank's country assistance strategy, the policy content of the proposed lending program would be directed at: fiscal issues, financial sector efficiency, domestic deregulation, trade and export development, subsidy control and pricing issues, improved public sector and parastatal enterprise management, decentralization and deconcentration of the public sector, social welfare and poverty programs, and environmental measures. As a result of recent high levels of Bank lending to Mexico, the Bank would, under the proposed US$2 billion annual lending scenario, increase its exposure by US$5.55 billion by 1994. Mexico's share in the Bank's total disbursed and outstanding loans would reach a peak of 11.8% at end-FY91 and decline slowly thereafter.

C. Bank Rationale for the Proposed Loan

75. As noted in preceding paragraphs, the Government of Mexico has moved very far in the implementation of a program of adjustment designed to reduce the involvement of the public sector in activities which can be conducted more efficiently by private enterprises and to provide a liberalized legal and institutional framework which promotes private investment and competition. The reforms already implemented and supported by the Bank in the trade regime, financial sector and industry and the program of divestiture of public enterprises reflect these objectives, and the project now proposed complements and reinforces these adjustments efforts by extending them to two sectors of strategic importance: road transport and telecommunications. These sectors provide services which are vital to business development and, particularly, to trade. As already discussed (para. 37), elimination of constraints to entry and of price controls in trucking have already taken place and deregulation of the automotive industry also is ahead of the agreed schedule (para. 41). In the case of telecommunications, the Bank played an important role in helping to shape the Government program, which goes far beyond what had been expected only one year ago. The privatization of TELMEX, one of the largest parastatals in Latin

America, and the opening up of the telecommunications market to private (including foreign) investment are unprecedented steps in Mexico. These measures, and the additional actions proposed under the project, would make transportation and telecommunications services much more efficient. They, therefore, justify the Bank's assistance to the Government's decision to extend its adjustment efforts to transportation and telecommunications. Furthermore, the depth and comprehensiveness of the adjustment efforts that Mexico is undertaking and the need to help restore growth, still limited by a balance of payments constraint (at a time when access to external financial markets is still very constrained), justify a significant level of adjustment lending and provide the basis for having framed the proposed operation as a sector adjustment loan.

D. Transportation

76. In the road transport sector, the proposed project would monitor the implementation of the deregulation measures already announced, and would promote additional measures, as outlined below:

(a) Open Entry: Much progress has already been made in providing open entry into the transport industry by replacing restrictive concession requirements by a simple and open system of permit awards, eliminating corridor and freight center restrictions, opening access into cargo handling and drayage services and introducing competition in the movement of containers. Also, a plan of action has been developed under which the Government will seek agreement with every state where this is warranted to deregulate trucking within its jurisdiction. This is expected to be fully achieved by March 31, 1991. In addition, improvement of customs operations, which would have a high economic significance for international trade and trucking, would be sought under an Export Promotion Project which is now in an advanced stage of preparation.

(b) Official Tariffs: On this important issue, all the actions that the Bank sought have been already taken, as tariffs are now freely negotiated by the truckers and their customers.

(c) Highway Safety and Environment: While highway safety is an important concern in its own right, in the future attention to safety will be particularly important since the issue may be used as a justification for the reintroduction of trucking industry regulations. To improve highway safety, we have agreed with the Government on:

(1) completion of phase I of the study, which is already under way (para. 45), on vehicle sizes and loadings and initiation of phases II and III;[11/] and

(2) the presentation of a satisfactory action plan to improve road safety, as a condition of second tranche release.

To address the air pollution caused by trucks (para. 47), by second tranche release, the Government would issue satisfactory regulations requiring mandatory periodic inspection of trucks to monitor compliance with federal emission standards. It is now expected that such inspections would be conducted through private service stations.

(d) Pricing and cost recovery:

(1) The analysis of cost recovery from truckers indicates that they have not been paying for all the maintenance and improvements costs which they cause to the road network. One of the main reasons has been that the price of diesel did not include an adequate surcharge through which to recover costs. This distortion has now been partially corrected, but cost recovery is still only about 50% and, consequently, further actions are still necessary to achieve full cost recovery (para. 48). The Government has now confirmed to the Bank its commitment to achieve full cost recovery. For second tranche release significant progress should have have been achieved through an increase of not less than 10% (in real terms) in the price of diesel fuel; and

(2) To ensure that the distribution of cargo between competing modes (road and railway) is conducted on the basis of the "right" price signals (which is necessary to ensure an efficient allocation of investment resources between the modes), the Government has advised the Bank that it intends to adjust FERRONALES rates so as to align them with long run variable costs (para. 49). For second tranche release the Government should furnish to the Bank the study on railway rates initiated under the Public Enterprise Reform loan, which will provide an improved data base for rate setting. In addition, for second tranche release FERRONALES should have approved increases (to become effective not later than January

---

11/ Phase I refers essentially to data collection; phases II and III to the development of policy options.

1, 1991) of not less than 25% (in real terms), or to long run variable cost levels, in the rates for the transportation of selected commodities and goods, which account for about 70% of the traffic. This increase would bring most of them to the required level, so that further real adjustment requirements would be limited to few commodities.

(e) Highway maintenance: Since 1982 Mexico has been facing a mounting shortfall in highway maintenance, which will be reflected in increased operating costs for trucking in the coming years (paras. 51-52). To help address this problem, in 1987 the Bank made a US$135 million loan to finance a Highway Maintenance Project (Loan 2875-ME) but the achievements so far have been very modest. Within a framework of fiscal discipline, much more can be done to address this problem than at present. Under the proposed project, the Government furnished a general policy declaration on the priority of maintenance expenditures over new construction and approved an increase of Mex$ 155 billion (i.e., about 40%) in SCT's 1990 budget for highway maintenance activities. At negotiations, it was agreed that presentation to Congress of a satisfactory budget proposal for CY91 (which should further increase by Mex$ 45 billion over the revised CY 1990 level to Mex$ 475 billion in 1990 prices, and should also provide that at least 40% of the allocation for maintenance is for routine maintenance) would be a condition of second tranche release.

E. Telecommunications

77. In the case of telecommunications, the Bank has an opportunity to play a valuable role at a critical juncture, when changes of a scope that would have been impossible to expect only a year ago are now being undertaken. We have a strong base to start from. First, a good high-level dialogue on policy matters has built up from 1988, and the Government's economic team, and now also SCT, are very interested in the views of Bank staff and consultants. Second, SCT and SHCP recognize that, should the Bank endorse the package of sector reforms and implementation plans, this would add confidence to potential (especially foreign) investors interested in TELMEX. Third, and perhaps most importantly, the Government is interested that the Bank help them in the critically important initial stages of reform implementation. The latter includes developing an effective regulatory process. Lastly, loan conditionality would add a degree of stability to the package of agreed reforms and initial implementation plans.

78. The progress achieved in the past few months towards developing new policies and defining the desired structure for the sector has been excellent and the key political commitments have been made. SHCP has taken firm control of the process of selling TELMEX and has appointed the investment bank that will advise them and conduct the sale, and a

satisfactory plan and timetable have been developed for this. A new franchise agreement and regulations for competition have already been drafted. However, SCT is still short of experienced staff and resources to address the development of sector regulation at an appropriate level and pace and consequently has engaged consultants, that will be funded under the proposed Telecommunications Technical Assistance project, to assist them in this field.

79. An effective regulatory process and the necessary institutional adjustments can only be built up over time and as experience develops among all major players. For example, price regulation for those services that TELMEX will continue to provide on a monopoly basis is likely to require development of cost accounting by TELMEX and related guidelines by SCT. Under price cap regulation (as used in the U.K. for British Telecom and in the U.S. for AT&T) it will still be necessary to review the caps from time to time, at which time the profitability (or lack thereof) of TELMEX will need to be taken into account. Even some of the formal changes (i.e., devise of dispute resolution procedures, including controversies over access and pricing) cannot be rushed. Although the current telecommunications law gives the government enough latitude to proceed with the planned reforms, at some point it will be necessary to prepare new legislation better suited to the new policies, but this may well be several years from now.

80. At negotiations, agreement was reached on the following conditions for the telecommunications sector:

(a) Privatization. As a condition for second tranche release, there should be satisfactory further progress in the privatization of TELMEX (which would be monitored against the plan already furnished to the Bank, which includes a timetable for the key steps in the process), including receipt of bids for a controlling interest in the company as well as an award decision by the Government.

(b) Regulation. Prior to second tranche release, (i) consultants should be engaged, under terms of reference satisfactory to the Bank, to assist SCT to develop its regulatory capacity, (ii) the Government should enact satisfactory regulations governing the licensing of telecommunications networks and services, and (iii) a satisfactory regulatory action plan, that takes account of the recommendations of the consultants that have been engaged to assist SCT in this field, should have been furnished to the Bank.

(c) Divestiture of SCT's Operations. Before second tranche release, a business plan for TELECOMM, including investment and financing plans until 1994, which should be satisfactory to the Bank, should be furnished to the Bank.

PART IV - THE PROPOSED LOAN

A. Background

81. The Bank has had a close involvement with Mexico's transportation sector, dating back to the first highway project, approved in 1960. In that context, concerns about the net benefits of the regulatory framework for trucking were periodically raised and were topics of discussion during the annual reviews that took place under two Highway Sector Projects (one of which is still underway) and extensive sector work was conducted over a period of time spanning at least 15 years. Under the Industrial Sector Policy Loan, approved in June, 1989, it was agreed that the Government would conduct a comprehensive study to identify and remove impediments to competition and efficiency in the trucking sector and before second tranche release would complete the study and agree upon a plan of action for its implementation. However, this was just one of a number of issues that the project addressed, and it was not envisaged that the actions to be taken would be as far reaching as is now being proposed.

82. The Bank's dialogue on telecommunications issues has not been as close, but over the years we have periodically fielded missions to keep in touch with sector developments. In a succession of short missions from mid-1988, the Bank produced an issues and options paper which opened up the discussion with senior government officials, followed by a proposed "minimum package" of sector reforms, which was also handed to the outgoing administration. This set the framework for the current programs, which go significantly beyond what had been envisioned under the minimum package. More recently, the Bank prepared a paper on issues in the implementation of the sector reforms proposed by the Government, and has been informally reviewing and discussing sector policies, TELMEX's franchise, and the process of privatization.

B. Loan Objectives, Benefits and Risks

83. The proposed loan is part of a program of Bank support to the Mexican Government's objectives of promoting private sector development and increasing the efficiency and effectiveness of public sector institutions so as to enable the resumption of economic growth. The loan supports a program of reforms in two sectors (road transport and telecommunications) which have in common that they both provide a vital service to business activities in general and to external trade in particular. By providing an appropriate institutional and regulatory framework, the project is expected to spur competition, thus serving to increase the efficiency of communications services and--in the case of telecommunications--greatly expand its coverage. Resource allocation would be improved through greater reliance on market forces, and (in the case of monopolies) on economic criteria for pricing.

84. The project would be cofinanced by IDB, which is expected to recommend a loan of $200 million to its Board. IDBs processing is expected to follow that of the Bank. IDB has already completed its

appraisal of the project and Board presentation is scheduled for June/July 1990. Coordination between the two institutions has been close.

85. The project would be supported by a parallel free standing technical assistance (T.A.) loan for telecommunications of US$22 million equivalent. The T.A. loan would finance consultants to prepare plans for developing SCT's telecommunications regulatory capacity, including management and monitoring of the radio spectrum, as well as long term experts, training and equipment (computer hardware and software, and radio monitoring facilities) required for the first two years' implementation of these plans. The technical assistance loan would also support TELECOMM in its start-up phase.

86. At negotiations, the Government furnished to the Bank a policy letter, which is provided in Annex IV. The agreed policy matrix is also attached (Annex I).

87. If the objectives outlined in para. 83 are achieved, the benefits accruing from the project would be significant: the quality of road transportation would improve and costs would drop, benefitting users in general and particularly those which make more intensive use of transportation, such as those engaged in foreign trade. Also, competition in various telecommunications services should result in better quality services to consumers and greater receptivity to technological change, both of which should improve the ability of Mexican firms to communicate with and compete in world markets. In addition, private ownership of TELMEX should remove present financial and other constraints to a faster pace of sector growth, rapidly expanding availability of telephone and more advanced services. Furthermore, greater reliance on market mechanisms for price setting should improve resource allocation and eliminate a source of corruption. Finally, improved regulation and enforcement of safety and environmental standards and of weight loads should bring about security and health benefits to large segments of the population.

88. There are, however, risks which also deserve to be highlighted. First, it is important to ensure that the divestiture of the Government's controlling interest in TELMEX is "well" handled, since this is the largest parastatal to be privatized in Mexico and all aspects of the operation will be particularly scrutinized by opponents to the Government's privatization policies. Errors in this respect could jeopardize subsequent privatization attempts in other sectors. Second, the Government does not now have staff with adequate experience to regulate public utilities, and the regulatory framework is still in an inception stage. The Bank and the Government should resist the urge to rush into solutions that have not been adequately thought through. Third, there are practical and financial limits to the pace at which investments in telephone services may proceed, even under private ownership. The Government should avoid developing undue expectations, which later may result in disappointment with the result of privatization.

89. The risks discussed above seem manageable, and are outweighed by the benefits of the proposed course of action. Of greater significance, however, may be the risks that either for external or internal reasons Mexico may be unable to stay the course of economic reforms. But even if that were to occur, which today does not appear too likely (even though there are still many uncertainties), the policy reforms that the proposed project would support would have a good chance of staying in place and yielding substantial benefits to the economy.

C. The Borrower, the Guarantor and Project Implementation

90. The Government has designated BANOBRAS as the borrower of the proposed loan, in line with its function as Mexico's official financial agent for infrastructure sector loans. The loan would be guaranteed by the Mexican Government, and SCT would be responsible for project implementation.

D. Disbursements, Procurement, Administration and Auditing

91. The loan would be released in two tranches, of US$190 million each. The first tranche would become available upon loan effectiveness, and the second tranche after November 15, 1990 and upon the fulfillment of specific conditions for tranche release. The closing date of the proposed loan would be June 30, 1991.

92. The loan proceeds up to US$380 million would be relent on terms and conditions satisfactory to the Bank, and will be used to reimburse 100% of the CIF cost of eligible general imports (on the basis of a negative list that stipulates that goods subject to QRs, goods financed from other multilateral or bilateral sources, goods intended for luxury consumption or goods imported for military or paramilitary purposes, would not be eligible for Bank financing).

93. Retroactive financing, up to US$76 million (20% of the loan), for expenditures incurred since February 1, 1990 would be available. Both private and public sector imports would be eligible for financing. Individual contracts under US$5 million equivalent each would be (i) awarded by public sector agencies on the basis of their established procurement procedures which have been found acceptable to the Bank; and (ii) awarded by private sector importers in accordance with established commercial practice and, when they are over US$1 million, providing evaluation and comparison of price quotations obtained from eligible suppliers from at least two countries, except where direct contracting is permissible under the circumstances described in paragraph 3.5 of the

Bank's procurement guidelines.[12] Individual contracts exceeding US$5 million equivalent in value would be awarded following simplified ICB procedures in accordance with Bank guidelines.

94. Except for contracts awarded through simplified ICB, disbursements would be made on the basis of statements of expenditure (SOE) from Banco de Mexico detailing individual import transactions in each relevant period, and certifying their eligibility under the loan. The minimum value for each request for disbursement would be US$20 million equivalent and the minimum value of each import transaction would not be less than US$10,000.

95. BANOBRAS would provide to the Bank quarterly reports prepared by their auditors, under terms of reference satisfactory to the Bank, verifying that all conditions governing the elligibility of the imports that the Bank financed during the period had been met. Detailed documentation evidencing expenditures claimed under SOE would be retained by Banco de Mexico and made available to independent auditors acceptable to the Bank. Complete auditors' reports would be submitted to the Bank within six months of the end of each fiscal year.

E. Loan Effectiveness and Conditions of Tranche Release

96. Loan effectiveness would be conditional upon BANOBRAS entering into contractual arrangements with the Government, which are satisfactory to the Bank, for relending the proceeds of the loan.

97. Second tranche release would be contingent upon:

(a) satisfactory assessment of the medium term macroeconomic framework (para. 27);

(b) actions to improve road safety (para. 76(c)):

(i) completion of Phase I of the study on vehicle sizes and loadings and initiation of Phases II and III; and

(ii) presentation of a satisfactory action plan to improve road safety;

(c) issuance of regulations requiring periodic inspection of trucks to monitor compliance with environmental standards (para. 76(c));

12/ Under the adjustment loans that were approved by the Board on June 1989 the Bank conducted a review of public and private sector procurement practices and found them to be acceptable. Because the time elapsed since that review was short, for this operation we conducted an update based on a representative sample of firms, which verified that our prior assessment remains valid.

(d) actions to further improve transport pricing and cost recovery (para. 76(d)):

(i) satisfactory compliance with commitments to significantly improve cost recovery from trucks through an increase of 10% (in real terms) in the price of diesel fuel, and

(ii) furnish to the Bank the completed study on railway rates, currently under way, and increase FERRONALES rates for cargo transport for selected commodities which account for about 70% of cargo revenues by not less than 25% (in real terms), such increase to be effective not later than January 1, 1991, provided however that rates would not be increased beyond the level of long run variable costs;

(e) presentation to Congress of a satisfactory budget proposal for highway maintenance for FY91 (increasing by Mex$ 45,000 million, in real terms, over the revised 1990 level to an amount equivalent to not less than Mex$ 475 billion in 1990 prices) and also providing that at least 40% of the budget would be for routine maintenance (para. 76(e));

(f) satisfactory progress towards the sale of a controlling interest in TELMEX, including receipt of bids and award decision (para. 80(a));

(g) engagement of consultants, under terms of reference satisfactory to the Bank, to assist SCT to develop its regulatory capacity, enactment of satisfactory regulations governing the licensing of telecommunications networks and services, and presentation of a satisfactory action plan to strengthen SCT's regulatory capabilities in telecommunications (para. 80(b)); and

(h) presentation of a satisfactory business plan (including financial and investment programs through 1994) for TELECOMM (para. 80(c)).

PART V - BANK GROUP OPERATIONS

A. Sectoral Composition of Bank Lending

98. As of March 31, 1990, Mexico had received 121 loans from the Bank, amounting to US$15.4 billion net of cancellations and terminations; of these, 82 loans, totalling US$7.5 billion, were fully disbursed and US$2.7 billion remained undisbursed. The Bank's exposure was US$9.1 billion on a cash basis. The sectoral composition and policy content of past lending, as well as the design of major new lending operations, are discussed below for key areas of the Mexican economy in which the Bank

has been active over the years. Additional information on the portfolio is provided in Annex II.

Agriculture

99. Because of the crucial importance of agriculture for the one-third of the country's population living in rural areas, some 27% of the Bank's past lending has supported agricultural development, and nine operations are currently under supervision. The Bank's lending program in agriculture is aimed at: (a) helping correct the incentive regime in agriculture through gradual reductions in input subsidies and export controls; (b) promoting more efficient and rational use of natural resources supported by improved technologies and services; (c) generating employment-intensive investments in rural areas and effective assistance to small farmers; and (d) creating an integral framework for sound rural development. To support these goals, the Bank made a US$300 million Agriculture Sector Loan in FY88, and has since made a loan for investment in agricultural marketing and storage facilities, and another for forestry development. Additional operations are planned to support further policy adjustment in agriculture, technology development, rehabilitation of the irrigation infrastructure, including improved cost recovery and maintenance operations, and for food security and poverty alleviation.

Trade

100. About 12% of past Bank lending has been for trade, and two loans remain under supervision. Two trade policy loans of US$500 million each were made in FY87 and FY88 in support of the Government's sweeping trade reforms. These operations supported the reduction of non-tariff barriers (quotas and official reference prices) and rationalization of the tariff system (reduced levels and dispersion). The Bank supported the development of non-oil exports through two export development operations in FY83 and FY87. These loans were intended to strengthen the supply response by Mexican industry to the new trade policy signals. A US$500 million Industrial Sector Policy Loan in FY89, the second tranche of which was released in early 1990, has supported additional trade measures designed to liberalize imports and rationalize the incentive regime in key subsectors. Further trade reform measures are under consideration, which would strengthen the temporary import regime, provide further support to indirect exporters, assure automatic access to finance by exporters under the various credit programs, streamline financial and administrative procedures, and seek further reductions in export controls.

Industry and Finance

101. Some 28% of the Bank's lending has supported industry, and currently eleven projects are under supervision. The Bank's lending strategy for industry, covering small-and medium-scale industry, mining, the capital goods industry, industrial restructuring and technology development, is designed to support industrial restructuring, regulatory

reform, clarification of foreign investment rules, and export promotion to assure a vigorous supply response to trade liberalization and increased international competitiveness. The FY89 US$500 million Industrial Sector Policy Loan and US$500 million Parastatal Enterprise Reform Loan have provided support for policy reform in industry, for the more efficient management and privatization of public enterprises, restructuring of the fertilizer, steel, automotive parts, textile, and flower sectors, and other key private industrial subsectors demonstrating a capacity for undertaking integrated restructuring operations. In the financial sector, the Bank's operations have supported the strengthening of competition and the restructuring of financial intermediaries. An adjustment operation in FY89, the US$500 million Financial Sector Adjustment Loan, has been providing support for the liberalization of the financial sector, elimination of forced lending to the Government at subsidized rates, increasing competition among banks and brokerage houses and improving regulations in the banking sector. The second tranche release conditions have been met under all three adjustment operations.

Infrastructure and Energy

102. Lending for transportation, power and water accounts for 22% of the Bank's total in Mexico, with fourteen projects currently under supervision. Lending for infrastructure is focussing on institutional development (including attracting private funding to the sector), decentralization, more efficient public investment allocation, and improved cost recovery. Recent Bank loans supported urban transport and the power and ports sub-sectors. In the power sector, special importance was attached to the achievement of financial self sufficiency through improved pricing policies, to least-cost expansion planning and to the consideration of environmental factors in project selection and project implementation. In transportation, emphasis was placed on obtaining more realistic user fees and deferring all but the highest-yielding investment projects so as to permit a minimum of budgetary outlays. Proposed loans would support the Government's initiatives for private sector development, decentralization, cost-based pricing, and managerial improvements. Loans are at an advanced stage of preparation for water supply and sewerage, and urban transport.

Housing and Others

103. The Bank has lent some 11% of its total for tourism, urban development, housing and vocational training. Currently three housing loans are under supervision. Government housing programs are designed to improve cost recovery. A Housing Finance loan under execution is supporting graduated loan cost recovery linked to the income of final borrowers, thus ensuring a reduced drain on the budget. Another housing project, focusing on low-income beneficiaries, has recently been approved.

Social Sectors and Environment

104. The Bank is assisting the Government in redesigning public health, education, and human resource programs to make them more cost effective and targeted to meet the needs of the poor. A proposed health project would support decentralization measures, finance new primary health facilities, and strengthen professional services. Similar initiatives are being pursued in education and nutrition. A pilot project in execution is improving the well-being of women in low-income areas. It includes the provision of piped water, health and educational services training for productive activities, and credit for launching new microenterprises. These targeted operations would be followed by broader programs, once the institutional conditions and capacity for project implementation can support a larger Bank presence.

105. The Bank is also preparing an air pollution operation in the Federal District, which would tackle urban transport related causes, and has amended an ongoing loan (Loan 2824-ME) to support immediate relief measures requiring investments. With strong Government commitment, other future operations would address industry related causes of air pollution in the Federal District, technical assistance for investment evaluation and institutional strengthening in the environmental area and strengthened environmental components in investment loans. Soil erosion and water conservation programs would also be supported. As soon as the policy framework and suitable institutional arrangements are in place the Bank would consider loans for sector-wide environmental programs in support of remaining policy issues.

B. IFC Operations

106. The IFC has worked with the Bank to: (i) identify private sector investment opportunities likely to thrive in the current climate of growth-oriented adjustment and greater integration with the world economy; and (ii) assist in strengthening the country's capital markets through economic sector work and venture capital operations. As of March 31, 1990, the IFC had invested US$1,129.2 million in 40 companies in Mexico, of which US$782.3 million had been sold, repaid, or cancelled. Additional information on IFC's portfolio is provided in Annex II, page 2.

PART VI - COLLABORATION WITH THE IMF

107. Bank/IMF collaboration has been close over the years, especially since 1982, when the Fund supported the Government to help address the underlying causes of the economic crisis. Since that time, the Government has benefitted from an extended arrangement of SDR 3.4 billion, a special emergency drawing for SDR 291 million after the 1985 earthquake, a stand-by for SDR 1.4 billion in 1986 and, in 1989, for an SDR 2.8 billion extended arrangement through 1992 and a drawing of SDR 453 million under the compensatory financing facility. Extensive consultations have taken place between Fund and Bank staff concerning

Mexico's economic situation and prospects, covering fiscal, monetary, financial and exchange and interest rate policies.

108. Since the approval by the Fund's Board of the current extended arrangement on May 26, 1989, consultations have continued between the two institutions to monitor macroeconomic performance, adjustment measures and further structural reforms so as to meet the objectives of the Government's agreed growth oriented program. To date, the Mexican Government has purchased under the extended arrangement an amount equivalent to SDR 1.45 billion, including SDR 466.2 million in augmentation of resources, based on economic performance through the end of 1989. A recent Fund mission to Mexico reviewed recent developments and policy intentions and prospects and agreed on targets for 1990.

109. The Fund has also contributed to Mexico's debt reduction program through the SDR 2.8 billion extended arrangement in the form of set asides and through an augmentation of the arrangement in an amount of SDR 466.2 million, equivalent to 40% of Mexico's quota. Set asides under the extended arrangement and the augmentation of resources amount to a total of SDR 1.3 billion, which is roughly equivalent to US$1.7 billion. Of this total amount, some US$1.2 billion had been released by early 1990. The remaining US$443 million would be available early in 1991 and 1992, after scheduled regular consultations have taken place. These funds would be used for the collateral of interest payments of exit bonds, replacing a commercial bank bridge loan made available in early 1990 for purposes of credit enhancement under Mexico's debt package.

PART VII - RECOMMENDATION

110. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the proposed loan.

Barber B. Conable
President

Attachments

May 3, 1990
Washington, D.C.

MEXICO

MEXICO - ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT
Policy Matrix

Objectives	Actions Already Taken	Actions to be Taken by Second Tranche
I. SCT		
1. Improve the institutional arrangements, organization, staffing and training for regulatory activities within SCT.	. A modernization unit has been set-up to undertake the reorganization.	
	. Developed and substantially implemented a plan to reorganize SCT's functions in the trucking sector.	
		. Consultants should be engaged to strengthen SCT's regulatory capacity in the telecommunications sector.
		. Satisfactory action plan to strengthen SCT's regulatory capacity in the telecommunications sector should be furnished
II. Road Transport		
2. Eliminate regulatory barriers to competition and efficiency.	. Eliminated system of concessions. . Eliminated system of route restrictions. . Eliminated system of freight centers. . Eliminated Multimodal's monopoly on multi- modal transport. . Eliminated restrictions to access into cargo handling. . Eliminated restrictions on "maquiladoras" to own and operate their own trucks.	

	. Eliminated restrictions on return loading of international containers. . Developed a plan of action to enter into trucking deregulation agreements with all states.	
3. Allow trucking prices to be determined by market forces, and eliminate distortions on costs.	. Eliminated 15% surcharge on imported goods. . Eliminated Government involvement in setting tariffs. . Eliminated preferential tax treatment for truckers.	
	. Provided commitment to achieve full cost recovery from truckers and increased diesel prices by 5.6%.	. Increase diesel fuel prices by 10% (in real terms) so as to significantly improve cost recovery from truckers.
4. Ensure that the price of competing mode (railways) is based on economic criteria).	. Provided commitment to adjust FERRONALES rates for key commodities to long run variable cost levels and approved a more agile system for rate revision. Initiated study to improve data base for tariff setting decisions.	. Furnish to the Bank a completed study of railway rates based on economic criteria and increase FERRONALES rates for key commodities, which account for 70% of cargo revenues, by 25% (in real terms) or to long run variable costs; such increase to become effective not later than January 1, 1991.
5. Improve allocation of highway expenditures.	. Provided commitment to increase highway maintenance budgets, taking into account macroeconomic constraints.	
	. Increased SCT's budget for maintenance expenditures in 1990 by Mex$ 155 billion.	. Submit budget proposal for highway maintenance for 1991, further increasing it by Mex$ 45 billion (in real terms); of the total at least 40% should be for routine maintenance.

6. Improve quality and enforcement of necessary regulations for safety, weight controls and environment.	. Strengthened group to coordinate safety policies.	
	. Started study on vehicle sizes and loadings.	. Complete first phase and initiate second and third phases (policy recommendations) of study. . Present satisfactory action plan to improve road safety.
	. Drafted regulations requiring periodic inspection of trucks to monitor compliance with environmental standards and initiated a program to improve fuel quality.	. Issue regulations requiring periodic inspection of trucks to monitor compliance with environmental standards.
III. Telecommunications		
7. Promote increased private sector participation and competition in telecommunications.	. Public announcement of policy goals in sector, including promoting competition and privatizing TELMEX.	
	. Engagement of investment bankers to handle sale of TELMEX's shares. Engaged foreign investment banker to assist in handling sale.	
	. Prepared program and timetable for handling privatization of TELMEX.	
	. Furnished a satisfactory draft franchise.	. Satisfactory progress towards sale of a controlling interest in TELMEX, including receipt of bids and award decision by Government.

	. Awarded concessions for cellular telephony in Federal District and in rest of the country.	
		. Issue regulations governing the licensing of telecommunications networks and services.
8. Improve resource allocation in the market for telecommunications services.	. Rates were adjusted in January 1990, reducing cross subsidies and increasing average level by 70%.	
	. Tax treatment of sector has been realigned.	
9. Improve the efficiency of sector institutions.	. Decree setting up TELECOMM has been issued, and SCT's operating functions have been transfered to TELECOMM.	
	. Furnished a statement of TELECOMM policy and objectives.	. Furnish satisfactory business plan (including investment and financing) for TELECOMM.
IV. <u>Macroeconomic Management</u>		
10. Macroeconomic consistency.		. Satisfactory assessment of the medium term macroeconomic framework.

STATUS OF BANK GROUP OPERATIONS IN MEXICO

A. STATEMENT OF BANK LOANS

(As of March 31, 1990)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation) Bank	IDA	Undisbursed
82 loans fully disbursed				7,489.58		
Of which SECALs, SALs, and Program Loans a>						
Ln. 1929-ME	1981	BANOBRAS	Railway IV	149.88		
Ln. 2428-ME	1984	BANOBRAS	Highway Sector II	200.00		
Ln. 2882-ME	1988	BANCOMEXT	Trade Plcy Ln II	500.00		
Subtotal				849.88		
Ln. 1706-5-ME	1979	NAFIN	Irrigation	81.80		14.28
Ln. 1858-5-ME	1980	NAFIN	Irrigation	64.40		12.51
Ln. 2281-ME	1983	BANOBRAS	Third Water Supply	100.30		19.02
* Ln. 2331-ME	1983	BANCOMEXT	Export Development	350.00		0.67
Ln. 2428-ME	1984	BANOBRAS	Highways	200.00		66.80
Ln. 2450-ME	1984	BANPESCA	Ports	38.25		20.00
Ln. 2516-ME	1985	NAFIN	Chiapas Agric. Dev.	58.00		40.71
Ln. 2546-ME	1985	NAFIN	Sm/Med Mining II	105.00		17.10
Ln. 2559-ME	1985	NAFIN	Vocational Educ	81.00		13.79
Ln. 2575-ME	1985	BANOBRAS	Railways V	300.00		135.61
Ln. 2612-ME	1986	BANOBRAS	Low Income Housing I	150.00		4.10
Ln. 2658-ME	1986	NAFIN	Proderith II	88.30		69.36
Ln. 2665-ME	1986	BANOBRAS	Earthquake Rehab	400.00		14.74
Ln. 2666-ME	1986	BANOBRAS	Municipal Strength	40.00		36.18
Ln. 2669-ME	1986	BANOBRAS	Solid Waste Pilot	25.00		18.57
* Ln. 2745-ME	1987	BANCOMEXT	Trade Policy Loan I	500.00		7.22
Ln. 2746-ME	1987	NAFIN	Industrial Recovery	150.00		19.74
Ln. 2747-ME	1987	NAFIN	Technology Dev	48.00		31.32
* Ln. 2777-ME	1987	BANCOMEXT	Export Dev II	250.00		12.48
Ln. 2824-ME	1987	BANOBRAS	Urban Transport	125.00		91.23
Ln. 2837-ME	1987	NAFIN	Agricultural Credit	400.00		10.10
Ln. 2858-ME	1987	NAFIN	Sm/Med Industry IV	100.00		85.00
Ln. 2859-ME	1987	NAFIN	Agric Extension	20.00		16.51
Ln. 2875-ME	1987	BANOBRAS	Highway Maint	135.00		125.00
Ln. 2876-ME	1988	NAFIN	Manpower Training	80.00		54.57
Ln. 2916-ME	1988	NAFIN	Steel Sctr Restruct	400.00		264.31
* Ln. 2918-ME	1988	NAFIN	Agric Sector Loan	300.00		1.99
* Ln. 2919-ME	1988	NAFIN	Fertilizer Sctr Loan	265.00		109.01
Ln. 2946-ME b>	1988	BANOBRAS	Ports Rehab	50.00		50.00
Ln. 2947-ME	1988	BANOBRAS	Housing Finance	300.00		188.19
* Ln. 3047-ME	1989	NAFIN	Industrial Restruct	250.00		224.98
Ln. 3083-ME	1989	NAFIN	Hydroelectric Dev	460.00		413.48
* Ln. 3085-ME	1989	BANCOMEXT	Financial Sctr Loan	500.00		15.00
* Ln. 3086-ME	1989	NAFIN	Public Ent Restruct	500.00		1.14
* Ln. 3087-ME	1989	NAFIN	Ind Sctr Policy	500.00		6.54
Ln. 3101-ME b>	1989	BANOBRAS	Water, Women & Dev	20.00		20.00
Ln. 3115-ME b>	1990	NAFIN	Forestry Dev	45.50		45.50
Ln. 3140-ME	1990	BANOBRAS	Low-Income Housng II	350.00		324.99
Ln. 3141-ME b>	1990	NAFIN	Agric Mktg II	100.00		100.00
Total				15,420.13		2,701.74
Of Which has been repaid				3,639.19		
Total now held by the Bank				11,780.94		
Amount sold : 92.34						
Of which has been repaid: 92.34						
Total Undisbursed				2,701.74		2,701.74

a> Approved during or after FY80.
b> Not yet effective.

* SAL, SECAL, or Program Loan

EBArevalo:LA2CO
File:MXC0390 (a1.o75)
20 April 1990

MEXICO

ANNEX II
Page 2 of 2

B. STATEMENT OF IFC INVESTMENTS
As of March 30, 1990
(US$ Million)

Fiscal Year	Obligor	Type of Business	-----Original Approvals--------- Loan	Equity	Total
1958/59	Industrias Perfect Circle, S.A. /a	Industrial Equipment	0.80	0.00	0.80
1958	Bristol de Mexico, S.A. /a	Aircraft Engine overhaul	0.50	0.00	0.50
1961	Aceros Solar, S.A. /a	Twist Drills	0.30	0.00	0.30
1962/5/6/8	Fundidora Monterray, S.A. /a	Steel	2.30	21.40	23.70
1963	Tubos de Acero de Mexico	Stainless Steel Pipes	0.90	0.10	1.00
1963	Quimica del Rey, S.A. /a	Sodium Sulphate	0.70	0.00	0.70
1964/66	Industria del Hierro, S.A.	Construction Equipment	0.00	2.00	2.00
1970	Minera del Norte /a	Iron Ore Mining	1.50	0.00	1.50
1971	Celanes Mexicana, S.A. /a	Textiles	12.00	0.00	12.00
1972	Promotora Papel Periodicos, S.A. de C.V. /a	Pulp and Paper	0.00	/b	/b
1973/79	Cementos Veracruz, S.A.	Cement	15.90	0.00	15.90
1974/81	Cancun Aristos Hotel	Tourism	1.00	0.30	1.30
1975/78	Mexinox, S. A.	Stainless Steel	12.00	3.20	15.20
1978/81/83	Papeles Ponderosa, S.A.	Pulp and Paper	10.70	5.00	15.70
1978	Tereftalatos Mexicanos, S.A.	Petrochemical	19.00	0.00	19.00
1979/81/86	Hotel Camino Real Ixtapa, S.A.	Tourism	0.00	4.20	4.20
1979/83	Empresas Tolteca, S.A.	Cement	168.00	7.90	175.90
1979	Conductores Monterray, S.A.	Electrical Wire & Cable	18.00	0.00	18.00
1980	Industrias Resistol, S.A.	Particle Board	25.00	0.00	25.00
1980	Vidrio Plano de Mexico, S.A.	Flat Glass	114.90	0.00	114.90
1980	Minera Real de Angeles, S.A.	Mining	110.00	0.00	110.00
1980	Corporacion Agro-industrial S.A.	Agri-Business	11.30	3.00	14.30
1981/86	Celulosicos Centauro, S.A.	Pulp and Paper	59.50	0.00	59.50
1983	Capital Goods Facility /a	Capital Goods Financing	100.00	0.00	100.00
1984/87	Metalsa, S. A.	Auto Chasis	8.00	1.40	9.40
1984	Proteison, S.A. de C.V.	Agri-Business	2.00	0.80	2.80
1984	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemical	16.40	0.00	16.40
1986/88	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and Paper	10.00	3.10	13.10
1986	Agromex Phase I (AESA)	Veg and Fruit Processing	1.50	0.50	2.00
1986	Cicasa Constr Guar Fac	Constr Guarantee Facility	20.00		20.00
1987	Industrias Sulfex, S.A. de C.V.	Chemical & Petrochemical	2.00	0.50	2.50
1987	Sealed Power de Mexico	Auto Assembly	9.00	0.00	9.00
1987	Crescent Market Aggregates	Construction Material	37.00	0.00	37.00
1988	Spasco, S.A. de C.V.	Cement	46.10	0.00	46.10
1988	Salumi, S.A. de C.V.	Food and Food Processing	20.40	2.00	22.40
1988	Polimar (ABS), A.S. de C.V.	Petrochemical	14.50	0.00	14.50
1989	Grupo Femsa/Visa	Consumer Goods Conglamorat	80.00	27.60	107.60
1989	Banca Serfin	Development Finance	60.00	0.00	60.00
1989	Cementos Mexicanos	Cement & Const Materials	68.00	0.00	68.00
1990	Condumex	Electromanufacturing	50.00		50.00
	Gross Total Commitments		1129.20	83.00	1212.20
	Less Cancellations, Terminations, Repayments and Sales		782.30	39.50	821.80
	Total Commitments Now Held by IFC		346.90	43.50	390.40
	Total Undisbursed (Including Participants)		130.14	0.08	130.22

/a Investments which have been fully cancelled, terminated, written off, sold, or repaid.
/b US$25,000.

EBArevalo:LA2CO
IFC Investment:MXC90.WK1
May 2, 1990

MEXICO
ROAD TRANSPORT AND TELECOMMUNICATIONS
SECTOR ADJUSTMENT PROJECT

SUPPLEMENTARY LOAN DATA SHEET

SECTION I: Timetable of Key Events

(a)	Time taken by the country to prepare the loan	8 months
(b)	Appraisal mission:	January 1990
(c)	Completion of Negotiations:	April 1990
(d)	Planned date of effectiveness:	June 1990

SECTION II: Special Bank Implementation Actions

None

SECTION III: Special Conditions

(A) The following are conditions met since appraisal:

- (i) Presentation of a plan to enter into trucking deregulation agreement with state governments;
- (ii) Actions to improve highway safety;
  - (a) strengthening of interagency group;
  - (b) initiation of a study to collect information on vehicle sizes and loadings;
- (iii) Increased SCT's 1990 budget for highway maintenance by 40%;
- (iv) Satisfactory progress in the divestiture of the Government's shareholdings in TELMEX, including receipt of a draft franchise and of a program and timetable for the sale of shares, and engagement of investment bankers;

(B) The following would be a condition for loan effectiveness: BANOBRAS should have entered into contractual arrangements with the Government for re-lending the proceeds of the loan which are satisfactory to the Bank (para. 96).

(C) The following are conditions of second tranche release:

- (a) satisfactory assessment of the medium term macroeconomic framework (para. 27);

(b) actions to improve road safety (para. 76(c));

(i) completion of Phase I of the study on vehicle sizes and loadings and initiation of Phases II and III, and

(ii) presentation of a satisfactory action plan to improve road safety;

(c) actions to address the air pollution caused by trucks (para. 76(c)); issuance of regulations requiring periodic inspection of trucks to monitor compliance with environmental standards;

(d) actions to further improve transport pricing and cost recovery (para. 76(d)):

(i) satisfactory compliance with commitments to significantly improve cost recovery from trucks through 10% real increase in the price of diesel fuel, and

(ii) furnish to the Bank the completed study on railway rates and increase FERRONALES rates for selected commodities which account for about 70% of cargo revenues by not less than 25% (in real terms), such increase to be effective not later than January 1, 1991, provided however that rates would not be increased beyond the level of long run variable costs;

(e) presentation to Congress of a satisfactory budget proposal (increasing by Mex$ 45,000 million in real terms over the 1990 level) for highway maintenance for FY91 and also providing that at least 40% would be for routine maintenance (para. 76(e));

(f) satisfactory progress towards the sale of a controlling interest in TELMEX, including receipt of bids and award decision (para. 80(a));

(g) engagement of consultants under terms of reference satisfactory to the Bank, to assist SCT to develop its regulatory capacity, enactment of satisfactory regulations governing the licensing of telecommunications networks and services and presentation of a satisfactory action plan to strengthen SCT's regulatory capabilities in telecommunications (para. 80(b)); and

(h) presentation of a satisfactory business plan (including financial and investment programs through 1990) for TELECOMM (para. 80(d)).

DRAFT

Mr. Barber Conable
President
The World Bank
Washington, D.C. 20433
U. S. A.

Dear Sir:

The Government of Mexico hereby requests a loan from the World Bank to support its modernization program in transportation and telecommunications, as described in the National Development Plan for 1989-1994. The Plan establishes that the legal and institutional framework will be updated, so that the Government will be better able to undertake its responsibilities to modernize, increase the efficiency and improve the quality of transportation and telecommunications services as well as promote competition and avoid the development of monopolies.

Road Transport

In the context of the Plan, on July 6, 1989 the Government issued new regulations for federal road transportation which allow free entry to the trucking market and eliminate various provisions which constrained an efficient market operation. At the same time, new regulations for multimodal transportation were also issued which will promote increased competition in this important activity. More recently, further steps were taken to improve the efficiency of various activities that are auxiliary to trucking, such as loading and unloading and drayage services, through the deregulation and promotion of competition. Other regulations that interfered with market efficiency, such as setting tariff ceilings for trucking or constraining the ability of in-bond assemblers to transport their goods with their own truck fleets, were repealed this past January. We have also decided to allow containers temporarily brought into the country to transport domestic cargoes on their return trips to ports, which should foster a better utilization of these containers. Also, during the next twelve months we intend to reach agreement with the state governments on measures to align their regulations with the new national framework. Finally, we have taken steps to reorganize SCT's structure to better reflect its new role in light of the revised policies in the road transport sector.

The various measures outlined above redefine the legal framework for road transportation in Mexico. They will be supported by various actions in other fields so as to help achieve the final objective, which is to modernize transportation so that Mexican producers will have access to a service that is efficient and of good quality.

Among the further actions considered, we should highlight ongoing and planned efforts on highway maintenance and rehabilitation. We have assigned priority in our budget to expenditures for these purposes and we have already approved an increase that exceeds 40% over the amount that had originally been planned for this fiscal year. The Government is committed to continue further increasing the budget for highway maintenance and rehabilitation, within the constraints imposed by macroeconomic considerations, until the needs of the network are fully met. This decision is linked to the Government's present policy to continue attracting private investment to the road sector, by granting concessions for the construction and operation of toll roads and bridges; this will free financial resources so that other needs, particularly highway maintenance, may be met.

We will seek an improved distribution of cargo transportation between the railways and the trucking fleet. The distribution should be based on economic criteria, since this will result in a more efficient use of installed capacity and will result in a better allocation of future investments, both public and private. To achieve this, within the context of the PECE (Stabilization and Economic Growth Program), we will periodically adjust railway cargo tariffs so as to align them with long run variable costs as soon as possible. Likewise, we will also periodically adjust diesel fuel prices and other charges on truckers so that by 1991 the maintenance and renewal costs which they cause to the highway network are fully recovered. Recently the Mexican Congress approved changes to the tax treatment of trucking, which was aligned with the general tax framework for all business activities, thus improving the equity of the system.

We are particularly concerned about road safety and are undertaking actions to improve it. Higher expenditures on highway maintenance should contribute towards this objective. At the same time, we will encourage truckers to purchase third party liability insurance which should provide a market incentive to maintain their vehicles in safe operating conditions. Likewise, we will increase to realistic levels and adjust periodically the truckers' responsibility for cargo damages, which should improve cargo handling. These measures will be complemented by actions that the Government will undertake to improve highway safety. We have already set up a coordinating committee of all agencies involved in road safety issues and have engaged consultants to conduct a study on vehicle sizes and loads, which should provide a sound basis for the formulation of future action plans.

Telecommunications

In the telecommunications sector the modernization and expansion of services will require major investments, and the Government has decided to attract private capital to the sector. Thus, fiscal resources will be freed to fund other priority needs, such as health, education and housing. In this context, we wish to highlight the Government's decision to sell its shares in TELMEX, so that in the future TELMEX's management and financing will be in private sector hands. The Government of Mexico is well aware that technological changes now allow expanded room for competition in the telecommunications field, and the regulatory framework will be adjusted so as to allow and promote competition wherever this proves to be feasible. Thus, we expect that many firms will be able to develop data transmission services, cellular telephony and data bank and other services. Towards the end of 1989 bidding competition for the provision of cellular telephony in various regions of the country was undertaken and awards were made. The process confirmed the great interest of the private sector to operate telecommunication services.

In order to adequately protect the public interest in the provision of telephone services, the Government needs to build up its regulatory capacity and we are developing technical assistance and training programs for this purpose. As regards to tariffs, the Government will only set them for services provided under monopoly conditions. In such cases the tariffs will be based on economic criteria and we will seek to assure a fair rate of return to the service provider. The Government will also regulate the tariffs and technical conditions for the interconection between monopoly and free market services.

Operating responsibilities in the telecommunications sector for various activities that were being handled by the Ministry of Communications and Transport have now been transferred to a newly established independent public enterprise, TELECOMM. This should help avoid conflicts of interest between the Government's role in policy formulation and regulation and the provision of services. We expect TELECOMM to operate as a financially autonomous institution and to be readily responsive to technological advances.

Best regards,

Pedro Aspe
Minister of Finance
and Public Credit

Andres Caso Lombardo
Minister of Communications
and Transport

MEXICO
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT
BASIC MACROECONOMIC INDICATORS

	1950-59	1960-70	1971-76	1977-82	1960	1965	1970	1976	1980	1981	1982	1983	1984	1985	1986	1987	1988 *
Growth Rates:																	
GDP	5.9%	7.0%	7.4%	6 6%	8.1%	6.5%	6.9%	4.2%	8.3%	8.8%	-0.6%	-4.2%	3.6%	2.6%	-3.8%	1.7%	1.4%
GDP deflator	8.0%	3.5%	15.3%	29 9%	4.9%	2.3%	10.9%	19.6%	26 7%	26.0%	60.9%	90.5%	59.1%	56.7%	74.4%	139.3%	100.1%
Inflation Rate (December/December)	..	..	..	..	..	..	4.8%	27.2%	29.8%	28.7%	98.8%	80.8%	59.2%	63.7%	105.7%	159.2%	51.6%
GDP per capita	2.5%	3.5%	3.1%	3.7%	3.1%	3.0%	3.1%	1.2%	5.4%	5.1%	-3.1%	-7.6%	0.8%	-0.1%	-1.4%	0.4%	-0.9%
Consumption per capita	3.3%	6.2%	2.9%	3.8%	-1.0%	1.2%	1.4%	1.7%	4.9%	4.8%	-1.4%	9.1%	0.2%	-0.8%	-7.7%	-0 9%	-2.2%
Real Industrial Wages	1.8%	5.1%	4.0%	-1.1%	1.7%	6.9%	0.5%	10.6%	-4.4%	1.2%	1.9%	-26.0%	2.9%	1.8%	-19.2%	-4.5%	-10.0%
Investment-Savings (as % of GDP):																	
Total Investment	16.2	19.6	21.9	25.2	16.0	20.5	22.8	22.3	27.2	27.4	22.9	20.8	19.9	21.9	18.4	18.5	20.5
National Savings	14.1	17.5	18.8	21.3	13.4	18.5	19.8	18.5	22.7	21.9	19.3	24.4	22.3	22 6	17.1	21.3	18.9
BoP Current Account	-2.1	-2.1	-3.1	-3.9	-2.6	-2.0	-3.0	-3.8	-4.5	-5.5	-3.6	3.6	2.4	0.7	-1.3	2.8	-1.6
BOP (million US$):																	
Current Account	(181)	(479)	(2,304)	(6,458)	(324)	(403)	(1,068)	(3,409)	(8,717)	(13,646)	(6,220)	5,418	4,239	1,237	(1,673)	3,967	(2,901)
Exports of Goods & Non Fact. Services	988	1,964	5,030	18,692	1,372	1,989	2,745	6,841	22,902	29,047	26,167	27,179	30,133	27,609	21,875	27,614	29,075
Net International Reserves (end period)	379	591	1,251	2,169	459	575	820	741	4,004	5,035	395	3,678	5,767	3,051	2,924	9,933	1,773
External Sector Indicators (percent):																	
Exports GNFS real growth rate	5.7	5.2	7.9	9.9	1.2	3.8	-5.8	16.6	6 2	11.5	21.7	13.7	5.7	-4.5	3.2	10.1	2.7
Oil Exports real growth rate	..	..	23.3	49.9	..	..	..	..	71.6	29.5	31.3	5.6	1.1	-5.8	-9.4	-0.3	8.2
Non-Oil Exports real growth rate	..	..	0.8	2 5	..	..	..	..	-1.8	9.2	-16.2	37.9	23.5	-4.8	38.5	31.9	-12.0
Exports GNFS nominal growth rate	9.7	8.2	18.0	27 4	3.9	16.7	0 0	12.7	56 4	26.8	-9.9	3.9	10.9	-8.4	-20.8	26.2	5.3
Exports of GNFS/Current GDP	15.4	9.3	8.0	12.3	11.4	7.8	6.5	7.1	10.7	10.4	15.3	19.0	17 4	15.4	17.2	19.7	16.7
Imports GNFS real growth rate	4.4	5.7	9.4	9.6	2.9	3.8	10.1	1.0	31.8	17.8	-37.9	-33.7	17.8	11.0	-12 4	5.0	38.0
Imports GNFS nominal growth rate	11.8	8.5	19.5	21.0	15.3	4.7	21.1	-0.8	55.2	30.2	-40.6	-36.1	28.0	13.8	-11.7	5.7	45.2
Imports of GNFS/Current GDP	16.6	11.4	9.5	12.0	13.9	9.6	9.0	9.3	13.0	12.9	10.3	9.4	9.6	10.3	12.6	12.6	14.4
Resource Balance/Current GDP	-1.2	-2.1	-1.5	0.3	-2.5	-1.8	-2.5	-2 2	-2.3	-2.5	5.0	9.6	7.8	5.1	4.6	7.1	2.3
Terms of Trade Index (1980 = 100)	95.7	68.6	83.5	104.9	68.7	66.1	69.4	75.3	100.0	97.4	84.8	77.4	76.1	72.0	51.4	57.8	56.2
Real Exchange Rate Index (1980=100) b/c/	115.3	108.3	106.2	111.3	113.9	105.5	104.6	108.3	100.0	90.7	134.3	137.5	114.0	111.7	145.9	151.4	122.4
Foreign Debt Indicators : a/																	
Total DOD (Million US$)	..	3,514	11,240	55,128	..	2,212	4,956	22,177	57,378	78,215	86,019	92,964	94,822	96,875	100,876	109,292	100,298
Public DOD	..	2,298	7,546	31,561	..	1,457	2,186	17,834	50,078	68,015	77,919	78,164	78,526	81,130	85,773	95,144	92,840
Private DOD d/	..	1,216	3,694	23,567	..	754	2,770	4,343	7,300	10,200	8,100	14,800	16,296	15,745	15,103	14,148	7,458
Total DOD/Exports GNFS (%)	..	146.5	211.1	311.3	..	111.2	180.5	324.2	250 5	269.3	328.7	342.0	314.7	350.9	461.1	395.8	345.0
Total DOD/Current GDP (%)	..	13.0	16 4	37.0	..	10.2	12.9	23.3	29 5	31 3	50.4	62.5	54 0	53 1	77.5	77.1	57.5
Debt service MLT (Million US$) e/	..	563	1,275	6,128	..	488	691	2,230	7,890	8,532	9,410	11,422	11,275	10,572	8,620	8,736	9,641
Debt service MLT/Current GDP(%) e/	..	2.1	1.9	5.2	..	2.1	1.8	2 3	4 1	3.4	5.5	7.7	6.4	5.8	6.6	6.2	5.5
Debt service MLT/Exports GNFS (%) e/	..	24.0	24.9	45 0	..	24.5	25.2	32 6	34 5	29.4	36.0	42.0	37.4	38 3	39.4	31.6	33.2
Interest MLT (Million US$) e/	..	133	552	3,669	..	87	216	1,083	3,880	4,818	6,169	6,594	7,380	7,516	6,176	6,302	6,554
Interest MLT/Exports GNFS (%) e/	..	5 5	10.2	19 5	..	4 4	7.9	15.8	16 9	16.6	23 6	24.3	24.5	27.2	28.2	22.8	22.5
Interest MLT/Current GDP (%) e/	..	0.5	0.8	2 4	..	0.4	0.6	1.1	2 0	1.9	3.6	4.4	4.2	4.1	4 7	4.4	3.8
Memorandum Item:																	
PSBR(as % of GDP)	-0.7	-3 0	-6.9	-10.0	-2.7	-0 9	-3.5	-9.2	-7 0	-13 7	-15.9	-8.2	-8.5	-9 6	-16.0	-16.1	-12.3
Primary Balance (as % of GDP)	..	..	..	..	..	0 0	-1 4	-4 6	-2 5	-7 6	-6 4	4.8	5.5	4 4	2.1	5.0	6 4
Inflation Adjusted Balance (as % of GDP)	..	..	..	..	..	-1.1	-3.6	-8.5	-5 0	-11.2	-10 9	-5.1	-0.6	-4 5	-6.1	0 4	-4.2
M4/GDP (as % of GDP)	15 0	22.7	29 1	27 9	16 8	21 8	30 7	26.5	21 3	27 8	28.7	27.0	27.0	27.0	29 4	27 0	27.0
Monetary Base (growth rate)	10.7	14 8	31.9	55.1	1.0	12.2	10.7	29 6	41.2	45 1	90 4	58.1	54.1	17.5	47.7	70.3	42.3

a/. It refers to 1965-70.

b/. As measured by relative wholesale price indexes.

c/. An increase in the index means real depreciation.

d/. Private Non-Guaranteed.

4-23-90

MEXICO
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT
KEY ECONOMIC INDICATORS

	Actual					Projected								
	1985	1986	1987	1988 p/	1989 e/	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP	2.7	-4.0	1.4	1.1	2.9	3.0	3.7	5.0	5.0	5.0	5.0	5.0	5.0	5.0
GDP/Capita Growth Rate	-0.1	-1.4	0.4	-0.9	0.9	1.0	1.7	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Consumption/Capita Growth Rate	-0.8	-7.7	-0.9	2.2	2.3	0.7	-0.9	1.9	2.8	2.8	2.7	3.1	3.1	3.1
Total DOD (US$, Mill)	96875	100876	109292	100298	96069	91245	94099	95989	97174	97715	98703	99583	100342	100965
DOD/XG&NFS	350.9	461.1	395.8	345.0	290.5	248.8	232.5	215.6	198.3	181.0	165.8	151.6	138.4	126.0
DOD/GDP	53.1	77.6	77.4	56.8	49.0	43.0	43.0	40.2	37.3	34.3	31.8	29.3	27.1	25.0
Debt Service (US$, Mill)	15292	12956	12182	15564	14711	12827	11713	11328	11136	10770	11375	11527	11604	11671
Debt Service/XG&NFS	55.4	59.2	44.1	53.5	44.5	35.0	28.9	25.4	22.7	20.0	19.1	17.6	16.0	14.6
Debt Service/GDP	8.4	10.0	8.5	8.8	7.5	6.1	5.4	4.7	4.3	3.8	3.7	3.4	3.1	2.9
Interest/XG&NFS	36.8	38.1	29.3	30.6	29.3	21.5	18.9	17.7	16.3	15.0	14.0	12.8	11.6	10.4
Interest/GDP	6.1	6.4	5.7	5.0	4.9	3.7	3.5	3.3	3.1	2.8	2.7	2.5	2.3	2.1
Gross Investment/GDP	21.9	18.5	18.6	20.3	19.3	20.6	22.9	23.8	23.8	23.9	23.9	23.9	24.0	24.0
Change of Stocks	2.7	0.9	0.2	1.8	1.5	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Private	1.7	0.8	-0.2	1.3	0.8	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Public	1.0	0.1	-0.2	0.5	0.8	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Fixed Capital Formation	19.2	17.6	18.9	18.5	17.7	19.4	21.7	22.6	22.6	22.7	22.7	22.7	22.8	22.8
Private/GDP	13.2	11.6	13.4	14.1	13.7	14.3	15.7	16.6	16.6	16.7	16.7	16.7	16.8	16.8
Public/GDP	6.0	6.0	5.5	4.4	4.0	5.1	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
National Savings/GDP	22.6	17.2	21.4	18.7	16.5	19.5	21.4	22.2	22.5	22.7	22.9	23.0	23.0	23.0
Gross Private Savings	19.5	16.0	13.6	18.2	14.3	14.2	12.7	13.4	13.5	13.6	13.7	13.5	13.4	13.3
Gross Public Savings	3.1	1.2	7.9	0.5	2.1	5.3	8.7	8.8	9.0	9.1	9.3	9.4	9.6	9.8
Gros Domestic Savings	26.8	23.3	26.0	22.6	20.4	21.9	24.0	24.8	24.9	24.9	25.1	24.9	24.8	24.7
Exports of G&NFS Real Growth Rates	-4.1	3.2	9.8	2.0	3.3	5.7	5.7	5.8	5.9	6.0	6.1	6.2	6.2	6.3
Non-Oil Export of G&NFS Growth Rate	-2.2	1.0	12.5	8.8	6.1	7.4	7.3	7.4	7.4	7.4	7.4	7.4	7.4	7.4
Exports/GDP	15.4	17.3	19.6	16.5	16.9	17.3	18.5	18.6	18.8	19.0	19.1	19.4	19.6	19.8
Imports of G&NFS Real Growth Rates	11.0	-12.4	4.5	34.8	17.5	4.3	7.7	6.6	5.6	5.7	5.5	7.1	7.2	7.1
Imports/GDP	10.5	12.5	12.2	14.2	15.8	16.0	17.4	17.7	17.8	17.9	18.0	18.4	18.7	19.1
Current Account (US$, Mill)	1237	-1673	3966	-2901	-5533	-2275	-3397	-3714	-3554	-3332	-3035	-3319	-3629	-3969
Current Account/GDP	0.7	-1.3	2.8	-1.6	-2.8	-1.1	-1.6	-1.6	-1.4	-1.2	-1.0	-1.0	-1.0	-1.0
Resource Balance/GDP	4.9	4.8	7.4	2.3	1.1	1.3	1.1	1.0	1.0	1.1	1.2	1.0	0.8	0.7
Terms of Trade (1985=100)	-1.2	-30.9	14.1	-10.5	4.9	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Primary Balance/GDP 1/	5.0	3.4	4.9	5.8	7.1	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Operational Balance/GDP 1/	-3.9	-4.9	2.5	-4.4	-2.7	-0.4	2.1	2.2	2.4	2.5	2.7	2.8	3.0	3.2
Memorandum Item														
Oil price (US$ per barrel)	25.4	11.9	16.2	12.2	15.6	16.4	17.1	17.8	18.5	19.3	20.1	20.9	21.7	22.6

Source: Mexican Authorities and Bank staff estimates
p/ preliminary
e/ estimate

4/18/90

IBRD 22252

MARCH 1990

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 7, 1990

TO: Distribution

FROM: Kathleen Di Tullio, Acting Chief, LA2C1 KAD

EXTENSION: 30028

SUBJECT: MEXICO - Public Enterprise Reform Loan (Ln 3086-ME) Draft PCR

1. Attached please find the draft PCR (Parts II and III) on the above-mentioned project. Please send your comments to Mr. C.N. Phung (ext. 39037, Room I-8163) by c.o.b. November 26, 1990. We hope to send to Mexico Parts II and III incorporating your comments by early December 1990.

CPhung/ss

Distribution: Messrs./Mmes. Knotter (LA2DR), Segura (LATDR), Rajapatirana (LATTF), Chaudhry (LATPS), Squire o/r, van Wijnbergen, Kanchuger, Oks (LA2C1), Halperin (LA2IE), Babelon, Mangan (ASTIE), Shirley, Kikeri, Bell (CECPS), Carvalho (LEGLA), Sugar (LOAEL).

PROJECT COMPLETION REPORT

MEXICO

PUBLIC ENTERPRISE REFORM LOAN

(Loan 3086-ME)

November 6, 1990

Country Operations Division I
Country Department II
Latin America and Caribbean Regional Office

MEXICO

PROJECT COMPLETION REPORT
Loan 3086-ME)

TABLE OF CONTENTS

Page No.

TABLE OF CONTENTS (cont'd)

MEXICO

PUBLIC ENTERPRISE REFORM LOAN
(Loan 3086-ME)

PROJECT COMPLETION REPORT

PREFACE

This is the Project Completion Report (PCR) for the Public Enterprise Reform Project in Mexico, for which Loan 3086-ME in the amount of US$500 million was approved on June 13, 1989. The loan is expected to be closed on June 30, 1991 as scheduled. As of end October 1990, the loan was fully disbursed except for 0.7 million under the technical assistance component.

[The PCR was jointly prepared by the Country Operations Division of the Latin America and the Caribbean Regional Office (Preface, Evaluation Summary, Parts I and III), and the Borrower (Part II).]

Preparation of the PCR was started during a Bank's mission in October 1990, and is based, inter alia, on the President's Report; the Loan and Guarantee Agreements; supervision reports; correspondence between the Bank and the Borrower; and internal Bank Memoranda.

MEXICO

PUBLIC ENTERPRISE REFORM LOAN
(Loan 3086-ME)

PROJECT COMPLETION REPORT

EVALUATION SUMMARY

Project Objectives

i. The project is part of a program of Bank support to the Mexican Government's efforts to stabilize the economy and resume growth. It aims at improving the efficiency of public enterprises whose poor performance accounts for much of Mexico's financial problems and at reducing the heavy burden that they impose on the Government budget. The project supports a PE reform program which includes (i) a disengagement component to continue with the sale, liquidation and merger of PEs; and (ii) reforms in the policy and institutional environment for PEs to improve the efficiency of the enterprises to be retained by the Government.

Implementation Experience

ii. Implementation of the project was good. The loan was signed two days after Board approval and became effective the following month. The second tranche was released in February 1990, i.e., two and a half months behind schedule. In retrospective, however, it appeared that the target date (end November 1989, i.e., 4 months after planned effectiveness) was too tight, given that some of the conditions were not only politically sensitive but also required substantial preparatory work which was time consuming. As of October 31, 1990, the loan was totally disbursed, except for 0.7 million under the technical assistance component. The project accounts have been audited regularly and the audits did not reveal any particular problem. The loan is expected to be closed as scheduled at the end of June 1991.

Results

iii. When assessing the PERL in terms of the disengagement of the Government, reduction in the size of the PE sector, and improvement in the working environment for retained PEs, there is not doubt about the project's success. The implementation of the disengagement program has gone smoothly and has been strong. From January 1989 to September 1990, 139 PEs have been diverted and 202 were at different stages in the process. Liquidations involved 50% of the enterprises, mergers and transfers 19% and privatization the remaining 31%. Recently, the Government announced its decision to privatize the telephone, steel and fertilizer sectors and to allow again private, foreign and Mexican capital participation in the banking system. This is much beyond what was agreed with the Bank under the PERL and demonstrated beyond any doubt the determination of the Mexican Government to disengage from the economy and to reduce the size of the PE sector.

iv. The Government also introduced the agreed institutional and legal reforms designed to enhance the autonomy and accountability of PEs. Although it may be too early to judge the impact of these changes on the performance and efficiency of public enterprises, some PE Boards of Directors have taken advantage of their greater legal autonomy and have been more active in the operation of the companies.

v. In a few grey areas, corrective actions have been taken and/or improvements noted. Thus, following several postponements because of the need to fight inflation under the PECE, the Government implemented the price adjustment program for fertilizer products agreed with the Bank and allowed steel prices to reach import parity. In the areas of PE managerial autonomy, while some companies still feel major Government interference, the issue appears less acute in others, particularly those implementing well designed Performance Agreements. This system is beginning to be taken as an important instrument to improve effectiveness, efficiency and productivity of parastatals as evidenced by its adoption by both SEMIP (Ministry of Energy, Mines and Public Industry) and SCT (Ministry of Communications and Transports) and its application to parastatals under these two Ministries' supervision.

Sustainability

vi. The loan documents identified three major risks regarding the sustainability of the PE reform: Institutional, political and macroeconomic.

vii. The institutional risk concerns existing vested interests within Government institutions which may resist measures aimed at increasing PE managerial and financial autonomy. This risk is real. During implementation of the project, Bank supervision missions have identified the reluctance of some Government agencies to relinquish centralized control and interference in PE management as the major issues. The transition from a centralized, ex-ante control system to one of ex-port evaluation, based on the assessment of PE management and performance is a difficult one, requiring time and perseverance. Recently, however, improvements were noted with a number of PEs reporting less interference and more flexible control from Central Government agencies.

viii. The political risk refers to possible opposition to the reforms by labor unions and Congress. This risk is very much mitigated by the Government's good and open dialogue with the private sector, labor unions and Congress and by the clarity of the reforms' objectives which are shared by these various economic and political groups. Indeed, implementation of the reforms did not meet strong opposition as the privatization and enterprise liquidations did not result in massive reductions of personnel. In addition, actions have been taken to minimize the short-term social cost. These include severance payments, early retirement plans, special retraining programs.

ix. The macroeconomic risk refers to a possible return to expansionary policies as a result of the high domestic costs of stabilization or insufficient financing of the adjustment and growth program. Were this to occur, a reversal of PE reform might take place. This risk is mitigated by the remarkable progress made by Mexico to maintain budgeting discipline and to control inflation. Furthermore, with the current oil bonanza, lack of financial resources should not be a constraint to the continuation of the Government's adjustment efforts. Under these circumstances, the risk of a derailment of the reform process is very much reduced, but it is not nil. An expansion of public expenditures beyond prudent limits is always a possibility and would have a devastating impact on the stabilization achieved so far. Conversely, with the windfall from the oil bonanza, the Government's will to continue reforms may be eroded. Hence, continued implementation of prudent fiscal policies is needed for the sustainability of the PE reforms.

Findings and Lessons Learned

x. Mexico's structural adjustment program has been far-reaching, particularly in the area of PE reforms where progress has been excellent. Several lessons can be learned from the preparation and implementation of the Mexico PERL. They are discussed below.

xi. PE Reform and Macro Adjustment. Mexico PE reform was conceived as an integral part of a larger program to restructure the economy and was implemented while successful macro adjustments were being made. Thus, it was under brighter economic prospects and improved private sector confidence and perception of the macro outlook that privatization and institutional and regulatory reforms took place. Successful macroeconomic reforms are preconditions to a successful PERL. Moreover, it can be added that it would even be wrong to go ahead with a PE reform program in the absence of an adequate macro framework. Without a competitive environment, privatization of public enterprises could have a negative impact, while continued distorted prices are likely to prevent PEs' efficiency improvements.

xii. Clarity of Purpose and Consensus on Reform Objectives. Perhaps even more than in other policy reform areas, a PERL program is likely to result in a drastic change of the power balance among different Government agencies and between these and the PEs. There is a real risk that vested interests within Government and the affected PEs block the reforms. Thus, while firm Government commitment is indispensable to the success of the reforms, it is also important to have, like in the Mexico case, very early in the process, a consensus among affected groups (labor unions, congress, private sector, etc.) on the reform objectives. It is also essential for the success of the reforms, particularly with regard to privatization, to establish clear rules and procedures to guarantee the transparency of the process.

xiii. Project Coordinator. PERL implementation is particularly complex, involving numerous government agencies and PEs. It is therefore essential to the success of the project to have a strong project coordinator with good access to Government officials and PE managers to monitor the various project activities and progress in the implementation of the reforms.

xiv. Premium on Flexibility. While a few conditions essential to the success of the PERL (such as price liberalization, regulatory reforms and PE restructuring) should be worded in such a way as to leave little room for interpretation, it is important to avoid locking in rigid targets. Thus, in the Mexico PERL, all the studies and secondary actions did not appear as dated covenants in the loan's legal documents, but included in an Action Plan whose "implementation satisfactory to the Bank" was a second tranche release condition. Regard for flexibility was also apparent in the wording of tranche release conditions with respect to reduction of Government transfers where absolute figures were avoided and reference made to levels only. This allowed to pass judgement on the overall progress without blocking the project if some non-essential actions have not been implemented or if a particular important condition has not been strictly met as described in the legal documents.

xv. Importance of Close Supervision. PERL supervision is a labor intensive activity and adequate staff resources should be programmed for it. It is also essential that the Bank team develops a good relationship with its project counterparts in the country so as to detect issues at an early stage and take the necessary corrective actions.

MEXICO

PUBLIC ENTERPRISE REFORM LOAN
(Loan 3086-ME)

PROJECT COMPLETION REPORT

PART I: PROJECT REVIEW FROM THE BANK'S PERSPECTIVE

A. PROJECT IDENTITY

Project Name:	Public Enterprise Reform Loan (PERL)
Loan Number :	3086-ME
RVP Unit :	Latin America and Caribbean
Country :	Mexico
Sector :	Public Enterprises

B. BACKGROUND

Macroeconomic Setting

1.01 Following three decades of high growth, low inflation and moderate internal debt accumulation, Mexico went through a period of high spending in the late 1970s in an attempt to stimulate growth through an expansion of public involvement in the economy and the encouragement of high-cost, capital-intensive investments. This strategy was made possible by rising oil export earnings and abundant foreign borrowing, but failed to sustain sound economic growth. It was put to an end in 1982 when world interest rates rose substantially, while oil prices fell. The refusal of external creditors to rollover Mexico's short-term debt left no option but fiscal retrenchment.

1.02 An IMF-supported stabilization program was launched in 1983 and succeeded in arresting the deteriorating trend. These positive results were, however, reversed by some relaxation of fiscal and monetary discipline in 1984-85. Moreover, the earthquake in late 1985 and major terms of trade deterioration in 1986 due to falling oil prices worsened Mexico's prospects. In response, the Government adopted a deeper and growth-oriented stabilization program designed to eliminate structural rigidities in the economy. The most significant elements included a major reorientation toward fuller integration with the world economy, the disengagement of the State and redefinition of the role of the public sector in the economy. In return for renewed monetary and fiscal austerity, the program also called for a concerted financial effort on the part of Mexico's creditors.

1.03 Performance under the program has been impressive in many areas. The trade reforms were far-reaching and have gone beyond the Government's initial plans, GATT's commitments and targets of Bank-supported trade policy loans. Fiscal austerity was strictly maintained in the face of adverse terms of trade developments and Mexico's continued difficulties in accessing the international capital markets. However, there was no real growth, and hence a severe decline in per capita income from 1982 to 1987. Also, inflation, rather than slowing down, in fact accelerated, partially in response to sharp nominal devaluations in 1986 and 1987.

1.04 The Government responded with the Economic Solidarity Pact (PACTO), a concerted effort between Government, labor and business to bring down inflation that was running well into triple digits by end-1987. The program consisted of further tightening of fiscal and monetary policy and renewed structural efforts in the areas of trade liberalization, credit and public enterprise divestiture. These measures were supplemented by a freeze of minimum wages, public sector prices and tariffs, and what was a corner stone of the Pacto: the freezing of the nominal exchange rate against the US dollar.

1.05 On almost every aspect, performance under the Pacto has been exemplary and often went beyond what was initially planned. The fiscal deficit was brought closely in line with the low inflation targets embedded in the program. This effort was all the more noteworthy, given the negative budgetary impact of further drops in oil prices and increasingly high real interest rates on foreign debt towards the end of 1988. The policy of a fixed Peso-Dollar rate, however, came under increasing pressure and, by the end of 1988, was abandoned.

1.06 In December 1988, the Mexican Government and the various sectors of society agreed on a renewal of the Pacto to consolidate price stability and further improve the budget situation. Under this renewed pacto -- now called Stabilization and Growth Pact (PECE) -- public sector prices and tariffs, as well as minimum wages, would remain controlled after initial adjustments, but the peso would be depreciated daily, according to a pre-announced schedule of one peso per day. The PECE has been extended several times and is still in force.

<u>World Bank and IMF's Roles in Mexico's Adjustment Process</u>

1.07 Once it became evident that Mexico's economic crisis would not be transitory and that the Government began looking for ways to address its structural development problems, the role of the Bank in Mexico was bound to change. In 1984, the Bank proposed to the Mexican Government a change in the direction of its lending strategy. A major discussion reportedly took place within the Mexican administration on the direction and importance of the Bank role in Mexico's adjustment process. In the end, the authorities agreed that they wanted the Bank to provide quick disbursing policy-based loans to Mexico and to assist them in their negotiations with the commercial banks to obtain rescheduling and new money. However, since the Mexican Government did not wish to receive a Structural Adjustment Loan (SAL), given the nature of the structural issues facing Mexico, the Bank formulated a program consisting of a series of sector loans, which taken together included the major elements of a SAL program. The Trade Policy Loans I and II were the first such operations and were followed by adjustment loans in agriculture, steel and fertilizer sectors. The project described in this report is part of a second series of adjustment loans designed to address the predominant long-term problem of continued low growth of the economy. It was prepared in parallel with the Financial Sector Adjustment Loan (FSL) and the Industrial Sector Policy Loan (ISPL). Together, they form a policy package aimed at providing the framework for the increase in private investment necessary for resumed growth.

1.08 Since the start of its adjustment lending in Mexico, the Bank has collaborated closely with the IMF. The roles of the two institutions are complementary. Since the Bank does not have a SAL in Mexico, it has relied on the Fund to monitor macroeconomic performance, particularly Mexico's exchange rate policy. Thus, most of the Bank's sectoral adjustment lending was carried out concurrently with IMF programs. Since 1982, Mexico has benefited from an extended arrangement for SARs 3.4 billion, a special emergency drawing for SDRs 291 million after the 1985 earthquake, a stand-by for SDRs 1.4 billion in 1986 and, in 1989, a drawing of SDRs 453 million under the compensatory facility, and another extended arrangement of SDRs 2.8 billion through 1992. So far, Mexico's performance under the on-going EFF arrangement has been satisfactory.

The Public Enterprise Sector and the Government Early Reform Efforts

1.09 The public enterprise sector is large, contributing about 12% of GDP and employing about one million people. Public enterprises control the most important branches of basic industry and infrastructure. During the 1970s, the sector grew rapidly without a clear definition of the roles of the Government and the private sector. There were 1,155 PEs in 1982, while only 491 existed in 1970. A major source of growth was the acquisition by the Government of bankrupt private firms to avoid their closure and maintain employment.

1.10 The economic and financial performance of PEs has not been satisfactory. Efficient administration has been hampered by the fact that prevalent PE legislation at that time focused on processes and controls that relied heavily on the administrative capacity of the Government and was not suited for industrial and commercial enterprises. PE efficiency was also affected by Government controls which kept PE prices and tariffs generally below their economic opportunity costs.

1.11 In 1982, as part of its structural adjustment strategy, the Mexican Government implemented a major disengagement program for most of the small and medium PEs and for some of the larger ones. By February 1989, this process left only 449 entities in the public sector, of which 94 were in the industrial, energy and mining sectors. Excluding the oil and electricity companies, which must remain with the Government as dictated by the Mexican Constitution, the enterprises disengaged since 1982 in the industrial, energy and mining sectors represented 77% of the number of enterprises, 66% of labor, 41% of sales, and 23% of the asset value of the initial universe of PEs in these sectors in 1982.

1.12 While implementing its disengagement program, the Government also took measures to improve the competitive environment for industrial and commercial activities. It thus carried out a major liberalization of the trade regime, abolished licensing requirements and other non-tariff barriers for most imports and export controls for 332 tariff positions, i.e., more than half the tariff positions under control in 1980. The Government also reduced substantially the scope of price controls, making the controls more flexible for most products. Still, a significant number of goods and services produced by large PEs remained under price controls.

1.13 By the early 1989, it was clear that although the disengagement program has helped reduce the cost of PEs to the budget, many enterprises were still facing low capacity utilization, high operating costs and substantial financial losses. They continued to receive large subsidies from the Government totalling 2.8% and 2.1% of GDP in 1987 and 1988, respectively. Despite the improvements in the environment introduced by the Government since the early 1980s, it appeared that the performance of the public enterprise sector remained adversely affected by two sets of issues. First, pricing policies for a few large PEs remained inadequate, forcing them to operate at a loss. Second, the managerial and financial autonomy of the PEs was still very limited due to the overcentralized structure of budgeting and control. Major budgeting, personnel, salary, investment, procurement and even some operational decisions of PEs were made at the Ministerial level, often with a short-term cost-containment focus. In 1986, as part of the program, the Government enacted the Law of Parastatal Entities, a major step forward to create the legal conditions for a more appropriate balance between PE's autonomy and accountability. However, the detailed interpretative regulations to this law, which are essential for its implementation, were not issued. Without these regulations, the PE Law was not operative and PEs remained subject to the web of legal, regulatory and administrative systems that deprived them of managerial and financial autonomy and negated their accountability. Reform of PEs has also been hindered by the inertia characteristic of large public organizations and the political sensitivity of many of the issues. As a result of these constraints, substantive reform of the PE sector during the six year period 1982-88 has been largely confined to the disengagement program.

C. PROJECT OBJECTIVES AND DESCRIPTION

1.14. The project is part of a program of Bank support to the Mexican Government's efforts to stabilize the economy and resume growth. It aims at improving the efficiency of public enterprises whose poor performance accounts for much of Mexico's financial problems and at reducing the heavy burden that they impose on the Government budget. The project supports a PE reform program which includes (i) a disengagement component to continue with the sale, liquidation and merger of PEs; and (ii) reforms in the policy and institutional environment for PEs to improve the efficiency of the enterprises to be retained by the Government. The project benefited from a cofinancing with the EXIMBANK of Japan in an amount of US$300 million equivalent.

The Disengagement Program

1.15. Earlier Efforts. From 1982 to 1988, the Government disengaged itself from 706 enterprises (61% of the sector in number) through liquidation, sale, merger, or transfer to municipalities. The disengagement program has been particularly important in the industrial, energy and mining sectors where the number of PEs was reduced from 398 to 90. During this first phase most disengaged enterprises were small and medium sized PEs, but valuable experience and knowledge have been accumulated that would be very useful in subsequent, more complex transactions. The disengagement process, which was a loosely defined system, decentralized among sectors ministries, was tightened up and standardized procedures established. The PE-Sales Unit at SHCP has also been strengthened and allocated budgetary resources for administering and monitoring the PE sales program. In complex cases or large transactions, the unit has the authority to establish an ad hoc committee that would draw as needed on other key Ministries that should be involved in the decision-making process. With these adjustments in the implementation arrangements, the disengagement process should be able to continue in a satisfactory manner.

1.16 Disengagement under the Project. To implement the next stage of the disengagement program, during preparation of this operation, all sectoral ministries submitted (i) a list of new PEs to be disengaged, and (ii) the justification for the permanence of the remaining PEs in the public sector. Based on this information, a disengagement program for 199 PEs was established. Sixty-three of such PEs were to be prepared for eventual sale, 124 for liquidation and 12 for either merger or transfer to local governments. Satisfactory progress in the implementation of this program is a condition for second tranche release of this operation.

1.17 Future Role of Government in the Sector. In order to avoid a recurrence of the massive Government take-over of the 1960s and 1970s, and to clarify the roles of the private and public sectors, the Government had stated that it would limit its involvement in the economy to strategic or priority sectors. However, while the Mexican Constitution clearly defines strategic sectors (to include oil, hydrocarbons, radioactive materials, electricity, basic petrochemicals, mail, satellite telecommunications, and railways), it does not define priority sector and this term has been widely interpreted. Consequently, there is a need for a definition of the Government role in these areas. Thus, under this project, the Government had been requested to reconfirm that, in non-strategic areas, it would not get involved in enterprises -- or establish new parastatals or PE subsidiaries, or acquire existing private sector companies -- which are of a commercial nature or are involved in the production of tradeable goods, except in cases of significant market failures involving the production of goods/services with major social welfare impact. Furthermore, as a condition of second tranche release, the Government would empower CGF with the authority to give final recommendation on a case-by-case basis on the creation of PEs (and subsidiaries), or the acquisition of companies by Government agencies -- consistent with a redefined priority concept.

Measures to Improve Efficiency of Retained Enterprises.

1.18 Following experience elsewhere, the Government believes that a valid strategy to encourage PEs to improve their efficiency is to force them to operate (i) in a competitive environment that subjects them to market forces; (ii) with sufficient managerial autonomy and incentives to encourage them to seek agreed upon performance goals and be rewarded (sanctioned) if the goals are (are not) achieved; and (iii) with sufficient financial autonomy and accountability. Measures agreed in the context of this operation and related to the above three aspects are briefly discussed below.

(a) Measures to Improve the Competitive Environment of PEs.

1.19 Since major reforms to liberalize the economy and increase its exposure to market forces have already been undertaken by the Government, this project only addressed market imperfections affecting the operation of PEs. More specifically, the project included (i) cross references to conditions under other sector operations to liberalize the prices of products of five large PEs: SIDERMEX (steel), FERTIMEX (fertilizers), CONASUPO (marketing of agricultural products), CFE (electric power) and FERRONALES (tariffs); (ii) limit on the aggregate transfers to PEs in 1989 which should be 13% below 1988 levels in real terms; and (iii) issuance of regulations to the Procurement Law which should make clear that there is no discrimination between local and foreign supplies.

(b) Measures to Foster Managerial Autonomy and Accountability.

1.20 These essentially included (i) issuance of interpretative regulations to the Federal Law of Public enterprises redefining the roles of different Government agencies involved in PE guidance, performance and evaluation, and clarifying the roles of PE Boards of Directors and PE management; (ii) preparation and implementation of Performance Agreements for five large PEs: FERTIMEX, CMC, FERRONALES, SICARTSA, and AHMSA; (iii) measures to make the Performance Agreement Unit (Unidad de Convenio de Desempeno - UCD) in CGF operational; and (iv) strengthening of PE reporting, financial management and accounting systems. Under the project training was also foreseen for PE managers, Board appointees and UCD officials.

(c) Measures to Foster Financial Autonomy and Accountability.

1.21 These essentially consist in (i) simplifying PE's budgeting procedures and practices which give PE managers little financial autonomy to operate efficiently; and (ii) rationalizing public involvement processes. Thus, under the project, the Government has been requested to furnish to the Bank an Action Plan to simplify, deregulate, and make more flexible the budgetary process and its implementation for PEs operating under Performance Agreements. With regard to rationalization of investment processes, concrete measures included issuance of guidelines for economic evaluation of public investment projects, introduction of multi-plan budgeting and establishment of a public investment evaluation unit.

D. PROJECT IMPLEMENTATION AND MAJOR RESULTS

Overall Evaluation

1.22 When assessing the PERL in terms of the disengagement of the Government, reduction of the size of the PE sector and improvement in the working environment for retained PEs, there is little doubt about the project's success. The conditionality of the loan was satisfactorily met with only small delays. Despite numerous and difficult conditions, the project became effective (and the first tranche released) about one month after loan signing (which followed Board presentation by 2 days). This was due to the intense discussions which took place during project processing and which succeeded in leveling out of many of the issues. Indeed, most of the effectiveness conditions were already meet at the time of Board presentation, following two rounds of lengthy negotiations in March and April 1989.

1.23 The release of the second tranche encountered some difficulties, in part because of the large number of conditions which needed to be fulfilled. In retrospective it also appeared that the target date (end November 1989, i.e., 4 months after effectiveness) was optimistic, given that some of the conditions were not only politically sensitive but also required substantial preparatory work which was time consuming. This was particularly true for the preparation of Performance Agreements for the five selected large PEs and the issuance of regulations to the Procurement Law and the PE Law. Eventually, all the conditions of the second tranche release were met and the project generally achieved its dual objectives of reducing the size of the PE sector and improving its efficiency. Sectors traditionally controlled by PEs, such as basic industry and mining, are now mostly in private hands. The achievements of the project (and difficulties encountered during implementation) are discussed further below.

Disengagement Program

1.24 The implementation of the disengagement program has been excellent. From January 1989 to September 1990, 139 PEs have been divested, and 202 were at different stages in the process. Liquidation accounted for 50% of the enterprises, mergers and transfers for 19% and privatization for the remaining 31%. Furthermore, the Government announced recently its decision to privatize the telephone, steel and fertilizer sectors, and to allow again private foreign and Mexican capital participation in the banking system. This is much beyond what was agreed with the Bank under the project and demonstrated beyond any doubt the determination of the Mexican Government to disengage itself from the economy and to reduce the size of the PE sector.

1.25 Gross proceeds from the PE sales are estimated at about US$3 billion, or 1.6% of 1989 GDP. A quick survey of the divested enterprises reveals the following characteristics: (i) they are predominantly small to medium-sized firms, for the most part operating in competitive markets; (ii) the buyers have been mainly local investors. Unions were involved only in the purchase of textile companies, while foreigners participated in a few large cases (auto part companies, Mexicana airlines); (iii) physical restructuring of the enterprises prior to sale has been kept to a minimum. New investments for physical rehabilitation and employment adjustments have been mostly left to the new private investors. This appears to have been due to the fact that most of the divested enterprises were of a modest size. For larger PEs, a certain amount of restructuring has or is taking place in preparation for sale. In the case of FERTIMEX, for example, investments are being made to rehabilitate the fertilizer plants.

1.26 The divestiture appears to have achieved the desired objectives, and the process has worked well with relatively few implementation problems. However, a potential effect may be a worsening of the already skewed and concentrated pattern of ownership distribution in the economy and an increase in vertical integration. Reportedly, only a small group of local conglomerates have been involved in purchasing PEs. To a large extent, this outcome reflects current ownership pattern in Mexico, and not the effects of divestiture per se. Mexican policy makers have not, as in some other countries, chosen to use divestiture as a tool to avoid further asset concentration and distribute ownership more widely in the economy. Their main objectives were to reduce the size of the PE sector and maximize the financial gains as quickly as possible. Achievement of these objectives have led the Government to sell PEs to qualified investors capable of improving performance, rather than to a large number of small and widely dispersed shareholders. Preparing the companies for sale to small investors (through listing on the stock exchange) would also be a cumbersome and time-consuming process, if at all feasible. Most of the divested PEs were small and relatively unknown and did not fit the criteria necessary for public floatations.

1.27 With regard to the implementation process, the strategic choice of starting small, gradually expanding to larger firms, and the importance given to speed paid off handsomely. Small firms operating in competitive markets were easier to sell, did not need much prior restructuring, and would only have marginal impact on allocative efficiency if mistakes were made, given their competitive nature. Moreover, early and quick sales helped demonstrate commitment, provided the necessary learning curve and tested the institutional procedures necessary for managing more complex privatizations.

1.28 Other factors of success included the strong institutional capabilities for handling the disengagement program and the transparency of the process. Initially, sector ministries were responsible for the sale of their PEs. Since 1985, however, this responsibility has been vested with the Disincorporation Unit in SHCP, which is staffed with motivated and qualified personnel. This has helped reduce inconsistencies and confusion and curtain the power of sector ministries to block reforms. Currently, the involvement of sector ministries is limited to the identification of candidates for privatization, with no other decision-making powers.

Sector Improvement Efficacy Program

(a) Measures to Improve the Competitive Environment of PEs

1.29 So far, the policy reforms undertaken under this project as well as under parallel operations has only started to have an impact on the efficiency of PEs. While the trade opening and industrial deregulation have had a positive impact on a number of small and medium-sized public enterprises which began to react to foreign competition, the performance of large public enterprises has remained poor, mainly as a result of the price controls on their products. Although the Government agreed under several different sector loans to a program of price adjustments on goods and services produced or marketed by five large PEs (SIDERMEX, FERTIMEX, CONASUPO, CFE and FERRONALES), their implementation has been postponed several times because of the need to fight inflation under the PECE. Prices of goods and services provided by these enterprises have thus remained for a large part controlled during the implementation of this project, with the notable exception of electricity tariffs for which the price adjustment program agreed with the Bank was satisfactorily implemented. On the other hand, the Government implemented the transfer reduction program agreed under this loan. Caught between significantly scaled down Government transfers and the inability to raise prices of their products, the financial situation of many of these enterprises deteriorated. In the case of FERTIMEX, the difficult financial situation and the resulting liquidity problems are complicating the on-going restructuring process as well as the privatization efforts. Recently, as part of its decision to privatize SIDEMEX, the Government allowed steel companies to set their prices at parity with international prices. It also agreed to fully implement the fertilizer price adjustment program agreed with the Bank, which had experienced delays. Consideration is also being given to a full price deregulation of FERTIMEX products as an incentive to private participation in this PE. Finally, the Government is envisaging liberalizing FERRONALES' tariffs for both passenger and cargo transport.

(b) Measures to improve PE Managerial and Financial Autonomy and Accountability

1.30 The Government introduced the agreed institutional and legal reforms designed to enhance the autonomy and accountability of PEs. The Regulations to the PE Law -- intended to eliminate contradictions among different laws and decrees dealing with budgeting requirements of PEs -- were issued as agreed, while the approved FY90 budget decree contained many measures going in the same direction of greater PE autonomy. The centralized Information System, which should allow PEs to report information to Government agencies in a timely and efficient manner was simplified, while the amount of information to be reported was reduced as agreed. Although it may be too early to judge the impact of these reforms on the performance and efficiency of public enterprises, some PE Boards of Directors have taken advantage of their new greater legal autonomy and have been more active in the management and decision-making of the companies. The problem of Government agencies' interference in PE management and operation, which was identified by Bank supervision missions as a major project issue appeared to have eased somewhat. While some companies still report tight Government control over their budgets and other operational matters, the issue seems less acute in others, particularly those implementing well designed Performance Agreements (para. 1.27-1.28).

(c) Performance Agreements

1.31 The establishment and development of a Performance Agreement System in Mexico is progressing relatively well although it is not clear at this stage what would be the scope of the PA system in 1991. As agreed under the project, PAs were developed for five major PEs: Altos Hornos de Mexico (AHMSA), Carbon y Minerales Coatinila (CMC), Siderurgica Lazaro Cardenas - Las Truchas (SICARTZA), Ferrocarriles Nacionales de Mexico (FNM), and Fertilizantes Mexicanos (FERTIMEX). While it may be too early to assess the results of these first PAs, it appears that they are already having a positive impact on some of the enterprises. At FERTIMEX the system has forced the company to prepare for the first time an internal plan which outlined its detailed strategy for reaching efficiency and restructuring goals and set detailed internal targets and responsibilities. Furthermore, in order to monitor performance and prepare information for Unidad de Convenios de Desempeno (UCD), FERTIMEX has complemented its cost accounting system with the design of systems permitting accurate measurement and consolidation of costs, margins and volumes, and has revised its accounting practices to better reflect values of inventories and assets. Although part of its management still perceive the PA system as an additional and time consuming way of Government control, the system has forced Fertimex to better analyze results from its production, distribution and financial operations and has given it a good basis for a meaningful discussion on its operations and needs with the Government. FERRONALES also reported that the PA has had a beneficial impact by helping focus management's attention on important targets and has led to the development of a good MIS at the company.

1.32 It is more difficult to judge the impact of performance agreements on the three other companies (AHMSA, CMC and SICARTSA, all of them part of the SIDERMEX complex), as the introduction of PAs coincided with the decision of the Mexican Government to privatize the steel sector. Thus, while these companies said they felt less Government interference and that their Boards of Directors have been taking a more active role in the management of the companies' operations, they did not know whether this greater managerial authority was due to the PA system or resulted from the privatization decision.

(d) Public Investment Evaluation

1.33 Following a slow start, progress in this area is now satisfactory. Delays in commissioning the agreed study on public investment evaluation and multi-year investment programming procedures, and unforeseen complexities in the process have delayed the original scheduling of this exercise by four months. At present, the final studies have been completed and a plan of action for implementing the new system has been discussed with the Bank. Moreover, the approval for the establishment of a centralized investment evaluation unit for public sector investment proposals has been obtained from the Presidency. The head of the unit has also been appointed and measures are being taken to ensure its operation.

E. PROJECT SUSTAINABILITY

1.34 The loan documents identified three major risks concerning the sustainability of the PE reforms: (i) disruption of the macro-economic adjustment program; (ii) possible opposition to some of the reforms by the strong public sector labor unions and/or Congress; and (iii) resistance to reforms by existing vested interests within governmental institutions and affected PEs.

1.35 The first major risk identified refers to a possible return to expansionary policies as a result of the high domestic costs of stabilization or insufficient foreign financing given the requirements of the macro-economic adjustment program and growth targets. Were this to occur, a reversal of PE reform might take place. The loan documents for this operation commented that this risk is mitigated by the continued efforts made by the Government in maintaining budgetary discipline and in controlling inflation. Indeed, in both areas, the Government performance has been exemplary and it can be said that in Mexico the budget situation and inflation are now largely under control. With regard to external financing, the debt reduction deal and continued large flows of external assistance have, so far, assured adequate financing for the implementation of the macro adjustment and economic recovery program. Furthermore, at present, with the oil bonanza, lack of financial resources should not be a constraint to the continuation of the Government's stabilization and growth efforts. Under these circumstances, the risk of a derailment of the reform process is very much reduced, but it is not nil. An expansion of public expenditures beyond prudent limits is always a possibility and would have a devastating impact on the stabilization achieved so far. Conversely, with the windfall from the oil bonanza, the Government's will to continue reforms may be eroded. Hence, continued implementation of prudent fiscal policies is needed for the sustainability of the PE reform.

1.36 The second risk is of a political nature and refers to possible opposition to the reforms by labor unions and Congress. The loan-documents note that this risk is very much mitigated by Government's good and open dialogue with the private sector, labor unions, and Congress, as evidenced by the formulation process of the Pacto and Pece, and by the clarity of the reforms' objectives which are shared by these various economic and political groups. Indeed, implementation of the reforms did not meet strong opposition as the privatization and enterprise liquidations did not result in drastic reductions of personnel. In addition, actions have been taken to minimize the short-term social cost. These included severance payments, early retirement plans, special retaining programs.

1.37 The third risk is mainly institutional and concerns existing vested interests within governmental institutions which may resist the measures aimed at reforming the situation, whereby various Ministries interfere with PE management and exercise ex-ante controls over critical PE activity.

1.38 As discussed in the report, this risk is real. Indeed, the reluctance of some Government agencies to relinquish centralized Control and interference in PE management have been identified as the main issues during implementation of the project. They have slowed down the transition from a centralized ex-ante system of control to one of ex-post evaluation, based on the assessment of PE management and performance. The problem seems to have eased recently with many enterprises reporting less interference and more flexible control from Government agencies. Continued progress in this area of PE managerial autonomy is essential to the sustainability of reforms achieved so far in the public enterprise sector.

F. BANK PERFORMANCE

1.39 In late 1988, when the Mexican Government asked the Bank to put together a package of reforms and financing that will permit Mexico to resume growth after six years of stagnation, the Bank's response was quick and thorough. On very short notice, a team of almost 60 professionals visited Mexico to start preparation of three large sector adjustment operations (including the PERL discussed in this report), which together amounted to US$1.5 billion and should help secure other sources of financing to trigger the increased investment necessary for renewed growth. The ability to respond so quickly and well was made possible by the intense program of economic, sector and operational work in Mexico over the last few years. It has, however, necessitated some modifications to the Bank's work program in Mexico with more emphasis given to policy-based lending and economic and sector work linked to structural adjustment.

1.40 The Bank's performance during project implementation was also fully satisfactory. The continuity of the Bank team working on the project and the good relationship they have succeeded in establishing with their Mexican counterparts greatly facilitate resolutions of issues. Contact with the Mexican authorities was almost continuous through telephone, correspondence and field visits. Supervision was intensive with the task manager or a full supervision mission visiting Mexico every quarter. Mexican representatives also came to Washington to discuss project related matters. Implementation issues were thus detected at a very early stage and corrective actions taken rapidly. The unexpected delays in the issuance of the regulations to the PE Law (a second tranche release condition), for example, were brought to the attention of the highest authorities and the issue was quickly resolved.

G. BORROWER'S PERFORMANCE

1.41 There cannot be any doubt about the commitment of the Mexican Government to its PE reform program and this very much explains the success of the PERL. In many instances, the Government went much beyond what was agreed under the project. In fact, the Bank just played a supportive role in the Mexico PE reform process, which started in 1982. The Bank-financed PERL fitted into that program and helped strengthen the position of the reform-minded elements in the Government. The Bank's assistance proved particularly useful in developing the PA system in Mexico and in starting the process of enhancing PE managerial and financial autonomy.

1.42 Mexico's performance in carrying out its operational responsibilities under the project was also very good. These were some initial project coordination problems at SHCP, but they were resolved once NAFIN assumed project coordination responsibility jointly with the SHCP team. The project accounts were regularly audited as mandated by the Loan Agreement and the audits did not reveal any particular problem.

H. CONCLUSION

1.43 Progress under the public enterprise reform program in Mexico has been impressive. The Government fully achieved what it set out to do in this phase of its PE reform program and in the Bank-supported PERL operation. Now that an adequate legal and institutional framework is in place, the next phase of the reform is likely to involve the privatization and/or restructuring of large PEs such as FERTIMEX, SIDERMEX, PEMEX petroquimico, CONASUPO, FERRONALES, etc., while improvements in the working environment for retained

PEs continue to be made. This is a difficult and complex undertaking as it involves the companies in Mexico which count. It is, however, essential to the success of the PE reform process and to carry through this difficult endeavour, Mexico needs -- and deserves -- the support of all its donors.

MEXICO

PUBLIC ENTERPRISE REFORM LOAN
(Loan 3086-ME)

PROJECT COMPLETION REPORT

PART III

STATISTICAL INFORMATION

(As of
Amounts (US$ million)

	Original	Disbursed	Cancelled	Repaid	Outstanding
Loan 3086-ME	500.0	499.0	-	-	499.3

	Original Loan Dates	Actual or Re-estimated
Initiating Memorandum	December 15, 1988	December 15, 1988
Letter of Development Policy	May 12, 1989	May 12, 1989
Negotiations	March 13-19, 1989	March 13-19, 1989 April 25-29, 1989
Board Approval	June 13, 1989	June 13, 1989
Effectiveness	July 1989	July 11, 1989
Loan closing	June 30, 1991	June 30, 1991
Actual completion	June 30, 1991	June 30, 1991

CUMMULATIVE LOAN DISBURSEMENT

		FY90	FY91
(i)	Planned	499.0	1.0
(ii)	Actual	499.3	0.7
(iii)	(ii) as % of (i)	100.1%	70.0%

MISSION DATA

	Month, Year	No. of Weeks	No. of Persons	Staff Weeks	Date of Report
Preparation	October 88				
Appraisal	Oct./Nov.88	2.0	19	38.0	May 22,1989
Supervision I	Sept. 89	1.0	4	4.0	Oct.18,1989
Supervision II	Dec. 89	0.5	1	0.5	Dec.12,1989
Supervision III	May/June 90	1.3	2	2.6	Aug.24,1990
Completion	October 90	0.6	2	1.2	Nov. 1990

FOLLOW-ON ADJUSTMENT OPERATIONS

NONE

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 12, 1989

TO: Mr. Paul Knotter, Division Chief, LA2TF

FROM: Enrique Mendez, LATTF

EXTENSION: 3-0779

SUBJECT: MEXICO - Public Enterprise Reform Loan (Loan No. 3086-ME) Supervision Report

1. I carried out a supervision mission from December 4 to December 7, 1989 under terms of reference dated November 30, 1989. The report is attached. Mr. Linder, LAC Procurement Advisor, while in Mexico on a separate mission, joined me in the review of the regulations to the Procurement Law. Form 590 will be distributed separately.

2. The following reports in connection with the supervision mission will be entered in the Project Implementation Index File, forwarded to the appropriate Regional Information Center, and made available upon request:

Title of Report	Date Issued
Convenio de Desempeño:	
- CGF: Fertilizantes Mexicanos, S.A.	November 1989
- CGF: Altos Hornos de Mexico, S.A. de C.V.	November 1989
- CGF: Ferrocarriles Nacionales de Mexico	November 1989
- CGF: Siderúrgica Lázaro Cárdenas-Las Truchas, S.A.	November 1989
- CGF: Carbón y Minerales de Coahuila, S.A. de C.V.	November 1989
Reglamento de la Ley Federal de las Entidades Paraestatales	November 28, 1989
Reforma y Adiciones al Reglamento de la Ley de Obras Públicas	November 28, 1989
Proyecto de Reglamento a la Ley de Adquisiciones	November 1989
Artículos Correlativos del Reglamento de la Ley Federal de las Entidades Paraestatales con otras Disposiciones Legales	December 6, 1989
Balance de Entidades Paraestatales	November 1989
Ferrocarriles Nacionales de Mexico - TOR: Estudio sobre Precios Económicos y Tarifas para el Servicio de Pasajeros	
? Transferencias de Operación y de Inversión a las Entidades Paraestatales, Enero - Setiembre 1989	December 1, 1989
CGF: Avance y Perspectivas para la Simplificación del SII	December 1989

cc: Messrs/Mmes. E. Segura, M. Linder, M. Selowsky (LACVP); R. Steckhan, K.W. Lee (LA2DR); N. Hughes (LA2TF); M. Martinez, S. van Wijnbergen, J. Varallyay, J. Johnson, J. Rosenblut (LA2CO); H. Binswanger, J. Garcia-Garcia (LA2AG); R. Halperin, M. Dick (LA2IE); M. Iskander (LATTF); R. Goodland (LATEN); G. Psacharapoulos (LA2HR); J. Collell, K. Mettala (LEGLA); M. Sugar (LOAEL); E. Mangan, D. Babelon (ASTIF); M. Voljc (Resident Representative).

EMendez:fb

MEXICO - PUBLIC ENTERPRISE REFORM LOAN (Loan No. 3086-ME)

SUPERVISION REPORT

1. The mission focused on the eight pending actions, referred to as "next steps" in Mr. Knotter's letter to the Mexicans, dated November, 22, 1989 (Annex 2). All other conditionalities for second tranche release should be considered to have been complied with, as recommended in the previous supervision report dated October 23, 1989, and subsequent memorandum to Mr. Steckhan, dated November 17, 1989. The mission presented its conclusions to the Mexican authorities in a wrap-up meeting chaired by Mr. A. Gurria, Undersecretary of the Secretary of Finance and Public credit (SCHP), which was attended by Mr. Gazca Neri, Undersecretary of the Secretary of Programming and Planning (SPP), Mr. Eduardo Gonzalez, Undersecretary of the General Comptroller's Office (SECOGEF), and Messrs. C. Mancera, L. Almeida (SPP), B. Gomez Palacio (Interministerial Commission Expenditure/Finance), A. Cervera, A. Brito, C. Gutierrez (SCHP), J.C. Cardoso (SECOGEF), E. Flores Magon (SEMIP); and J. Delgado (Nacional Financiera S.N.C., NAFIN). Mr. Voljc, Bank resident representative, also attended the meeting. NAFIN, at my request, distributed during the wrap-up meeting a list of pending information to be furnished to the Bank in connection to the second tranche conditions of the PERL (Annex 1).

2. The status of all actual and remaining actions taken as of December 12, 1989, to meet second tranche release conditionality of the PERL is summarized in Annex 3. The mission recommends that overall progress in the implementation of the agreed upon actions for second tranche release of the PERL be considered satisfactory, once all pending matters referred to in paragraph 16 have been resolved to the Bank's satisfaction. The mission was reassured during the wrap-up meeting that all pending matters would be resolved by December 19, 1989.

3. Macroeconomic Consistency and Adequate External Financing (Schedule 1, section 4, paragraph b and c of the Loan Agreement)

Progress to date is satisfactory. Details on the actions taken in relation to these two conditions are provided in the forthcoming supervision report for the Financial Sector Adjustment Loan (FSAL).

4. Satisfactory progress in the Implementation of the Disengagement Program (Schedule 1 para 1)

Progress from January 1 to November 30, 1989 has been satisfactory: (i) 75 parastatals have been disengaged; (ii) 167 are at different stages in the process and (iii) some 80 additional public enterprises (PEs), identified as candidates for future disengagement by sector ministries, were under review by SECOGEF prior to requesting final authorization by the CGF to formally enter these PEs in the process. Accordingly, this condition has been met. (No specific quantitative target had been set to meet conditionality). Based on data for the period January - August 1989, the mission estimates that sales accounted for about three fourth of the total value of assets of PEs disengaged. Following numerous privatizations of small and medium size industrial and mining operations during 1987/88, privatizations during 1989 have been more complex in nature, including several agroindustries, especially sugar mills, an airline, and, though not yet completed, that of the telephone state monopoly. Upon completion of the disengagements already in process, only 42 PEs will remain in the industrial, energy and mines sector, down from 179 PEs in 1988.

MEXICO - STATUS OF PEs UNDER DISENGAGEMENT
AS OF NOVEMBER 30, 1989

	Asset value (%)	Number of public enterprises		
	Completed a/	Completed	In process	Total
Liquidation	23	25	82	107
Extinction	-	6	20	26
Mergers	-	3	10	13
Transfers	6	3	3	6
Sales	71	38	52	90
Total	100	75	167	242

Sources: Number of PEs: SECOGEF, mission estimates; Asset value: PE Sales Office, Ministry of Finance, mission estimates.

a/ Based on January-September data.

5. Issuance of regulations to the Procurement Law and to the Public Works Law, providing procedures, satisfactory to the Bank, for the provision of services by local and foreign suppliers and contractors (Schedule 1, para 3)

The regulations to the Public Works Law, which have been finalized and are scheduled to be issued by December 31, 1989, have been reviewed by Mr. Linder, and found satisfactory to the Bank. The regulations to the Procurement Law , however, are in draft and are only expected to be finalized, substantially in the form of the current draft, by late January. The draft regulations of the Procurement law state in article 4, para.III c) that SECOFI (ministry of trade and industrial promotion) "..is responsible for establishing the criteria for import authorizations for the public sector, in a manner consistent with article 31 of the Law." Mr. Linder found these draft regulations satisfactory, provided that article 4, in its application: (i) does not differentiate between public and private sector procurement of goods and services and (ii) is not in conflict with agreements reached with the IBRD regarding the ongoing removal of non-quantitative restriction on imports. The Mexican representatives explained to the mission that article 4 refers exclusively to the issuance of import licenses by SECOFI, without differentiating between private and public sector procurement. This will be officially confirmed in a letter about to be sent to the Bank.

6. Under the parallel Industrial Sector Policy Loan (ISPL), agreement has been reached with the Government authorities on first, the removal, from the list of products requiring import permits, of all industrial products, except for those regulated by sector programs (i.e. automotive, pharmaceutical and computer sector programs) and, second, the gradual phasing out of the imports licenses for products within such sector programs. The second agricultural sector loan (AGSAL II), currently under preparation, is expected to include progress in the removal of quantitative restrictions on agricultural imports as a tranche release condition. Consequently, upon written confirmation regarding the interpretation and application of article 4 as mentioned above, the mission recommends that the regulations be found satisfactory. Regarding the delay in the publication of the regulations, if management believes that disbursement of the second tranche should not be held up until its formal publication, the mission recommends to consider the draft as acceptable evidence. This is likely to require changes in the legal documents which might have to be approved by the Board. The justification for not insisting on formal publication would be that issuance of such regulations is not in the critical path of other PERL actions nor does a delay in its publication reduce the probability of success of the parastatal reform program.

7. Issue Regulations to the Law of Parastatals (Schedule 1, para 4)

The regulations have been approved by the Mexican President, will be issued on December 31, 1989, and will be in force beginning January 1, 1990 (the regulations cannot be enacted during 1989 as it would conflict with the Federal Budget Law of 1989). The Parastatal Law is subordinated to other Laws, which are more generic in nature and regulate some areas of the PEs and their regulatory agencies. Consequently, the focus of the regulations to the PE Law is on the definition of the role and composition of Boards of Directors (BODs) and Technical Committees of PEs, on the responsibilities of PE management and on the clarification of areas not covered with sufficient precision in the existing PE regulatory framework. The regulations are consistent with agreements reached upon during negotiations, regarding the detailed description of: (i) the role, composition, and accountability of the BODs and their Technical Committees, and (ii) the responsibilities of PE management. Some areas related to the supervision and control of PEs by Centralized Government Agencies, agreed upon during negotiations, are not explicitly dealt with in the PE regulations, as these are covered under other existing laws with its corresponding regulations. Based on the analysis of the regulations to the PE Law and of relevant articles contained in complementary legislation (i.e Ley Organica de la Administracion Publica Federal, Ley del Servicio de la Tesoreria de la Federacion, Ley General de Sociedades Mercantiles, Ley General de Titulos y Operaciones de Credito, Decreto del Presupuesto de la Federacion para el Ejercicio Fiscal de 1990, Ley Federal de Responsabilidades de los Servidores Publicos, and Ley de Presupuesto, Contabilidad y Gasto Publico Federal), the mission concluded that the detailed agreements reached during negotiations regarding the PE regulatory framework have been satisfactorily dealt with. Consequently, the mission recommends that the regulations to the PE Law be found satisfactory.

8. The regulations to the PE Law and modifications introduced in the Decree of the Federal budget for 1990 strengthen the composition of the BODs of PEs, allowing participation of private sector representatives.

The enhanced authority and responsibilities of BODs include, inter alia: defining the PEs' by-laws; final approval, upon recommendation from the chief executive officer (CEO), of PE production programs, adding, modifying or eliminating products and/or processes; setting prices of products not subject to price controls; final approval of borrowings and investments below limits to be established by SCHP and SPP, respectively; appointment, upon recommendation of the CEO, of the second and third layers of managers; defining the work contract to be entered with the CEO, setting income at levels consistent with market practices; approval of the corporate plans and multi-annual investment programs prior to these being forwarded to sector ministry; final approval of investments on office equipment and of the lease, purchase or sale of offices and buildings related to the operation of the PE; and the approval of annual budgets which are forwarded, via Sector Ministry, to SPP for its final approval based on macro-consistency of monetary and fiscal aggregates. The enhanced autonomy of BODs and CEOs is accompanied by increased responsibilities in the area of performance evaluation of PE staff and related sanctions or bonuses based on such performance. Accordingly, the PE Law and its regulations require the development, by the CEO, of internal evaluation mechanisms to measure the efficiency and effectiveness of staff and enterprise performance; the findings must be reported to the BODs at least twice per annum. Performance of BODs' members will also be closely monitored and evaluated by the BOD itself, as well as externally by the SECOGEF, based on standards laid out on the PE Law regulations and on the Law of Public Servant's Responsibilities. The BOD's, upon recommendation of the CEO, will approve or reject the establishment of an internal bonus system to promote PEs' staff productivity based on performance. The mission considers this to be fully satisfactory to meet the respective tranche release condition.

9. Regarding the financial autonomy of PEs, in addition to the above referred budgeting responsibilities provided to PEs' BODs and management, there are two important complementary actions to be implemented during 1990 and beyond. First, a document entitled "Manuales de Normas y de Procedimientos para el Ejercicio Presupuestario" is under preparation to be issued on December 31, 1989. This manual clarifies the term "public entity" referred to in the relevant budgeting Laws, expliciting that budgetary regulations, originally conceived for decentralized Government Agencies, will not apply to PEs of commercial nature. Consequently, budgeting procedures followed by PEs will be simpler, providing greater autonomy to PE management and BODs (for example, BODs will approve PEs' employment and salary structures and the technical approval by SPP on PEs' investment in information systems will not be required). Detailed examples of areas where PE budgeting process will be simplified as a result of the publication of such document will be furnished to the Bank by December 19, 1989. Second, it was explained to the mission that the quarterly "Convenios Deficit/Superavit", currently used as "locks" on PEs' operational and capital expenditures at a disaggregate level (e.g. calendarized ceilings imposed on labor, supplies, and other operational expenses), will evolve, starting on the first quarter of 1990, to a mechanism of monitoring and control of aggregates only. Accordingly, the operational "lock" will be on the quarterly operational deficit/superavit only and, as macroeconomic conditions improve, the period between "convenios" will be extended. The evolution of these contract is deemed necessary in order to provide PE management with the degrees of freedom

required for them to be autonomous and accountable for results, as is the case under the Performance Agreement contracts (below). During the mission the Mexican authorities agreed that a communication be sent to the Bank by a senior Government official by December 15, 1989, confirming the greater flexibility of future convenios Deficit/Superavit and the move away from expenditure ceilings at a disaggregate operational level.

10. <u>Signed Performance Agreements (PAs) with the Five Selected PEs and that such PEs are operating under the PAs (Schedule 1, para 5)</u>

The five PAs have been signed and the selected PEs will begin operating under such contracts on January 1, 1989. Though the PAs clarify the role of the PEs, clearly defining the enhanced autonomy of PE BODs and management, there is room for improvement in some of the indicators used to measure management performance. The PAs include between 13 to 21 indicators, some carrying insignificant weight in total evaluation, and others resulting in double counting and/or conflicting signals to PE management. These views were conveyed to the Mexicans by the mission and a follow-up meeting with a Mexican delegation at headquarters has been scheduled for Monday, December 18. Two possible outcomes are (i) that the review of some indicators be advisable at the end of the first quarter of operation of PAs, or (ii) that the risk of launching the PA scheme without renegotiating some indicators with PE management, based on the comments provided by Bank experts, be considered too great and thus should be made prior to initiating this scheme. Based on the outcome of the meeting, the mission will make a recommendation to management concerning compliance with this covenant of the PERL.

11. <u>Satisfactory progress in restricting Operational and Investment Transfers to PEs during fiscal year 1989 to levels consistent with the total aggregate PE transfers contained in the Federal budget for 1989 (Schedule 1 para. 8)</u>

Overall investment plus operational transfers between January 1 and September 30st, 1989, are consistent with the Federal Budget 1989. At a company level there have been, however, some noticeable deviations, such as those of FERTIMEX (fertilizer monopoly), CFE (electric power monopoly) and of IMSS (social security). These deviations were explained as follows: FERTIMEX cleared during the first semester some arrears scheduled for payment during the last quarter of 1989; requiring higher than expected transfers up to the third-quarter. Also, additional transfers were authorized on July to fund severance payment for 950 employees who left the company in connection with its restructuring program; CFE, though increasing its operational income above the budget, had to accelerate its investment program to respond to a higher than originally forecast growth in demand for 1989 (i.e. electric power consumption growth is estimated at 8.0% for the year, compared to 6.1% used as basis for the preparation of the original budget). As a result, investment transfers, above the level contained in the original budget, were approved; and, lastly, the IMSS received higher operational transfers because, after approval of its 1989 budget, it raised some pensions in line with Congressional amendments to social security legislation. The mission was also informed that aggregate transfers to PEs for investment and operational concept will remain in line for the rest of 1989, despite sharply higher projected transfers to controlled PEs shown in the Federal Budget report for 1990. This will be substantiated in detail in a forthcoming communication to the Bank. Given the above, and provided that we receive written confirmation that transfers for the whole of 1989 will remain in line with the original budget, the mission deems this condition fulfilled.

OPERATIONAL AND INVESTMENT TRANSFERS TO PEs BUDGET
AND EFFECTIVE DURING JAN. - SEPT. 1989
(in billion of Mex. $)

		Operational		Investment		Total	
		Budget	Realized	Budget	Realized	Budget	Realized
A.	Controlled PEs	1168.6	1257.8	714.1	797.0	1882.7	2054.8
	C.F.E.	-	-	74.8	224.8	74.8	224.8
	FERTIMEX	59.1	155.2	57.2	72.2	116.3	227.4
	CONCARRIL	21.5	6.1	-	-	21.5	6.1
	SICARTSA	130.8	118.9	78.1	12.2	208.9	131.1
	AZUCAR	347.1	197.0	-	2.5	347.1	199.5
	FERRONALES	-	-	123.5	96.3	123.5	96.3
	PROFORMEX	-	-	0.7	0.3	0.7	0.3
	FOVIGRO	0.6	4.1	0.2	0.6	0.8	4.7
	INMECAFE	28.0	38.0	1.0	0.5	29.0	38.5
	CONASUPO	581.5	613.7	27.3	22.6	608.8	636.3
	IMSS	-	124.8	351.3	365.0	351.3	489.3
B.	Non-Controlled PEs	8493.9	6917.1	2448.6	3011.9	10942.5	9929.0
C.	Total PEs	9662.5	8174.9	3162.7	3808.9	12825.2	11983.8

12. Commence study for the Economic Pricing in FERRONALES (Schedule 2, para I.1.(i)

Revised TORs have been furnished to the mission. These incorporate the Bank's comments on a previous draft TORs and are satisfactory. The short list of consultants, draft letter of invitation to consultants, technical proposal of winning bid and draft contract, will be made available to the Bank for comments as soon as possible. LA2 management endorsed the recommendation, made in Mr. Mendez memorandum to Mr. Steckhan (dated 11/17/89), to deem this condition satisfied upon the issuance of letter of invitation to consultants, should all other conditions for PERL's second tranche release be fulfilled prior to the initiation of this study.

13. Study to promote private Sector Presence in Areas currently Dominated by the PEs (Schedule 2, para I,1)

It was agreed during PERL negotiations that such study would apply to FERRONALES. Information was furnished to the mission on related actions already implemented by FERRONALES, including (i) actions already implemented to increase private sector presence in areas previously dominated by FERRONALES; (ii) studies already under way to promote the presence of private sector in new areas; and (iii) studies which are at the idea stage and would look into the possibility of developing additional mechanisms to further promote private sector presence within areas currently dominated by FERRONALES. On the basis of a review of the evidence provided, and upon receipt of a report documenting such actions, the mission recommends that the Bank deem this condition satisfied.

14. Revision of the Integrated Information System (IIS) to be followed by the PEs in the provision of information for evaluation and planning by the Guarantor (Schedule 2, para II.3)

In addition to the evidence about recent simplification of the IIS, resulting in a reduction in the number of reporting formats from 57 to 46, the Bank requested that an action program be prepared to further simplify the IIS. Based on the revision of this action plan, the mission considers this condition fulfilled. According to the action plan, (i) a survey about the use of information by each recipient Government agency will be undertaken and its results used to further simplify the IIS, redesigning the volume and formats of information requested from PEs, as deemed necessary in order to ensure IIS consistency with more autonomous PEs; and (ii) the system will be automatized, from PE level to the final user of information. The later would also provide ample room to further simplify the IIS, as it would allow to tailor made the information requests per PE (at present only a small proportion of the information requested in the IIS is applicable to each and every PE). It is expected that the first phase would be completed by the end of the first quarter of 1990, and the automation be initiated during the second quarter of 1990.

15. Commence a study on public investment evaluation and multi-year investment programming procedures; monitor the implementation of the budgeting and payment procedures for externally funded public investment projects (Schedule 2, para.II. 4 (b) and (e)

These two conditions are also included under the parallel FSAL. There has been some delay in contracting the investment study, but its preparation has been technically sound. Regarding the budgeting and payment procedures, satisfactory review took place during the FSAL supervision mission. Details on the actions taken in relation to these two conditions and recommendations regarding the delay in the investment study, are provided in the forthcoming supervision back to office report of the parallel FSAL.

16. Pending Actions

i) receipt of an official communication confirming the information provided to the mission regarding the interpretation and application of the article 4 of the Procurement Law (para 5);

ii) receipt of an official communication, from a senior government official confirming the future evolution of the Convenios Deficit/Superavit (para 9);

iii) receipt of an official communication indicating areas where the PE budgeting process will be simplified in connection with the document "Manuales de Normas y de Procedimientos para el Ejercicio Presupuestario" to be issued by December 31, 1989 (para 9);

iv) meeting at headquarters scheduled for Monday, December 18th, 1989, to review in detail the five Performance Agreements and decide whether changes to such documents is guaranteed prior to their coming into effect, or later, in the context of their first quarterly review. In the context of the first quarterly review, agreement must be reached on the Terms of Reference for consultants to (i) participate in such exercise and (ii) support the implementation of the PA information system. Lastly, the Bank must be furnished with a description of the procedures to be followed in the implementation of the bonus system under the PAs (para 10);

v) receipt of an official communication confirming that the transfers to PEs for the whole of 1989 will remain in line with the budget (para 11);

vi) receipt of an official communication providing examples under the three areas where actions are being implemented to promote private sector presence in activities undertaken by FERRONALES (para 13);

vii) issue the regulations to the Public Works Law (para 5) and to the PE Law (para 7);

viii) management decision is required on how to deal with the delay in the publication of the Regulations to the Procurement Law (para 6) and, in consultation with legal department, on the need to request Board approval of an ammendment to the Loan Agreement on a waiver if disbursement of second tranche should not be held up until publication of such regulations.

17. Regarding other changes recommended in this memorandum and in the memorandum to Mr. Steckhan (Annex 2), and which refer to the cancellation of some studies in Schedule 2 to the Guarantee Agreement --based on evidence provided to the Bank which make such studies redundant-- the second tranche condition referring to the Implementation Program set forth in Schedule 2 requires that progress, satisfactory to the Bank, be made in the implementation of such Program. It would therefore appear that such changes do not require of Board approval; this is to be confirmed by the legal department.

ANNEX 2

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 473-0779
Cable Address: INTBAFRAD
FAX: (202) 676-8373

November 22, 1989

Lic. Arturo Ortiz Hidalgo
Director de Organismos Internacionales
Nacional Financiera, S.N.C.
Insurgentes Sur No. 1971
Col. Guadalupe Plaza Inn
Torre Norte - 8 Piso
Mexico, D.F., Mexico

Lic. Antonio Cervera
Direccion General de Captacion de
Credito Externo
Direccion de Organismos Financieros
Internacionales
Secretaria de Hacienda y Credito Publico
Palacio Nacional, Edificio 4, 4to.Piso
06066 Mexico, D.F., Mexico

Re: Loan 3086-ME
Public Enterprise Reform Loan (PERL)

Dear Sirs:

We have reviewed several documents furnished to the Bank, after the PERL supervision mission, in connection with the second tranche release conditionalities detailed in Schedules 1 and 2 of the Guarantee Agreement of the PERL. The following comments do not cover those conditions which have been previously met as communicated in my letter to you dated October 26, 1989 (reference to paragraph number in the following are references to the respective paras of schedules 1 and 2 to the Guarantee Agreement):

Schedule 1, para 7: The document entitled " The 1989 Planning Process: Guidelines and Methodologies for 1990 Budgeting and Programing", issued by SPP on August 1989, provides a comprehensive set of guidelines for the budgeting and planning process at the sector and enterprise level and, consequently, this condition has been complied with, in respect of PE corporate program. As you are aware we have at an earlier stage communicated that the condition in respect to the National Development Plan was complied with.

Schedule 2, para I.1.(i): We have reviewed the Terms of Reference (TORs) submitted on November 15, 1989 and provided you with comments on a separate telex. Due to the delays in the submission of the TORs, it is of utmost urgency that you make every effort to assure that satisfactory procedures are followed in the most expeditious manner, as to avoid delays in the release of second tranche. We are prepared to help you as much as possible at our end by reviewing the revised TORs, short list of consultants, letter of invitation, technical proposal and contract, as soon as such documents are delivered to us.

<u>Schedule 2, para I.1 (iii)</u>: Information has been furnished to the Bank on actions already implemented at the <u>Comision de Fomento Minero</u>, <u>Fideicomiso de Recursos Minerales no Metalicos</u>, <u>Direccion General de Minas</u>, and <u>Consejo de Recursos Minerales</u>. Also, we understand that a task force has been established to review administration of national mineral reserves, and that a government policy statement with respect to (i) the creation of new national mining reserves; (ii) the discretionary powers that it expects to exercise over existing NMRs; and (iii) an overall plan for disincorporating existing reserves, is under preparation. On the basis of our preliminary review, we would be prepared to deem this condition satisfied; this, however, is subject to confirmation by senior Bank management, once we are in a position to evaluate compliance with all the conditions for the release of the second tranche.

<u>Schedule 2, para II.1</u>: Information has been furnished to the Bank on actions already implemented at AHMSA, SICARTSA, CMC and FERTIMEX. On the basis of our preliminary review, we would be prepared to deem this condition satisfied; this, however, is subject to confirmation by senior Bank management, once we are in a position to evaluate compliance with all the conditions for the release of the second tranche.

<u>Schedule 2, para II.2</u>: Information was furnished including, <u>inter alia</u>, the enforcement by SPP of PEs' adherence to the existing accounting norms and regulations in connection to the preparation of their annual budgets, a sample of letters sent by SPP to several PEs on April 1989, approving or rejecting their accounting records and budgets, and the regulatory framework empowering the General Controller's Office, through the comisarios placed at the PEs, for the monitoring and verification of PEs' compliance with accounting guidelines, norms and regulations. This condition has, therefore, been complied with.

<u>Schedule 2, para II.3</u>: CGF furnished evidence about recent simplifications to the integrated information system (IIS) resulting in a reduction in the number of reporting formats from 57 to 46, as well as, in the frequency of reports and number of PEs required to file information. The referred simplifications, and the reduced sized of the parastatal sector due to the sales, merges, transfers and liquidation of PEs, results in a total reduction of the number of formats submitted annually to the CGF of 37 %, from 280,000 to 176,0000. Our review of the IIS indicates that the simplification efforts have focussed on the quantitative side of the system, overseeing the apparent ample scope for simplification of a qualitative nature. The IIS includes a significant amount of reporting in areas which do not bear significance for the monitoring and control of PEs operations, financial performance and their impact on the fiscal budget. Consequently, it seems appropriate that a further effort be undertaken to review the IIS, particularly at this juncture, when PEs are to be provided with enhanced autonomy and accountability through the issuance of the regulations to the PE Law, as well as, through the launching of the Performance Agreement Scheme. Detailed comments about the IIS are provided in a document which we are forwarding to you separately. Given the above, in order to comply with this condition, we would need your submission of a satisfactory action plan to further simplify the IIS.

<u>Schedule 2, para II.5</u>: SPP's review of existing PE budgeting laws, regulations and practices concluded that the Budgeting, Accounting and Public Expenditures Law and the Organic Law of Public Administration, given their lack of specificity regarding differences between centralized and decentralized public

entities, severe'- constrain the financial autonomy and accountability of the PEs. Though current budgeting regulations could be appropriate for centralized government agencies and PEs that perform government functions and/or provide special social services such as hospitals and universities, these are too restrictive for most other PEs. Consequently, SPP furnished to the Bank an Action Plan to simplify budgeting procedures through the clarification of the term public "entities" referred to in the relevant laws, thus making it explicit that, except for specific cases, the budgetary regulations are not applicable to the PEs. The Manuales de Normas y de Procedimientos para el Ejercicio Presupuestario, to be issued in December 1989 for its enforcement in 1990 and beyond, will provide such clarification as well as simplify the PEs' investment approval process. The proposed action plan is satisfactory, thus complying with this condition.

Next Steps: The pending information to be furnished to the Bank for review, in connection with second tranche conditionalities of the PERL, is as follows:

A. Schedule 1, para 1: Update of the progress of the disengagement program (i.e., "Balance de Entidades Paraestatales," January 1-October 31, 1989);

B. Schedule 1, para 3: Revised regulations to the Public Procurement Law;

C. Schedule 1, para 4: Regulations to the Law of Parastatals;

D. Schedule 1, para 5: Signed Performance Agreement contracts with the five selected public enterprises;

E. Schedule 1, para 8: Update of operational and investment transfers to PEs (preferably up to September 30), indicating deviations from the approved fiscal budget for 1989;

F. Schedule 2, para I.1.(i): Revised TORs for the study on economic pricing in FERRONALES and, subsequently, short list of consultants, draft letter of invitation to consultants, technical proposal of winning bid, and draft contract;

G. Schedule 2, para I,1.(ii): TORs and, subsequently, short list of consultants, draft letter of invitation to consultants, technical proposal of winning bid, and draft contract, of a study on methods to contract, on a competitive basis, with private sector companies, services and activities which are currently being undertaken by selected PEs.

H. Schedule 2, para II.3: Action plan to further simplify the integrated information system, in a manner consistent with the enhanced autonomy to PEs embodied in the Regulations to the PE Law and Performance Agreement Scheme (see comments on schedule 2, para II.3 above)

Please note that, in addition to the above mentioned project related conditions, the Bank, prior to the release of the second tranche, has to be satisfied with compliance with paragraph a through c of section 4 of Schedule 1 to the Loan Agreement. As you are aware, November 30th, 1989, the target date for second tranche release is approaching soon, and although the pace at which PERL has been implemented so far is most commendable, there are still several important actions to be completed in order to meet all requirements for tranche release, including the initiation of the two studies which have fallen well behind schedule. We are planning to visit Mexico during the week beginning December 4, by which time we would like to have received and hopefully, depending on the timing of receipt of information, also reviewed all the documents listed to in the above paragraph. It is critical that every effort be made to furnish such information to us as soon as it becomes available, in order to avoid unnecessary delays in the process. As stated earlier, you have our full commitment to review information furnished to us as soon as possible.

Yours sincerely,

Paul Knotter
Chief
Trade, Finance and Industry Division
Country Department II
Latin America & the Caribbean

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 17, 1989

TO: Ranier Steckhan, Director LA2

THROUGH: Paul Knotter, Division Chief, LA2TF

FROM: Enrique Mendez, LATTF

EXTENSION: 30779

SUBJECT: MEX-PERL: Update of Project Status

1. This note (a) makes reference to documents reviewed, after the supervision mission, in connection with the Second Tranche conditionalities described in the Guarantee Agreement sections: Schedule 1, 7; Schedule 2,I.1.(i); Schedule 2,I,1.(iii); Schedule 2,II.1; Schedule 2,II.2; Schedule 2,II.3; and Schedule 2.II.5; (b) makes recommendations on how to deal with emerging issues, and (c) solicits your reaction to the attached draft follow-up letter which I propose to send to Mexico as soon as possible.

2. Schedule 1, 7 "That the Guarantor has furnished evidence to the Bank that...the sector programs contain guidelines for PE corporate programs".

The Mexican authorities furnished to the Bank a document entitled: "The 1989 Planning Process: Guidelines and Methodologies for 1990 Budgeting and Programming", in lieu of the sector programs which have not yet been finalized. The document, issued by SPP on August 1989, provides a comprehensive set of guidelines for the budgeting and planning process at the sector and enterprise level and, consequently, we recommend that this condition be considered complied with. The contents of the report include (i) general guidelines and responsibilities by the different Government agencies in the budgeting and planning process; (ii) a detailed calendar of activities conducive to the submission of Sector and PEs' Budgets to the Congress; (iii) detailed guidelines for the elaboration of annual budgets and investment programs at the enterprise level and (iv) detailed reporting requirements at the enterprise and sector level.

3. Schedule 2.1.(i) "Commence study, under terms of reference acceptable to the Bank, on the economic price of railway transportation in Mexico"

TORs were submitted for Bank review on November 15, 1989. Mr. Dick (LATIE) reviewed the TORs and provided comments which we have already forwarded to the Mexicans. Due to the delays in the submission of the TORs, the study will not commence prior to November 30th, 1989. Such delays, however, bear no significant impact on the successful implementation of PERL. Moreover, the undertaking of this study will be closely monitored by the Bank in connection with a possible deregulation operation being prepared by LA2IE -- results of this study are expected to provide the basis for price adjustment conditionalities under such loan. Consequently, it is recommended that, in the event of satisfactory compliance with all other Second Tranche Release conditionalities, the Bank be prepared to accept issuance of the Letter of Invitation to consultants as satisfactory evidence of compliance with this covenant.

4. Schedule 2.1.(iii) "Commence a study to reassess the role of governmental mining agencies in light of the reduced participation of PEs in the mining sector"

Evidence has been furnished to the Bank on actions already implemented and which make the study redundant. These actions are acceptable and we support the exemption of the study. A waiver would be required in the context of Second Tranche Release. Reference is made to (i) the merging of the Comision de Fomento Minero and the Fideicomiso de Minerales no Metalicos and the development of various action plans to first, clean up the non-performing portfolio of CFM, second, improve the efficiency of the financial and budgeting department, and third, to manage the mining portfolio which remains under CFM (ii) the modernization of the main activities at the Direccion General de Minas, including computerization of its administrative functions, the streamlining of the mining licensing procedures and the strengthening of its monitoring of exploration commitments, in order to cancel concessions which remain undeveloped beyond reasonable time; and (iii) the discontinuation of the functions as credit agent by Consejo de Recursos Minerales, focussing its activities in the provision of geological technical assistance and support.

5. Schedule 2.II.1 "Provide the bank TOR to assess and improve the financial management of selected PEs, and propose remedial action as needed".

Evidence has been furnished to the Bank on actions already implemented in four large PEs and which make the study redundant. These actions are acceptable and we support the exemption of the study. A waiver would be required in the context of Second Tranche Release. Reference is made to:

(i) actions undertaken in AHMSA to redefine and streamline its information systems, improve the evaluation system of operational performance in the areas of productivity and quality control, and to improve accounting, making it more suitable to the company's needs. Also, and as part of the modernization program, the implementation of an integrated computerized system for information and control is contemplated, thus facilitating the integration of the various administrative and operational areas, improving and systematizing inventory management, quality control, procurement, storage, transport and shipping, preventive maintenance and the evaluation process;

(ii) SICARTSA's Master Plan, which is well advanced in its implementation, and aims to improve the quality and timely availability of information flows to management, raise product quality, and improve utilization of plant capacity. Some of the specific actions included in the Plan are the upgrading of office and plant technology, to streamline and improve information flows for management, and to improve maintenance management systems, product quality control, and inventory management;

(iii) the modernization program currently underway in Carbon y Minerales Coahuila, S.A., including the automation in some areas to expedite information, production control and administrative processes. Financial information systems are being integrated in order to provide support to management in the decision-making process and elaboration of reports to the Federal Government. In the short run, CMC expects to install a satellite communications network to serve as liaison among the various mining areas and the holding company; and

(iv) actions implemented in FERTIMEX, within the context of the organizational restructuring currently under implementation. Such actions include, inter alia, the development of a (1) cost accounting system per plant and per region, in order to establish independent cost and profitability centers; (2) operations model to evaluate alternatives for fertilizer supply, determine the influence zones of each productive plant and improve fertilizer distribution; (3) financial model to carry out medium-term financial projections and establish the basic criteria for enterprise restructuring; (4) integrated information model to develop information systems suitable to the company's needs and support the strategic planning and decision-making process, thus facilitating the evaluation and follow-up actions of FERTIMEX reorganization.

6. Schedule 2.II.2 "Furnish to the bank evidence that a program, satisfactory to the bank, for the use by the PEs of the accounting rules included in the Catalogo de Formatos e Instructivos del Sector Paraestatal".

The existing norms and regulations make the adherence by the PEs to the accounting guidelines issued by SPP compulsory. Accordingly, the regulation provides for three different vehicles by which the accounting practices and records of PEs are monitored and reviewed, assuring their consistency with guidelines contained in the Catalogo de Formatos e Instructivos del Sector Paraestatal and the Normas de Informacion Financiera. First, the General Controller's Office (SECOGEF) assigns external auditing companies from the private sector to each PE for the annual review of the accounting statements; the assessments of the external auditors is reviewed by SECOGEF and reports about irregularities and inconsistencies with the existing accounting norms and regulations are prepared. Second, and as laid out in the document Marco de Actuacion de las Contralorias Internas de la Administracion Publica Federal, SECOGEF, through the comisarios placed at the PEs, monitors and verifies PEs' compliance with accounting guidelines, norms and regulations, as well as the implementation of corrective actions which derive from the assessment of the external auditors. Finally, Article 42 of the Public Sector Budget, Accounting and Expenditure Law states that SPP is responsible for the issuance of accounting guidelines to be followed by parastatals and for the monitoring and control of accounting practices by PEs. The accounts of PEs are submitted to SPP for review and approval during the process of budget preparation, and their approval or rejection are officially communicated to the PEs in written form (sample letters sent by SPP to several PEs on April 1989, approving or rejecting their accounting records and budgets are in the PERL file). In cases where the accounting records are found to be unsatisfactory, SPP requests from the PE to undertake corrective action and resubmit their accounts for further review and approval. The enforcement by SPP and the Controller's office of the use of sound accounting standards by PEs is satisfactory, and meets the requirements of this legal covenant.

7. Schedule 2.II.3 "Revision by CGF of the integrated information system to be followed by the PEs in the provision of information for evaluation and planning by the Guarantor".

CGF furnished evidence about recent simplifications to the integrated information system (IIS) resulting in a reduction in the number of reporting formats from 57 to 46, as well as, in the frequency of reports and number of PEs required to file information. The referred simplifications, and the reduced sized of the parastatal sector due to the sale and liquidation of PEs, results in a total reduction of the number of formats submitted annually to the CGF of 37%, from 280,000 to 176,000. Our review of the IIS indicates that the simplification efforts have focused on quantitative aspects only, overseeing the apparent ample scope for simplification of a qualitative nature. The IIS includes a significant amount of reporting in areas which do not bear significance for the monitoring and control of PEs' operations and financial performance. It seems appropriate, therefore, that further efforts be undertaken to review the IIS, particularly now that regulations to the PE Law and the Performance Agreement Scheme, provide PEs with greater autonomy. Accordingly, we recommend to provide detailed comments about the IIS to the Mexicans and request that, in order to comply with this covenant, CGF prepare and satisfactory action plan to further simplify the IIS.

8. Schedule 2.II.5 "Furnish to the Bank, a plan of action, acceptable to the Bank, to deregulate, simplify and expedite the budgeting procedures and practices applicable to PEs under the Performance Agreement Plan".

As stated in the supervision back to office memo, SPP's review of existing PE budgeting laws, regulations and practices concluded that the Budgeting, Accounting and Public Expenditures Law and the Organic Law of Public Administration, given their lack of specificity regarding differences between centralized and decentralized public entities, severely constrain the financial autonomy and accountability of the PEs. Though current budgeting regulations are appropriate for centralized government agencies and PEs that perform government functions and/or provide special social services such as hospitals and universities, these are too restrictive for most other PEs. Consequently, SPP furnished to the Bank an Action Plan to simplify budgeting procedures through the clarification of the term public "entities" referred to in the relevant laws, thus making it explicit that, except for specific cases, the budgetary regulations are not applicable to the PEs. The Manuales de Normas y de Procedimientos para el Ejercicio Presupuestario, to be issued in December 1989 for its enforcement in 1990 and beyond, will provide such clarification as well as simplify the PEs' investment approval process, eliminating inter alia the approval requirement by SPP of PEs' investments in information systems. The proposed action plan is satisfactory, but the impact of the simplification of the budgeting process and control to be granted to PEs will be subordinated to the issuance of satisfactory Regulations to the PE Law.

9. Next Steps. Your endorsement to the recommendations referred to throughout this memorandum would narrow the actions pending for full compliance with second Tranche Conditionalities of the PERL to the satisfactory implementation of actions in seven different areas; in order to assess the progress in such areas, the following information must be furnished to the Bank:

a. Update of the progress of the disengagement program (i.e., "Balance de Entidades Paraestatales," January 1-October 31, 1989);

b. Revised regulations to the Public Procurement Law;

c. Regulations to the Law of Parastatals;

d. Signed Performance Agreement contracts with the five selected public enterprises;

e. Update of operational and investment transfers to PEs (preferably up to September 30), indicating deviations from the approved fiscal budget for 1989;

f. Revised TOR for the study on economic pricing in FERRONALES and, subsequently, short list of consultants and draft letter of invitation.

g. Action plan to further simplify the integrated information system, in a manner consistent the enhanced autonomy to PEs embodied in the Regulations to the PE Law and Performance Agreement Scheme.

10. We plan to communicate to the Mexicans our views on the documentation furnished to us in connection with PERL, indicating next steps and the urgency of their prompt implementation (draft attached).

cc: Messrs/Mme. E. Segura (LACVP); M. Martinez, J. Varallyay (LA2CO); R. Halperin (LA2IE); M. Dick (LATIE); M. Iskander (LATTF); E. Mangan, D. Babelon (ASTIF); J. Collell, K. Mettala (LEGLA); J. Sugar (LOAEL); Black Book.

ANNEX 3

STATUS OF COMPLIANCE WITH LEGAL COVENANTS AS OF DECEMBER 11, 1989

MEXICO
PUBLIC ENTERPRISE REFORM LOAN

...ment	Section	Status	Original Date	Proposed Revised Date	Description of Covenant	Comments
Guarantee	Schedule 1					
	1.	OK			Satisfactory progress in the implementation of the PE Divestiture Program.	Completed.
	2.	OK			Empower CGF to make recommendations for the approval or rejection, on a case-by-case basis, of the creation of PEs and PE subsidiaries.	Completed
	3.	Soon			That the Guarantor has issued satisfactory regulations to the Procurement Law and to Public Works Law.	Regulations to the PWL, to be issued by December 31, 1989, are satisfactory. Procurement Law regulations, still in draft, expected to be issued by late Jan. 1990. Draft satisfactory to the Bank subject to official communication certifying that application of article 4 does not conflict with agreements reached with the Bank on trade liberalization.
	4.	Soon			That the Guarantor has issued satisfactory regulations to the PE Law.	Satisfactory regulations have been approved by the President of Mexico and are expected to be issued on Dec. 31, 1989.
	5.	OK/soon			Have signed Performance Agreements with five selected PEs.	Completed. Fine-tuning of PAs expected during first quarter review of the system (to be confirmed).
	6.	(a) OK			(a) That UCD is fully opeating in accordance with the UCD mandate, and	Completed.
		(b) OK			(b) that progress satisfactory to the Bank has been made in the implementation of the UCD Plan.	Completed.

...ement	Section	Status	Original Date	Proposed Revised Date	Description of Covenant	Comments
	7.				That the Guarantor has furnished evidence to the Bank that:	
		(a) OK			(a) the National Development Plan of the Guarantor contains guidelines for the elaboration of sector programs, and	(a) Completed.
		(b) OK			(b) such sector programs contain guidelines for PE corporate programs.	(b) Completed. Guidelines contained in the document "El Proceso de Planeacion 1989," August 1989.
	8.	Soon			Satisfactory progress in restricting PE transfers to levels consistent with the Guarantor's budget for fiscal year 1989.	Satisfactory progress during January-Sept., 1989; awaiting confirmation that estimate for the whole of 1989 also in line with budget.
	9.	Soon			Satisfactory progress in carrying out the Implementation Program as follows:	(see below)
Guarantee	Schedule 2					
	Implementat-ion Program					
	I.1.(i)	Soon	July 31, 1989	October 31, 1989	Commence study on the economic price of railway transportation.	TORs agreed upon, study expected to commence in coming weeks.
	I.1.(ii)	OK	July 31, 1989	October 31, 1989	Commence study on methods to increase private sector presence in areas currently dominated by PEs.	The mission recommends that based on evidence of actions already implemented in the sector, which make the proposed study redundant, management consider this condition fulfilled.
	I.1.(iii)	OK	Oct. 31, 1989		Commence study to reassess the role of governmental mining agencies in light of the reduced participation of PEs in the mining sector.	Actions already implemented in the sector make the proposed study redundant.

...ement	Section	Status	Original Date	Proposed Revised Date	Description of Covenant	Comments
	II.1.	OK	July 31, 1989	October 16, 1989	Provide to the Bank terms of reference, satisfactory to the Bank, to assess and improve the financial management of selected PEs and propose remedial action, as needed.	Evidence of actions already implemented in the sector makes the proposed study redundant.
	II.2.	OK	Aug. 31, 1989	October 6, 1989	Furnish to the Bank evidence that a program, satisfactory to the Bank, for the use by the PEs of the accounting and auditing rules, is included in the CFISP.	Completed.
	II.3.	OK	Sept. 30, 1989		Revision by CGF of the integrated information system to be followed by the PEs in the provision of information for evaluation and planning by the Guarantor.	Completed. Evidence of the simplification of the information system has been complemented by a satisfactory Plan of Action for further simplifications in 1990.
	II.4.(a)	OK	Sept. 1, 1989		Furnish terms of reference for a study on public investments evaluation and multi-year investment programming procedures establishing a centralized unit for monitoring such investments.	Completed.
	II.4.(b)	Soon	Oct. 15, 1989		Commence the carrying out of such study pursuant to such terms of reference.	Supervision of this clause is under the parallel Financial Sector Adjustment Loan; the study has not yet commenced.
	II.4.(c)	NYD	March 15, 1990		Complete such study pursuant to such terms of reference.	
	II.4.(d)	NYD	April 15, 1990		Provide to, and discuss with the Bank, a plan or plans of action, acceptable to the Bank, to adopt measures to improve public investment evaluation and programming procedures.	

Agreement	Section	Status	Original Date	Proposed Revised Date	Description of Covenant	Comments
	II.4.(e)	OK	Aug. 31, 1989		(i) monitor the implementation of its budgeting and payment procedures for externally funded public investment projects; and	Completed. Satisfactory review of (i) and (ii) took place during the supervision of the parallel Financial Sector Adjustment Loan.
					(ii) exchange views with the Bank on the implementation of such procedures and on the measures to improve such procedures.	Completed (as above).
	II.5.	OK	Sept. 30, 1989		Furnish to the Bank a plan of action to deregulate, simplify and expedite the budgeting procedures and practices applicable to PEs under the Performance Agreement Plan.	Completed. First stage in such plan will be finished by Dec. 31, 1989 with the publication of a document clarifying the budgeting regulatory framework.

Key:

OK : Covenant complied with
SOON : Compliance expected in reasonably short time and, unless specified otherwise, no later than December 31, 1989
NYD : Not yet due

Banamex Stake Of 31% Is Sold To Investors

Hernandez Ramirez Seeks Additional 40% of Bank, Confirming Mexico Bulls

By DIANNA SOLIS
Staff Reporter of THE WALL STREET JOURNAL

MEXICO CITY—A controlling stake in Mexico's largest nationalized bank, **Banamex**, was sold for $3.25 billion to an investment group led by Roberto Hernandez Ramirez, a self-made Mexican millionaire and head of a brokerage house.

The price fetched by the crown jewel of the 18-bank state system once again confirms the bullish confidence in Mexico's economic turnaround. The sale of the stake—which was sold for 2.62 times its book value, that is, assets minus liabilities—is the seventh state-bank privatization to bring prices that have averaged three times book value.

Mr. Hernandez Ramirez, 49-year-old president of **Acciones & Valores de Mexico**, and his 800-member investment group purchased a controlling 31% stake in Banamex, and surprised some at the Mexican Ministry of Finance and Public Credit by offering to buy two more stakes, totaling an additional 40% of the bank's stock. About 29% of Banamex has traded publicly on the Mexican stock exchange. And yesterday, the stock responded positively to the news, rising to 16,100 pesos, or about $5.29 a share, up 400 pesos, or 13 cents a share, from Friday.

The winning Banamex bid came in at 19,220 pesos, or $6.32, a share.

Mexican authorities had structured the sell-off in digestible chunks, with a 31% controlling stake and two 20% options. Analysts said Mr. Hernandez Ramirez was hell-bent on purchasing Banamex and only Banamex: The competing bid was 2.3 times the book value of Banamex.

Mr. Hernandez Ramirez and his associates refused repeated phone calls during the past week leading to the sale but have scheduled a news conference for today.

Many industry analysts and Mexico watchers termed the privatization of Banamex "the crowning feat" in the program of economic liberalization of President Carlos Salinas de Gortari. Once facing tri-

Sales of Existing Homes ... After Rising for Five Co...

ECONOMY

By MITCHELL PACELLE
Staff Reporter of THE WALL STREET JOURNAL

After five months of steady gains, sales of existing single-family homes slumped in July, damping hopes that the housing recovery would outpace the sluggish national economic recovery.

Existing homes sold at a seasonally adjusted annual rate of 3.35 million, down 6.7% from June, and up just 0.9% from the year-earlier level, according to the National Association of Realtors.

The median national sales price was $103,000, up 1% from June and up 5% from a year earlier.

The July decline in sales volume follows two months of sharp gains that carried sales to an annual rate of 3.59 million, which economists now consider unsustainable.

"The May and June numbers were surprisingly high," says David Berson, chief economist for the Federal National Mortgage Corp. "Today's number puts the existing home sales consistent with other figures indicating a modest recovery rather than a strong one."

"It is consistent with other [national economic] data, which are mixed and less than impressive," said David Hensley, director of the UCLA Business Forecasting Project. "Very few [economic data] tend to be moving on with uninterrupted growth."

Construction Activity Bounced Back in July, Rising 7% From June

By a WALL STREET JOURNAL *Staff Reporter*

NEW YORK—After retreating 4% in June, new construction contracting bounced back 7% in July, according to F. W. Dodge, **McGraw-Hill Inc.**'s forecasting unit.

The Dodge Index rebounded to 144 from 134 in June. The index is seasonally adjusted, using 1982 as its base year of 100.

Total construction value rose 7% in July to an annualized rate of $226.36 million, up from $211.16 million in June.

In contrast to June, when nonresidential construction—including commercial and industrial building—wilted, July showed the past week leading to the sale but have scheduled a news conference for today.

Many industry analysts and Mexico watchers termed the privatization of Banamex "the crowning feat" in the program of economic liberalization of President Carlos Salinas de Gortari. Once facing triple-digit inflation, massive capital flight and the migration of many Mexicans to the U.S., Mr. Salinas now presides over the greatest economic upsurge since before oil prices crashed in May 1981.

"This sale is clearly a major bet on the future of Mexico," said Alan J. Stoga, a senior associate at the New York consulting firm Kissinger & Associates. "Mexico has moved beyond its debt crisis."

The Financial Community

Added Jorge Mariscal, head of Latin-American research for Nomura Securities Co.: "What you are seeing is Mexico becoming part of the North American financial community. Soon, the level of risk in Mexico is going to approach that of Canada and other advanced countries."

Banamex has assets of about $26 billion, 30,000 employees and 720 Mexican branches. It also has 28 offices outside Mexico. In 1978, Banamex bought a San Jose, Calif., bank, now California Commerce Bank, to gain a foothold among California's burgeoning Hispanic population. Plans to buy a bank in Houston were stalled recently when U.S. regulatory authorities requested additional information.

The new owners of Banamex will inherit the seasoned management of Antonio Ortiz Mena, who was twice a finance minister during Mexico's so-called miracle years of economic boom in the 1960s. He also served as president of the Inter-American Development Bank for 17 years until 1988. Mr. Ortiz Mena, however, is almost 80 years old.

The 'Vultures'

Mexico's bank nationalization in September 1982 immediately followed the country's default on the prinicipal of its then $60 billion foreign debt, jolting the private sector. President Jose Lopez Portillo expropriated the banks to stymie the "vultures" he said were sending their money out of the country after the oil-price collapse. Rather than stanch the capital flow,

Please Turn to Page A4, Column 4

CORRECTIONS & AMPLIFICATIONS

BAY STATE GAS Co. isn't a unit of Summit Bancorp. as reported in yesterday's edition.

justed, using 1982 as its base year of 100.

Total construction value rose 7% in July to an annualized rate of $226.36 million, up from $211.16 million in June.

In contrast to June, when nonresidential construction—including commercial and industrial building—wilted, July showed gains in housing and nonresidential construction.

"Although home building has been gaining steadily, if not spectacularly, since early this year, nonresidential work has been erratic at best," said George A. Christie, Dodge's chief economist. "Lacking the support of the troubled commercial real estate market, which includes apartments and condos as well as offices and hotels, this recovery will develop slowly by past standards."

Residential construction grew 6% in July, continuing an unbroken rise since February, to $101.11 billion from $95.78 billion, after seasonal adjustment. Residential construction in July was 25% above its January low, with virtually all of the gain centered on single-family home building.

Nonresidential building rose only 2%, to $73.68 billion from $72.22 billion, reflecting continued weakness in that sector. But nonbuilding construction surged 19%, to $51.57 billion from $43.16 billion, reflecting a below-average June and the start of a $400 million cogeneration plant being built in New Jersey.

For the first seven months of the year, total unadjusted values of all newly started construction was down 14% to $130.1 billion from $150.46 billion a year earlier. By region, the West suffered the most, with a 19% decline in total construction value, while the South Central region showed only a 1% decline. The Northeast dropped 10%, while the North Central and South Atlantic regions each saw a 15% decline.

	a-July '91 Construction Contract Val. (000,000)	Seasonally Adjusted % Change From Prev. Month
Nonresidential bldg.	$73,682	+ 2
Residential building	101,105	+ 6
Non-building constr.	51,570	+ 19
Total construction	226,357	+ 7

a-Monthly construction contract values are reported on an annualized, seasonally adjusted basis.

	7 Months 1991 (000,000)	7 Months 1990 (000,000)	Cumulative % Chg
Nonresidential bldg.	$45,445	$53,333	– 15
Residential building	55,068	66,870	– 18
Non-building constr.	29,591	30,256	– 2
Total construction	130,104	150,459	– 14

THE WALL STREET JOURNAL (USPS 664-880)
Editorial and publication headquarters:
200 Liberty St., New York, N.Y. 10281.

Published daily except Saturdays, Sundays and general legal holidays. Second class postage is paid at New York, N.Y., and other mailing offices. Subscription rates (postage paid): In the United States, territories and possessions, two years $238, one year $139, 6 months $71, 3 months $37; foreign rates on request at the Chicopee, MA address.
POSTMASTER: Send address changes to The Wall Street Journal, 200 Burnett Rd., Chicopee, MA 01020.

All Advertising published in The Wall Street Journal is subject to the applicable rate card, copies of which are available from the Advertising Services Department, Dow Jones & Co. Inc., 420 Lexington Ave., New York, N.Y. 10170. The Journal reserves the right not to accept an advertiser's order. Only publication of an advertisement shall constitute final acceptance of the advertiser's order.

11501 Columbia Pike, Silver Spring, Md. 20904

Cham
ation
cost o
The
appro
Cham
to stoc
sory b
bank
amou
eral's
mum
No
purch
Ameri
be con
pion
with a
billion

rn California

California Banks Could Face Moderate Hits

(In billions)

	COMMERCIAL REAL-ESTATE LOANS	WORST-CASE LOSS[1]	YEARLY INCOME[2]
Wells Fargo	$12.4	$1.0	$1.5
Security Pacific	11.1*	0.9	1.9
BankAmerica	8.5	0.7	2.5
First Interstate	5.0	0.4	0.4

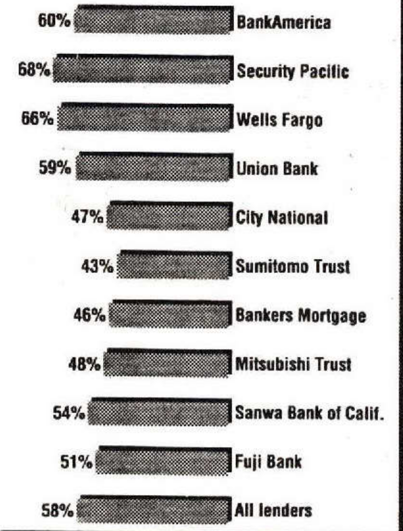
[1]Assumes 20% become non performing, with average loss rate of 40%

[2]Annualized first half 1991 income before taxes and loan-loss provision

*Sutro & Co. estimate Source: Sutro & Co.

While a Credit Crunch May Eventually Ease the Glut

Percent decline in construction lending for top 10 construction lenders in L.A. and Orange counties (first half '91 vs. '90)



Source: Dataquick Information Systems, San Diego

? Los Angeles
Estate Disaster

loans to build homes or offices and generate proceeds to repay his land loans.

"You can't get blood out of a turnip," says Mr. Watt, who laid off half his staff of 700 people last fall, sold his corporate jet and will build only 1,200 units this year, half as many as in 1989. Plans for California Springs have been scaled back. And after a vain search for big tenants, Mr. Watt is desperately trying to sell the downtown land, but any buyer he may find isn't likely to find financing.

Similarly, Transpacific's Mr. Curci can't get funds for the improvements needed to fill rising vacancies in his buildings and can't sell any properties in his $1 billion portfolio because, he says, the market "is almost nonexistent." So, he hasn't paid interest on some of the $140 million he and his partners owe Wells Fargo.

Mutual Benefit's Rescue Efforts Delayed As Insurers, Regulators Split Over Sale

By SUSAN PULLIAM

Staff Reporter of THE WALL STREET JOURNAL

Hopes of a bailout of **Mutual Benefit Life Insurance** Co. policyholders by **Metropolitan Life Insurance** Co. and **Prudential Insurance Co. of America** are fading because of a split between the two huge insurers and state regulators.

Until recently, the two insurers played a large role in the rehabilitation of Mutual Benefit, initially agreeing to back Mutual Benefit's future sales. Most recently, they agreed to help New Jersey Insurance Commissioner Samuel Fortunato come up with a plan for selling Mutual Benefit, a role regulators hoped would eventually lead to their purchase of some or all of Mutual Benefit's businesses.

Now both companies say that is increasingly unlikely. Harry Kamen, executive vice president of Metropolitan, said the chances are "slight" that Met will be involved in a rescue of Mutual Benefit, although he added that the insurer has told the Insurance Department that it is "willing to cooperate." Prudential is unwilling to acquire any of Mutual Benefit's businesses, especially if it means "transferring large losses" to Prudential, said James Gillen, senior vice president.

Mutual Benefit, Newark, N.J., was taken over by New Jersey state insurance regulators in July after suffering heavy losses on its real estate portfolio.

The difference in opinion between the insurers and regulators centered on how far Met and Prudential were willing to go to bail out policyholders. Under an initial plan devised by Met and Pru, Mutual Benefit's businesses would have been split apart and sold, with the state's newly formed guaranty fund chipping in to cover losses on Mutual Benefit's assets. One estimate of the toll on the guaranty fund stood at $100 million, people close to the situation say.

Mr. Fortunato said, however, that he does not want a piecemeal solution for the rehabilitation of Mutual Benefit's businesses. "We're hopeful [they] will sit at the table and look at a global solution."

But Mr. Fortunato said he is considering putting Mutual Benefit's corporate owned life insurance business up for sale separately. He said he believes the company could sell for about $225 million. Earlier, the company announced the sale of its group health business for $300 million in cash and $200 million in notes.

The change in attitude at the nation's two largest insurers is just the latest in a series of bumps in the road to recovery for Mutual Benefit, which had $13.8 billion in assets before it was seized by regulators in mid-July.

Chief among the problems faced by regulators has been finding someone to run the company. Mr. Fortunato put that issue behind the company two weeks ago when he announced that Victor Palmieri, a turnaround specialist had been named as trustee for Mutual Benefit.

His appointment capped one month of dizzying changes in the management of the company.

The confusion in the rehabilitation effort has delayed even further a solution for policyholders, whose funds are tied up with the insurer. Prudential's Mr. Gillen said the two insurers believed they could have developed a plan within four to eight weeks. Mr. Fortunato admits the process has hit a "bit of a slowdown." He said, however that he expects negotiations on the sale of Mutual Benefit's businesses to begin in "a couple of months."

Banamex 31% Stake Is Sold to Investors, 40% More Is Sought

Continued From Page A2

the nationalization seemed to confirm the conviction among the monied class that their wealth wasn't safe at home.

While nationalization was widely viewed as a slap against capitalism, some analysts concede that it helped to end the incestuous relationships between major industrial groups and the leading banks they controlled. Key to the entire bank privatization is whether smaller credit-hungry enterprises will be able to obtain long-term loans at manageable interest rates. Mexico is now in its second month of negotiations on a tariff-busting free-trade pact with the U.S. and Canada and grumbling is increasing among entrepreneurs eager to compete, but fearful they won't get the credit rates to do so.

The bank nationalizations spawned a parallel banking system of stockbrokerage and insurance firms. The government encouraged the parallel bankers by ceding such services as marketing treasury bills that had been the exclusive domain of banks.

In nearly each of the seven banks that were de-nationalized, a brokerage house has led the investment group buying the bank. Mexico has no law comparable with the 1933 U.S. Glass-Steagall Act, which separates banks and securities firms. Embracing the so-called universal bank model of Europe, the new Mexican bankers hope to capitalize on the synergies of melding brokerage and insurance client lists with bank client accounts, analysts say.

Ross Stores Inc.

Ross Stores Inc., Newark, Calif., said second-quarter net income rose 74% to $8.7 million, or 35 cents a fully-diluted share, from $5 million, or 21 cents a share, a year earlier.

The off-price retailer said sales rose 20% to $232 million from $193 million. Sales at stores open for more than a year were up 4%.

In the first half, earnings increased 64% to $10.8 million, or 44 cents a share, from $6.6 million, or 28 cents a share, a year earlier. Sales rose to $431 million from $364 million.

Pratt & Whit

HARTFORD, (
a unit of United T
was chosen to pro
the Republic of K
16 fighter aircra
as much as $500

The contract i
majority of which
and built in Kore

Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No. 9428-ME

STAFF APPRAISAL REPORT

MEXICO

MINING SECTOR RESTRUCTURING PROJECT

MAY 30, 1991

Infrastructure and Energy Division
Country Department II
Latin America and Caribbean Regional Office

CURRENCY UNIT PESO (MEX$)

On May 20, 1991, the exchange rate in the controlled market was US$ = Mex$2980.40; and in the free market US$1 = Mex$3002. The controlled exchange rate is currently being devalued by Mex$0.40 a day.

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

Metric System

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

CETES	Certificados de Tesorería (Treasury Bills)
CFM	Comisión de Fomento Minero (Mining Development Commission)
CRM	Consejo de Recursos Minerales (Mineral Resources Council)
DGM	Dirección General de Minas (General Directorate of Mines)
FFM	Fideicomiso de Fomento Minero (Trust Fund for Mining Development)
FMNMM	Fideicomiso de Minerales No Metálicos Mexicanos (Trust Fund for Mexican Non-Metallic Minerals)
FRR	Financial Rate of Return
GDP	Gross Domestic Product
LIBOR	London Interbank Offered Rate
NAFIN	Nacional Financiera, S.N.C.
NMMP	National Mining Modernization Program
NMR	National Mining Reserve
PECAM	Programa Especial Complementario de Apoyo a la Pequeña y Mediana Minería (Small and Medium Scale Mining Project)
PFI	Participating Financial Intermediary
SEDUE	Secretaría de Desarrollo Urbano y Ecología (Ministry of Urban Development and Ecology)
SEMIP	Secretaría de Energía, Minas e Industria Paraestatal (Ministry of Energy, Mines and Parastatal Industry)
SMM	Small and Medium Scale Mining Enterprise

MEXICO
STAFF APPRAISAL REPORT
MINING SECTOR RESTRUCTURING PROJECT

Table of Contents

This report is based on the findings of an appraisal mission and a post-appraisal mission, which visited Mexico in September 1990 and January 1991. Mission members were: Messrs. Alberto F. Jiménez de Lucio (Task Manager, LA2IE), N. Hughes (Original Task Manager, AS1IE), F. Remy (AFTIE), P. Fozzard (AFTIE), I. Rizo (LA2IE), I. Rivera (LA2C2), M. Stoller (Cons.), T. Heintz (Cons.), T. Loomis (Cons.) and K. Rock (Cons.). Mrs. Rafaela Reff assisted in the production of this report.

List of Annexes

MEXICO

MINING SECTOR RESTRUCTURING PROJECT

LOAN AND PROJECT SUMMARY

Borrower:	Nacional Financiera, S.N.C. (NAFIN)
Guarantor:	United Mexican States
Executing Agencies:	Comisión de Fomento Minero (CFM), Fideicomiso de Fomento Minero (FFM), Consejo de Recursos Minerales (CRM) and Dirección General de Minas (DGM)
Amount:	US$200 million equivalent.
Terms:	17 years, including 5 years of grace, at the standard variable interest rate.
Relending Terms:	NAFIN would relend the proceeds of the Loan to the Guarantor and CRM. The Guarantor would further onlend to FFM the amount (US$191.5 million) to be relent through the commercial banking system to small and medium scale mining enterprises (SMMs). Subloans would be denominated in Mexican pesos or U.S. dollars at the option of the subborrower. The cost to FFM of peso funds would be the 28-day CETES (Treasury Bills) rate and the cost of dollar funds would be the three month LIBOR (London Interbank Offered Rate) plus 0.5%, in line with Mexican internal guidelines on the transfer of external resources from the Government to trust funds. The cost to participating financial intermediaries (PFIs) in pesos and dollars would be the respective rates plus an FFM fee, adequate to cover financial intermediation costs. For both peso and dollar denominated subloans PFIs would be free to set the lending rate to final borrowers. The Government of Mexico would assume the foreign exchange and cross-currency risks on peso subloans and the cross-currency risk on dollar denominated subloans.
Project Objectives:	The main objectives of the proposed project are to: a) support the Government's program to deregulate the mining sector and stimulate private domestic and foreign investment through the establishment of an appropriate policy and institutional framework; b) build broader financial market support to the mining industry; and c) help finance the surge in demand for investment funding that is expected to result from the improved policy and institutional setting for mining operations.

Project Description:

To accomplish its objectives the project, in addition to providing financing for SMMs, would support the following policy changes and institutional reforms in the mining sector: (i) liberalizing private sector access to land with mineral potential and releasing state-held mining reserves; (ii) reducing barriers to foreign investment in mining enterprises; (iii) implementing a mineral rights policy that is conducive to an improved allocation of resources; (iv) reforming the system of mining concessions; (v) phasing out state ownership of enterprises in the sector; (vi) modernizing the government agencies providing support to small and medium scale mining enterprises; (vii) establishing environmental standards for the mining sector; and (viii) phasing out direct Government financing of mining activities.

The proposed loan would provide financing for:
(i) a credit component of US$191.5 million, representing 95.75% of the loan, to help fund subloans to SMMs for the acquisition of fixed assets (including pollution control equipment), permanent working capital and the development of existing mineral reserves; and (ii) technical assistance of US$8.5 million, representing 4.25% of the loan, mainly to help fund institutional strengthening programs for DGM and CRM.

Project Benefits and Risks:

The proposed project would help develop Mexico's mining sector, which is believed to have strong growth potential, in an environmentally sound manner. The recent changes in the regulatory framework providing for, inter alia, increased private sector access to land and mineral rights, and for the streamlining of concession procedures and majority foreign ownership of mining firms, should result in higher investment by private domestic and foreign companies. Furthermore, the reorientation of the sector's policies and public institutions in favor of activities that directly support private mining exploration and exploitation, and the increase in commercial bank lending for mining operations that would be expected to be initiated by the project, should also lead to higher investment in the sector. Increased investment would in turn result over time in higher mining output, exports and employment. Moreover, the establishment of environmental standards for the mining industry should help ensure that the sector's development is sustainable.

Policy reversals, which would be the main concern to private investors, seem unlikely given Mexico's impressive and sustained efforts to open up and deregulate its economy. Hence, the main project risks relate to issues that could adversely affect loan disbursements: a) continued low international metal prices; b) an overvalued exchange rate; and c) lower than expected commercial bank participation in lending to mining, particularly during the coming years when these banks are to be privatized. The potential negative impact of these risks is, however, ameliorated by the fact that Mexico is a low cost mineral producer, the Government has export promotion as a key objective of its economic policy and CFM/FFM have been successful in the past in attracting commercial banks to financing non-metallic mining operations. Moreover, the proposed loan amount has been based on a conservative demand estimate for financial resources. In this context, the risks faced by the project are considered acceptable.

Estimated Costs:	Local	Foreign	Total
	(Millions of U.S. Dollars)		
Equipment	114.0	191.5	305.5
Civil Works (Mine Dev.)	58.0	7.0	65.0
Working Capital	31.0	-	31.0
Exploration	21.0	3.0	24.0
Technical Assistance	2.5	8.5	11.0
TOTAL	226.5	210.0	436.5
Financing Plan:			
Beneficiaries	138.9	10.0	148.9
World Bank	-	200.0	200.0
Government (CFM)	66.3	-	66.3
PFIs	21.3	-	21.3
TOTAL	226.5	210.0	436.5

Estimated Disbursements:	FY92	FY93	FY94	FY95	FY96
	50.0	40.0	45.0	45.0	20.0
	50.0	90.0	135.0	180.0	200.0

Rate of Return: Eligible subprojects should have financial rates of return (FRR) of at least 12%, reflecting the cost of capital in the Mexican market.

I. THE ECONOMY AND THE MINING SECTOR

A. Macroeconomic Context

1.1 Over the past three years macroeconomic policy in Mexico centered around the "Economic Solidarity Pact" (Pacto), an agreement between business, labor and government. This agreement called for accelerated structural reform, further tightening of monetary and fiscal policy, a freeze of minimum wages and of basic public and private sector prices, and, the cornerstone of the Pacto, a freeze of the nominal exchange rate against the U.S. dollar. This partial freeze was extended at three-month intervals through the end of 1988, and was renewed with some modifications by the present Mexican Administration, under the name of "Pact for Stabilization and Growth" (PECE). The main change under the PECE was a daily adjustment of the exchange rate against the U.S. dollar. The recent extensions of the Pacto have reduced price controls. Moreover, remaining controlled and public sector prices have been increased considerably. Thus, progress has been made towards the reduction of interference in private price setting behavior. The PECE is currently running until the end of 1991.

1.2 The fiscal measures, backed by the temporary exchange rate freeze and the array of formal and informal wage and price controls, have had dramatic success in reducing the rate of inflation, from 159% in 1987 to 20% in 1989. Some rebounding occurred in 1990, however, as inflation rose to 30%. The increase in inflation observed in 1990 cannot be ascribed to lack of fiscal austerity. It is due, instead, to the above mentioned loosening of price controls and upward adjustment of controlled and public sector prices. On the whole, the program has clearly been a success. It is in particular noteworthy that a major recession has been avoided; in fact, this period has seen the recovery of economic growth, as GDP rose by 3.1% in 1989 and an estimated 3.9% in 1990.

1.3 Mexico has transformed itself throughout this period of macroeconomic turmoil into one of the most open economies in the world by undertaking an extensive trade reform. Trade liberalization, most of which took place between 1985 and 1988, has lowered the percentage of domestic (non-oil) tradeable production covered by import quotas from 100 percent in 1984 to less than 15 percent at present. Maximum import tariffs were cut by similar magnitudes. Non-oil merchandise exports, which represented less than one-third of total exports in 1984, have since doubled their share.

1.4 The aforementioned reforms have been complemented by several others. Foreign investment regulations were considerably relaxed and made more transparent. The tax system underwent a series of reforms, as marginal tax rates were brought more in line with levels in major industrial countries, repatriation of flight capital was encouraged, and sanctions for tax evasion were increased. In addition, the impact of inflation on the corporate tax system was eliminated by removing purely inflationary gains from the tax base. At the same time, the Government initiated a process of financial market liberalization. Ceilings on commercial banks' deposit interest rates and forced allocation of commercial credit towards favored sectors were abolished, and credit subsidies through official development banks were substantially eliminated. More recently, the privatization of the commercial banks, which were nationalized in 1982, was announced. The process of bank privatization was initiated early this year.

1.5 Notwithstanding the far reaching reforms implemented in Mexico, international capital markets did not provide the resources needed to service the external debt. The Government therefore initiated negotiations to restructure its external debt in early 1989. On September 15, 1989, the Government of Mexico and the Bank Advisory Committee representing the commercial bank creditors reached agreement on a financing package covering the period 1989-92, that entailed restructuring US$48.9 billion of Mexico's external debt. The debt relief package has reduced Mexico's net transfer to its creditors by almost $4 billion per year over the 1989-1994 period, i.e. slightly below 2 percent of GDP on average.

1.6 The increase in oil prices caused by the Gulf crisis has had a substantial impact on the Mexican balance of payments. The oil windfall gain in 1990 is estimated to have been around US$3 billion. The situation, however, is one of uncertainty as to the future course of oil prices. Thus, the Government recently created an oil contingency fund to insulate its 1991 budget from oil price fluctuations, assuming oil prices don't fall below US$10 per barrel on average. Finally, the Government is scheduled to begin negotiations on a free trade agreement with the United States and Canada later this year. This agreement should help to both consolidate the structural change achieved so far, and to accelerate structural change in areas where adjustment has lagged, e.g. agriculture and services.

1.7 Mexico's fiscal adjustment over the past decade has been extraordinary, its primary balance turned from a deficit of 7% of GDP into a surplus of around 5% in the mid-eighties. This surplus was further increased to between 7% and 8% of GDP in the last couple of years. The period over which the adjustment has been sustained is as impressive as its extent. Today, the fiscal balance exerts no inflationary impulse, as it can be financed without reliance on monetary financing. Thus, Mexico's fiscal adjustment is more than adequate for controlling inflation and provides cause for optimism regarding future economic growth.

B. Sectoral Context

1. Structure and Importance

1.8 The mining sector in Mexico contributes 1.5% and 1% to total GDP and employment, respectively (see Annex 8, Table 1). The sector is characterized by the concentration of production in a few big enterprises, mostly private, that coexist with a large number of small and a handful of medium firms [1/]. The total value of Mexico's mining production in 1990 was US$2.5 billion, of which about 90% was accounted for by the big firms. Another characteristic of the sector is the wide variety of metallic and non-metallic minerals produced (see Annex 8, Table 2).

1.9 Notwithstanding its relatively small GDP share, the Mexican mining sector is a world leading producer of a number of minerals, in addition to its traditional first place in world silver production. As of 1989, Mexico was the largest world producer of bismuth, sodium sulfate and strontium. It was second in barite and fluorspar, third in graphite, antimony and soda ash; and was a leading producer of many other minerals (see Annex 8, Table 3).

1.10 While Mexican mineral production includes a large variety of minerals, it is highly concentrated in a few products. Three minerals, silver, copper and zinc, accounted for 55-65% of the gross value of production in the last decade. However, their relative contribution changed significantly over the period. Thus, between 1980 and 1990 silver (partly reflecting historic lows in silver prices) reduced its participation from 42% to 14%, copper increased its share from 16% to 30% and zinc also increased its share from 8% to 20% (see Annex 8, Tables 4 and 4A).

1.11 A substantial part (about 60%) of Mexico's mineral production is exported. Thus, mining output is more linked to international mineral prices than to fluctuations in domestic market demand. Mining sector exports reached US$1.5 billion in 1990, accounting for 5.7% of total exports (see Annex 8, Table 1). Export growth over the past 10 years has been due mainly to the increased production of copper and zinc, and to a lesser extent of non-metallic minerals; which have more than offset the decline in the value of silver exports, resulting from the collapse of its price during the last decade (see Annex 8, Tables 2, 5 and 5A). Nonetheless, silver remains at the center of Mexican mining today.

2. Institutional Framework

1.12 Mining in Mexico is guided by Article 27 of the Constitution, and the Mining Law and its "Reglamento" (implementing regulations). The Government's supervisory body for the sector is the Secretaría de Energía, Minas e Industria Paraestatal (SEMIP), through the Subsecretaría de Minas e Industria Básica (see Annex 8, Table 11), with the support of two General Directorates (Dirección General de Minas and Dirección General de Operaciones Minero-Metalúrgicas) and three semi-autonomous agencies (Comisión de Fomento Minero, Fideicomiso de Fomento Minero and Consejo de Recursos Minerales).

1/ A small (medium) scale mining enterprise, SMM, is defined by CFM as having an annual production value not in excess of US$3.0 (US$35.0) million and a daily production capacity of less than 200-300 (2,000-2,500) tons a day for metallic and non-metallic operations, respectively. This definition is also being used to determine eligibility for Bank financing under the proposed project.

1.13 The Dirección General de Minas (General Directorate of Mines; DGM) administers the sector and consequently is responsible for: a) establishing mining policy; b) granting and controlling mineral concessions and assignments; c) establishing and assigning National Mining Reserves (NMRs); d) keeping the Mining Public Registry and the Mining Cadastre; and e) applying and supervising the observance of the Mining Law and its "Reglamento". The GDM employs 259 people, 127 in its central office in Mexico City and 132 in its 8 regional offices throughout the country (see Annex 8, Table 11A).

1.14 The Dirección General de Operaciones Minero-Metalúrgicas (General Directorate of Mining-Metallurgical Operations) is responsible for: a) coordinating and controlling mining parastatal enterprises; b) preparing and reviewing sectoral programs; and c) coordinating the activities of the public institutions that provide financial and technical assistance to miners, including managing their budgets. In addition, until mid-1989 it supervised the "Programa Especial Complementario de Apoyo a la Pequena y Mediana Minería" (Small and Medium Scale Mining Project; PECAM), established under previous Bank lending for the sector.

1.15 The Comisión de Fomento Minero (Mining Development Commission; CFM), was established in 1934 as a multi-purpose public entity to promote and develop mining, particularly SMMs, in the metallic subsector. CFM functions as: a) a holding company for state participation in mining enterprises; b) an owner and operator of mines and beneficiation plants; c) a credit and technical assistance agency; d) an operator of research plants and laboratories, selling services to private and parastatal enterprises; and e) a major holder of land in National Mining Reserves. CFM has a staff of 1,206 people, including 506 professionals, located mostly in its Mexico City office (see Annex 8, Table 12).

1.16 The Fideicomiso de Fomento Minero (Trust Fund for Mining Development; FFM), was created in early 1990 to replace and supersede the Fideicomiso de Minerales No Metálicos Mexicanos (FMNMM), which had been established in 1974 as a trust fund of the Government under NAFIN. The main functions of FMNMM were to promote the development of non-metallic minerals and to allow indigenous agricultural communities ("ejidos") to benefit from the non-metallic operations located within their territory. Over time FMNMM had moved away from exploration and investment activities and become mainly an efficient and fast growing credit agency; however, it remained limited to the non-metallic subsector. The new trust fund, FFM, remains under NAFIN but is administered by CFM and provides financing and technical assistance to both metallic and non-metallic SMMs.

1.17 The Consejo de Recursos Minerales (Mineral Resources Council; CRM), was established in 1955 as the public institution responsible for: a) carrying out geologic-mining exploration and quantifying the country's mineral resources; b) supporting SMMs through financial and technical assistance; c) providing recommendations to the Government on the areas and minerals that should be considered NMRs; d) advising the Government on matters related to the exploration, exploitation and preservation of mineral resources; and e) coordinating its research work with other public entities and preparing the country's mining geology inventory. In the past, CRM has not limited itself to the basic infrastructure and research work characteristic of a geological survey institute, but has also spent considerable effort in undertaking a wide range of exploration activities, including detailed exploration and pre-feasibility work under contract and in areas over which it has control. CRM has a full time payroll of 503 people and a larger part-time and temporary staff, spread among its central office, four regional offices and a Mexico City office (see Annex 8, Tables 14, 15 and 16).

II. REFORM AND RESTRUCTURING OF THE MINING SECTOR

A. Mining Sector Potential

2.1 Mexico is a country with vast mining potential. Its comparative advantage as a mineral producer includes: a) polymetallic ores of high quality and high precious metal content, b) a wide range of exportable non-metallic minerals, c) a low wage structure, d) a broad base of experienced mine workers and professionals, and e) a strategic location next to its most important market, the United States, plus access to both oceans. This comparative advantage is so significant, that although exploration efforts to date have been relatively modest, Mexico is a major mineral producer and exporter (para. 1.9).

2.2 Notwithstanding the above, mining is today a relatively small and declining sector within the Mexican economy. Over the past 50 years mining output has decreased from 4.0% to 1.5% of GDP. Stringent policy barriers to entry to domestic and foreign investors, as well as a complex and discretionary regulatory framework, have impeded the realization of the sector's full potential by restricting private participation (e.g. 50% of the 12 million hectares of discovered mineral land are currently reserved for the State). This regulatory framework also resulted in a very bureaucratic and inefficient administrative structure in the public agencies that deal with the sector.

2.3 The Bank shares the view of the Government that Mexico's mining sector has significant growth potential. Total annual exploration investment in the recent past is estimated at US$40 million; however, based on statistics from other countries, exploration investment could reach 8 to 10% of output value or about US$200 million a year, i.e. five times the current level (see Annex 8, Table 6). A comprehensive 1989 Bank study of Mexico's mining sector, entitled Republic of Mexico-Mining Sector Review, states that increased access to land and mineral rights, reduced foreign ownership limitations, a revision of mining tax legislation, a restructuring of the existing institutional setup, and stabilization of the macroeconomic environment are the basic elements for Mexico to more fully exploit its comparative advantage in the mining sector. By helping to eliminate the sector's main policy and institutional constraints, the proposed project is expected to stimulate private investment in mining by both domestic and foreign firms.

B. National Mining Modernization Program, 1990-1994

2.4 The National Development Plan 1989-1994, which provides the global context for economic policy, sets as the general objectives for the mining sector: a) providing an adequate supply of mining-metallurgical inputs for local industry, b) strengthening the commercialization of mining-metallurgical products in international markets, with emphasis on those of higher value added, and c) promoting profitable transformation processes. These objectives are to be reached through the modernization of the sector.

2.5 In 1990 the Government issued a sectoral strategy program entitled "National Mining Modernization Program 1990-1994" (NMMP), which complements the National Development Plan by providing the specific policy framework for the mining sector. The objectives of said program are: increasing mining exploration; revising and updating mining legislation; modernizing mining administration with emphasis on decentralization; updating tax legislation to make mining internationally competitive and to encourage investment; strengthening the Government's promotional role, and encouraging a more direct participation by the national private and social sectors, as well as by foreign investment; maintaining state participation only in those firms that exploit strategic minerals as defined by the Constitution and the Mining Law; developing mining projects in backward areas; promoting better industrial safety and social welfare conditions for miners; and taking measures to protect the environment, reducing the contamination caused by the mining-metallurgical activity.

2.6 In order to attain the above objectives, the Government has prepared a number of specific operational programs, where detail is provided on the various actions to be taken in each case. Moreover, the Government has already taken significant steps towards executing these programs, including in particular the recent issuance of new implementing regulations ("Reglamento") to the Mining Law, which are discussed below. Given the importance of the new regulations, agreement was reached at loan negotiations that any material change in the "Reglamento" that could adversely affect the objectives of the proposed project or any occurrence that would prevent its implementation, would be an event of default (para. 4.1, i).

2.7 It is expected that the implementation of the NMMP will result in: a 2.2-2.6% annual real mining sector output growth for the 1990-1991 period, rising to 4.5-5.0% for the 1992-1994 period; the release for private sector development of half the land currently under National Mining Reserves (NMRs) between 1990 and 1994; and a 3.7% annual employment increase in the mining industry. Progress towards achieving these goals would be monitored through annual reviews, to be conducted jointly between the Government and the Bank (para. 4.1, ii).

C. Mineral Rights Policies

2.8 Ownership of all mineral deposits by the Mexican Nation creates a situation in which market processes cannot operate efficiently. Therefore, appropriate Government mineral rights policies are needed, in particular for two closely related issues that affect mineral output: a) the criteria and procedures for allocating mineral rights to private firms and individuals, and b) the taxes and other payments attached to mineral rights concessions and to mineral production. A brief description of the previous situation and of the major changes introduced by the new "Reglamento" of the Mining Law in relation to these matters is provided below.

1. Mineral Rights Allocation System

2.9 Two aspects of the mineral rights allocation system have been hindering development of and investment in Mexico's mineral resources: a) the vast amount of land tied up by the State and thus unavailable to the private sector for exploration, and b) the inefficient administration of the concession system. Private sector access to land and mineral rights is an essential factor for vigorous mining development, but in the past was severely limited by the Government through the establishment of national mining reserves and the issuance of decrees assigning land to public entities, and the protracted, often discretionary, processing of requests for mining rights.

2.10 NMRs can be established with respect to both areas and minerals; afterwards they can be assigned to CFM, CRM, a state-owned enterprise (SOE) or may remain unassigned (see Annex 8, Table 7). When not dealing with "strategic" or "priority" minerals, special mining concessions within reserves can be granted to private parties. The area under NMRs at year-end 1990 was 4.4 million hectares. The Government can also assign land directly to public entities and institutions by decree (see Annex 8, Table 8). The areas assigned are often those where mineralization has been detected, thus, the negative impact of this policy is more significant than may be inferred from the absolute number of hectares involved, 1.9 million as of December 31, 1990.

2.11 Mineral land not reserved by the State is made available for private sector use through concessions; at year-end 1990 the total area under concession was 6.1 million hectares (see Annex 8, Table 9). However, due to cumbersome procedures and inefficient administrative practices, the award of a mineral concession took on average 6 years from the date of application. Since exploration concessions were issued for 3 years and could be renewed for 3 more years, the filing of an application for a concession could effectively lock up an area for up to 12 years. Moreover, the procedures for approving the transfer of a mineral concession were also slow and complicated.

2.12 Mexican mineral rights policies are in the process of being substantially reformed to promote more efficient development of the mineral endowment. Noteworthy are: a) the release of state-held mining reserves and restrictions on future establishment of such reserves, and b) the modernization of the administrative systems for processing concessions, as to substantially reduce the time required to obtain or transfer a mineral concession.

2.13 With regard to its land reservation policy, the Government has decided to: (i) release for private sector development not less than 50% of existing NMRs within four years, which under the new regulations only requires Ministerial approval; and (ii) limit the designation of new reserves to minerals for which future scarcity can be proved. Furthermore, SEMIP now intends to release 2.7 million hectares in 1991, thereby exceeding in a single year the four year goal set in the NMMP and significantly increasing the area with mineral potential available for concession to the private sector.

2.14 With regard to its concessions policy, the Government has: (i) streamlined administrative practices and substituted automaticity for discretion, thereby reducing the time required to issue an ordinary concession to 1 year, which a new computerized cadastral system will further reduce to three months in the near future; (ii) eliminated the requirement for DGM prior authorization for transferring concessions, making the same similar to any other transfer of rights and providing a major stimulus to the secondary market in mineral rights, and (iii) introduced an auction mechanism for allocating "special" (i.e. within NMRs) concessions.

2. Mineral Rights Payments

2.15 An important issue in the discussion of mineral rights payments is their effect on the efficient allocation of resources. Mexico uses three types of payments: royalties (ad valorem), surface taxes and work requirements. In the past, substantial ad valorem taxes applied to mining output, whereas surface taxes and work requirements became increasingly irrelevant due to inflation. This resulted in significant distortions in resource allocation, high ad valorem taxes discouraged production and minimal surface taxes and work requirements encouraged holding idle land.

2.16 The new "Reglamento" has introduced changes in relation to mineral rights payments that complement the modernization of the mineral rights allocation procedures. Surface taxes and work requirements have been increased from negligible to moderate levels and have been tied to inflation (see Annex 8, Tables 10 and 10A). In addition, the recent Federal Rights Law eliminated royalty payments from 1991 onwards. These changes shift payments from the production phase, during which they reduce the incentive to produce, to the exploration phase, during which they provide an incentive not to hold concessions that are not worth investment in exploration. Moreover, the new "Reglamento" provides that the surface taxes and work requirements apply equally to private holders and to reserve holders of mineral land, thereby introducing an incentive for public entities to release those holdings they do not intend to explore or exploit soon.

2.17 The changes recently introduced regarding the allocation system and payments for mineral rights represent a major improvement over previous land management policies. In order to evaluate the impact of the new regulations and to provide an analytical basis for adjusting the same in the future, the proposed project would include financing for two studies: a) a first one on the effectiveness of the recent changes in the regulatory framework, particularly in terms of increasing private domestic and foreign investment in mining exploration and exploitation, and b) a second one on alternative approaches to mineral rights allocation and payments, which would include a comparative analysis of mining policy in other countries. Before evaluating the results of the new regulations they must be in place for a reasonable period. Therefore the terms of reference and timing for the studies, to be conducted by consultants satisfactory to the Bank, would be discussed and agreed upon during the first joint annual project review (para. 4.1, iii).

D. Foreign Participation

2.18 A major constraint to the growth of the mining sector, until recently, originated from a provision of the Mining Law restricting direct foreign investment. Foreign ownership of mining enterprises operating in ordinary concessions was limited to a 49% equity share, and ownership of companies obtaining special concessions on national mining reserves was further limited to a 34% equity share only. Moreover, some of the "priority" minerals (i.e. sulfur, potassium and phosphates) could only be exploited by enterprises with state majority ownership. Such limits constituted a significant barrier to entry of foreign companies and thereby discouraged foreign investment in the mining sector.

2.19 The most effective measure to promote foreign investment in the mining sector would be to eliminate the existing foreign ownership restrictions. However, such a change entails modifying the Mining Law, an action the Government considers not desirable at present. Instead, the new "Reglamento" has introduced ownership alternatives, based on the use of trust funds and a pyramiding scheme, that enable foreign investors to circumvent the limits established under the Mining Law. These ownership alternatives, discussed below, represent a very significant advance in opening up the mining sector to foreign investment.

2.20 The new "Reglamento" extends to mining the trust fund mechanism successfully used for many years in the real estate and tourism sectors. The mechanism is simple. Foreign investors can own up to 100% of a trust fund established by a Mexican financial institution, which in turn can purchase the 51% equity share of a firm reserved for Mexican ownership by the Mining Law, as the trust fund is considered to be Mexican (the other 49% can be owned outright). There are two basic types of trust funds, the first one requires prior approval from SECOFI (Ministry of Trade and Industrial Development), whereas the second one needs only be recorded in the Mining Public Registry. The first type was already contemplated in existing legislation for other sectors and has now been made applicable to mining; however, the second type of trust funds has been introduced by the new "Reglamento" and applies exclusively to mining.

2.21 Under the new type of trust funds foreign investors interested in an exploration concession can establish a 30 year, renewable, exploration trust fund. If interested in an exploitation concession, they can establish a 13 year, non-renewable, exploitation trust fund. After that period the trust fund must be Mexicanized (51% ownership must be sold to Mexicans); however, the time limit only starts to run when the beneficiation plant begins industrial scale production. In other words, the exploration, development and construction phases are covered by the exploration trust fund. Moreover, the foreign investor can retain ownership and control of the firm beyond said time limit by pyramiding his investment, as described below.

2.22 The other important ownership alternative introduced by the new "Reglamento" relies on a pyramiding scheme, which in the case of a firm holding an ordinary concession operates as follows: foreign investors acquire 49% of the stock in firm A (the other 51% is owned by Mexicans according to the Mining Law), which in turn acquires the 51% of firm B owned by Mexicans (the other 49% of firm B is purchased directly by the foreign investors); firm B in turn acquires the 51% of firm C owned by Mexicans (the other 49% is again purchased directly by the foreign investors), and so on. In practice, foreign investors own 87% of firm C (74% of firm B), however, since the initial firm (A) acquiring 51% of firm B owned by Mexicans is itself 51% owned by Mexicans, both firms B and C are considered to be majority owned by Mexicans, and therefore in compliance with the limits set by the Mining Law. In the case of a firm holding a special concession the scheme operates in an analogous manner, except that foreign investors can only own directly 34% of all firms (A, B, C...).

2.23 The new "Reglamento" also extends to mining an ownership alternative already applicable to other sectors, whereby international financial development institutions can acquire stock in mining companies without limits. However, said stock does not entitle its owner to management control (it is considered neutral), which remains in Mexican hands. Finally, the new regulations allow local private firms to exploit priority minerals previously limited to enterprises with state majority participation.

2.24 As a result of the aforementioned changes, the business climate for private investment in the mining sector has improved considerably and there are already indications of significant investor interest, reflected in the hiring of local law firms by foreign companies to set up trust funds for investment in mining. The potential contribution of foreign firms to the Mexican mining sector is not only investment in general, but also opening new mining districts outside the traditional mining areas where local firms prefer to invest, and improving the efficiency and productivity of the sector through the use of modern technologies. In addition, the geographical location of Mexico should attract small scale foreign miners, who could bring risk capital and adequate technologies to the small and medium mining subsector.

E. Institutional Modernization

1. General Directorate of Mines (DGM)

2.25 The implementation of the Mining Law's new "Reglamento" requires the use of modern technology and systems, which will represent a qualitative change in the way DGM presently functions. More specifically, DGM's document control system, mining cadastral system (including both the public registry and cartographic offices), obligation control system and the statistics office are being reformed. This modernization will result in decentralization of many processes and increased effectiveness by: a) establishing more systematic, automatic and computerized internal controls and procedures, b) eliminating redundant and unnecessary requirements, and c) utilizing state of the art technology.

2.26 Agreement has been reached with DGM on a program to implement the modernization described above, to be partly funded by the proposed Bank loan (para. 4.1, iv). At present, off-the-shelf specialized software is being adapted and hardware is being installed for the areas of Document Control, Public Registry and Cartography, with financing under the Bank's second small and medium scale mining project (PECAM II, Loan 2546-ME). In addition to the activities already under way, the program entails the acquisition of software and hardware for the areas of Control of Obligations and Statistics, the completion of the mining geodetic net of Mexico and the interconnection between DGM offices. These activities would require an estimated US$1.257 million in financing from PECAM II and US$0.790 million from the technical assistance component of the proposed loan (see Annex 1).

2.27 CFM would make loans to mining experts for the acquisition of positioning equipment, necessary to complement the installation of the mining geodetic net; up to an aggregate amount of US$0.8 million. In addition, the program requires the Government to train and hire adequate personnel, as well as to relocate DGM's head office, i.e. to provide DGM with the appropriate staff and working environment to achieve its objectives. Progress in the implementation of the modernization program would be assessed during the joint annual project reviews (para. 4.1, ii).

2. Mining Development Commission (CFM)

2.28 In early 1988, while preparing the Mining Sector Review, the Bank found that CFM was experiencing difficulties in all its activities. It could not manage effectively the large number of companies in which it held equity positions, its beneficiation plants were suffering substantial operating losses, and its direct lending operations were plagued by mounting loan arrears. Moreover, this adverse situation was not adequately reflected in the financial statements due to an inadequate accounting policy. Since FMNMM's competent former management assumed control of the institution in 1989, significant steps have been taken to transform CFM into a more effective and efficient development agency.

2.29 First, CFM began an active policy of divestment and transfer of its equity participation in mining companies to the private sector, decreasing from 44 to 11 the firms in which it has an ownership interest, and intends to sell three more companies during 1991 (see Annex 8, Table 13). Moreover, it discontinued its involvement in the promotion (i.e. taking equity positions) of new mining projects.

2.30 Second, CFM sharply raised the traditionally low ore processing fees charged by its money-losing beneficiation plants. Furthermore, given the persistent deficits of its beneficiation plants, during 1990 CFM decided to sell or close down its main loss makers, and to experiment with the purchase of ore instead of tolling it for a fee. Ore trading is, however, expected to present its own difficulties due to fluctuations in the price of metals. The economic viablity and overall adequacy of CFM's ore purchasing practices would be assessed during the joint annual project reviews, and adjustments introduced as needed (para. 4.1, ii). At present CFM operates 14 beneficiation plants and one mine ("El Bote").

2.31 Third, CFM management introduced proper accounting policies and procedures for its loans, which made evident a serious portfolio problem. CFM's response to the problem was to significantly increase the provision for loan losses and to establish a committee to determine each project's true condition. The committee has determined that additional provisions for an estimated amount of Mex$72,000 million are still needed to fully write off CFM's non-recoverable loans, i.e. to clean up the institution's balance sheet. Agreement was reached during loan negotiations regarding the size and timing (September 30, 1991) of the necessary additional loan-loss provisions (para. 4.1, v). Non-recoverable loans (about 500) are being transferred to private collection agencies for collection on a commission basis. The salvageable portion of the portfolio (about 100 loans) will be subject to a restructuring exercise focussed on the 35 largest loans, which account for most of the arrears (see Annex 4).

2.32 Fourth, as a result of the difficulties on its credit operations CFM decided to: a) substantially suspend its long term first-tier lending operations (see para. 2.39); b) channel PECAM reflows to FFM for onlending through commercial banks; and c) upgrade staff capabilities in (i) credit analysis and management and (ii) technical appraisal and feasibility studies (plus use external geologic consultants for larger projects). Agreement was reached during loan negotiations to include under the project's technical assistance component training for CFM staff on project evaluation and supervision (para. 4.1, iv).

2.33 The decisions taken by CFM's management aim in the right direction and have improved the financial position of the institution, but need to be complemented with additional measures taken within a long term framework, i.e. with a clear view of the institution's future role. Thus, institutional restructuring and strengthening of CFM would focus on establishing: a) a planning and programming capability, and b) sound operating policies and procedures that ensure financial viability. To this effect, a comprehensive policy statement and a five-year financial plan have been prepared by CFM, reviewed by the Bank, and agreed upon during loan negotiations (para. 4.1, vi).

2.34 Another major element in defining CFM's framework for future operations is the preparation of a 5-year business plan for its beneficiation plants, currently under way. Presentation of said plan by December 31, 1991, and a commitment to put it into effect, in a manner satisfactory to the Bank, not later than June 30, 1992, were agreed to during loan negotiations (para. 4.1, vii). The remaining "El Bote" mine will be sold in line with CFM's recent Board decision. In addition, a program to deal with its problem portfolio has also been prepared by CFM, reviewed by the Bank, and agreed upon during loan negotiations (para. 4.1, vi). Progress in the implementation of both CFM's plan for beneficiation plants and its program for dealing with the problem portfolio would be examined during the joint annual project reviews (para. 4.1, ii).

2.35 Finally, CFM has retained a consultant to study its organizational structure in the context of: a) the Government's mandate to decentralize its operations, b) its emergence as a large second-tier financial institution serving the entire mining sector, c) its sharply reduced role as a holding company for state-owned enterprises, and d) its 5-year business plan for beneficiation plants. The consultant's report is expected by mid-1991. At loan negotiations agreement was reached that this report be furnished to the Bank for review not later than September 30, 1991, and that the Bank be kept informed of any proposed modification to CFM's organizational structure (para. 4.1, viii).

3. Trust Fund For Mining Development (FFM)

2.36 For many years since its establishment, FMNMM was virtually the sole direct lender to SMMs in the non-metallic mining subsector. It was only when FMNMM, with the support of the Bank, established a second-tier facility offering technical assistance in subproject identification and evaluation, as well as long-term financing to complement working capital financing from commercial banks, that the latter began to show interest in the subsector. Today, all financing provided to non-metallic enterprises is channelled through rediscount operations. Meanwhile, CFM maintained a direct lending relationship with metallic mining enterprises and commercial banks refrained from financing the subsector, mainly due to their inability to compete against CFM on account of its relaxed policy concerning arrears.

2.37 In 1989 the Government integrated the organization and operations of CFM and FMNMM, though they remained two separate legal entities, in an effort to rationalize its financial and technical assistance support to small and medium mining. Furthermore, in 1990 the Government broadened FMNMM's mandate to include the metallic mining subsector and changed its name, as indicated above. The new institution, FFM, remains a separate legal entity, but has no organizational structure and staffing of its own. An agreement between FFM and CFM, formalizing the latter's responsibility for the administration of the trust fund, has been signed and a copy provided to the Bank.

2.38 The next step towards meeting the objective of phasing out direct financing of mining activities by the Government is to induce commercial banks to lend more to mining enterprises, particularly in the metallic subsector. A basic condition to this effect has already been fulfilled with the introduction of appropriate accounting and credit policies regarding overdue loans. Now it is necessary to familiarize commercial banks with the subsector and to develop their capability to evaluate metallic mining projects. Thus, CFM has prepared an ad hoc program of promotion and technical assistance. This program has been reviewed by the Bank and agreed upon during loan negotiations (para. 4.1, vi).

2.39 At present commercial banks finance 51% of the borrowing needs of SMMs, the Government's objective is to increase that percentage to 70% by 1994. Progress towards achieving the objective of increasing commercial bank financing to the sector would be assessed during the joint annual project reviews, together with a discussion of further measures that may be required (para. 4.1, ii).

2.40 During the transitional period until such time as commercial banks begin to actively seek and compete for mining business, CFM intends to continue to exercise its mandate to lend directly to artisan and small scale metallic miners. However, CFM would channel most of its resources, including all the proceeds from the proposed Bank loan and the reflows from the two PECAM projects, through its second-tier facility (FFM). During loan negotiations agreement was reached that CFM would engage in first-tier lending only for financing short-term working capital needs of SMMs, and that its combined (CFM plus FFM) direct financing operations as percentage of total annual lending volume would not exceed, on an annual average basis, 25% for 1991, 23% for 1992, 20% for 1993, 17% for 1994, and 15% for 1995 and thereafter (para. 4.1, ix).

4. Mineral Resources Council (CRM)

2.41 The new management of CRM, in line with Bank recommendations, has been working over the past year to reorient the institution's activities away from the exploration and promotion of prospects in reserved areas and toward the data gathering and development work characteristic of a geological survey institute. The emphasis in CRM's future work will be on mapping, regional exploration, mineral inventories, collection and storage of relevant geological data, dissemination of geological information, deposit-model recognition, technical assistance (geology/deposit appraisal) to small scale miners and other similar related activities.

2.42 CRM has prepared a 5-year business plan, which spells out the institutional reorientation being pursued in terms of objectives, strategies and specific programs for the 1991-1995 period. The Bank has reviewed the plan and found it to be consistent with CRM's goal of becoming a modern geological survey institute. This document, agreed upon during loan negotiations, includes the recommendations resulting from three recently completed expert consultancy studies, a first one on CRM's aerial reconnaissance and ground verification work, a second one on CRM's laboratory operations, and a third one on CRM's information network (para. 4.1, vi). Progress in the implementation of the business plan would be assessed during the joint annual project reviews (para. 4.1, ii).

2.43 To support CRM in its efforts to become a modern geologic survey institute, funds would be provided under the technical assistance component of the project for: a) development of a computerized information network to handle exploratory and administrative work data; b) evaluation visits to sites with mineral potential; c) acquisition of laboratory equipment and the general upgrading of laboratory facilities; d) purchase of cartography and geophysical equipment; and e) training of personnel in Mexico and outside. These activities have an estimated total cost of US$6.812 million (see Annex 1) and were agreed to during loan negotiations (para. 4.1, iv).

F. Mining and the Environment

1. Background

2.44 Over the last three years there has been increasing environmental concern and awareness in Mexico, reflected in the enactment of the General Ecology Law in early 1988, as well as in the establishment of mandatory environmental assessments (EAs) for new projects and for expansion of existing projects. In addition, the Ministry of Urban Development and Ecology (SEDUE), created in 1982, has promulgated general standards for air, water, and solid (including hazardous) wastes; and is now in the process of establishing industry-specific norms.

2.45 SEDUE is the public entity responsible for the implementation of the General Ecology Law, its functions include: a) establishment of regulations and norms or standards for the various industries and guidance on and review of EAs; b) identification and designation of ecologically sensitive or unique areas and ensuring that new projects do not conflict with these protected areas; c) inspection of facilities and operations for environmental compliance and responding to citizen complaints or requests by other agencies; and d) environmental education and community participation in environmental protection.

2.46 SEDUE maintains a delegation in each of Mexico's 31 States. These delegations monitor and enforce compliance by local firms with the general standards for discharges to air and water. Much of the enforcement is based on local complaints and it is generally sought to resolve problems by reaching agreement with the companies involved. SEDUE "letters of compliance", instructing companies to take corrective action, are often issued after minor problems are detected. For larger and more significant environmental problems, an assessment is made and formal agreements negotiated between SEDUE and the company involved. These agreements involve commitments for significant investments in environmental controls and are generally undertaken only by large companies.

2.47 Regulations for environmental assessments of new projects were published in late 1989, which are satisfactory. These regulations establish detailed requirements for the contents of an EA. The first step in the EA process is for the applicant to submit basic project information (i.e. a brief description of the project and process) to SEDUE. The information is used to determine: a) if the project site lies within an ecological reserve area as shown on maps prepared by SEDUE, and b) if not, which of three types of EAs will be required for the project.

2.48 Present SEDUE policy is to reject any projects proposed within ecological reserve areas. If the site is not within a restricted area, a decision is then made about whether to require a general, intermediate, or specific EA; which must be prepared by experts registered with SEDUE. Although EAs are required for all projects (including CFM financed mining projects), small projects with relatively minor environmental impact usually require only a general EA. Large projects, however, require a specific EA, which entails a detailed assessment of potential environmental problems. Once completed the EA is sent to SEDUE for review. Currently, SEDUE's capability to effectively review mining sector environmental assessments is limited and only in few cases are EAs rejected.

2.49 SEDUE is in the process of establishing an ordering system for different ecological reserve areas. The ecological order assigned to an area will help determine if a proposed use is prohibited outright, allowed with conditions, or allowed with no conditions. The ecological ordering system is being developed with input from industry and is currently in a formative stage. Ultimate plans at SEDUE are to establish a framework for environmental and ecological planning that can be used by all 31 States in Mexico. The plan would require the States to notify SEDUE at an early stage about the major projects (including mining projects) that are intended to be carried out in their jurisdiction, and thus would help ensure that the potential environmental impact of these projects is considered in the planning process. SEDUE anticipates that the framework will be introduced in 1992.

2.50 At present the Bank is advanced in the preparation of an Environmental Project for Mexico, which aims to: a) reform and strengthen the administrative structure of SEDUE's federal and state offices; b) support development of a sectoral strategy and a coherent policy framework; and c) support SEDUE's efforts in three critical areas: (i) monitoring and control of water and air pollution, (ii) minimizing negative environmental impacts of investment projects, and (iii) conservation of biodiversity. This project would improve SEDUE's overall capacity to design and enforce environmental policy.

2. Mining Sector Environmental Issues

2.51 From the proposed project's perspective, the major shortcoming of the present environmental regulatory context is the lack of specific standards for the mining industry. Existing norms for industrial discharges to air and water are general in nature and do not address the major environmental and safety problems associated with mining operations, which include: stability of tailings impoundments, discharges to air from smelters and refineries, mine dumps, wastewater discharges and reclamation. Industry-specific standards would provide a rational basis for project planning, meaningful environmental assessment and would facilitate monitoring and enforcement.

2.52 A second significant shortcoming refers to the limited effectiveness of the current mining environmental risk evaluation process. Existing legislation and regulations have established the framework for an effective environmental assessment and review process for mining sector projects. Unfortunately, the EA process is not yet well established at SEDUE and needs to be improved. Viewed within a broader context, including other government agencies and private industry, the process of environmental planning, impact assessment, and mitigation for the mining sector is generally at an early stage of development.

2.53 Under the proposed project, industry-specific standards would be established for tailings dams, smelters and refineries, mine dumps and wastewater discharges. To this effect, SEMIP has signed an agreement with SEDUE, CFM and CMM (Camara Minera de Mexico) to establish a working group. The working group would initially attend a specially designed course at the University of Colorado School of Mines. Upon its return it would begin drafting the standards with the assistance of an international expert on the subject. The process would include a two month diagnosis of the environmental impact of mining operations in the major mining districts and would take into consideration the results of a study to be conducted by Japan's International Cooperation Agency on three of CFM's beneficiation plants. During loan negotiations agreement was reached to have the new standards, satisfactory to the Bank, established by June 30, 1992 (para. 4.1, x).

2.54 To support the Government's efforts to establish environmental standards for mining operations US$0.155 million would be provided under PECAM II to: a) train the working group that would draft the standards, b) implement the two month study of environmental problems associated with current mining operations, and c) carry out other activities directly related to setting the standards. In addition, in order to facilitate implementation, monitoring and compliance with the standards to be issued, the proposed project would include US$0.150 million to fund workshops and other related activities, aimed at raising awareness and explaining the new environmental regulations (see Annex 1). Progress in the establishment and enforcement of the environmental standards would be monitored during the joint annual project reviews (para. 4.1, ii).

2.55 Once in place, the new environmental standards for the mining sector would apply to all new projects, including all subprojects presented for Bank financing under the proposed loan. In the meantime, all subprojects would have to comply with existing SEDUE regulations and procedures. In addition, CFM would be required to provide to the Bank a concise statement concerning the environmental impact of each subproject before any subloan is approved. Moreover, CFM would assume the obligation to provide advice to SMMs on how to deal with their respective project's potential environmental problems. Agreement to this effect was reached during loan negotiations (para. 4.1, xi). In order to satisfactorily fulfill the above two commitments CFM would strengthen its environmental capability, mainly through training, as agreed during loan negotiations (para. 4.1, iv).

III. THE PROJECT

A. Project History

3.1 Past Bank Experience. Past Bank lending for mining has been mostly oriented towards specific investment projects, limited experience exists with directed lines of credit to the sector as a whole (Loan 1290-BO, Credit 455-BO, Loan 1820-ME and Loan 2546-ME). Nonetheless, some important lessons emerge from previous operations, the main one is that investment in mining exploration and exploitation depends not only on the availability of funds, but more importantly on the existing policy and institutional framework. Policies that hinder private sector participation and institutions that impose cumbersome and unnecessary controls and procedures, constitute serious constraints to mining sector growth.

3.2 As indicated above, there have been two line of credit operations for mining to Mexico: the First Small and Medium Scale Mining Project (Loan 1820-ME) and the Second Small and Medium Scale Mining Project (Loan 2546-ME), i.e. the PECAM projects. In addition to the lesson outlined in the preceding paragraph, other lessons extracted from the PCR for the first PECAM project and the supervision reports for the second one, are the importance of avoiding lending segmentation and of addressing environmental issues. Under the PECAM projects there were three public institutions lending to SMMs and up to five investment categories. These arrangements proved highly inefficient. Furthermore, under those projects the potential environmental impact of mining projects was given cursory consideration. All these lessons have been taken into account in the design of the proposed project.

3.3 Project Origin. Notwithstanding previous Government efforts and the two Bank PECAM projects, investment in the mining sector remained below the levels reached in other countries with similar mining potential. A 1989 Bank Mining Sector Review (Report No.7379-ME) identified an inadequate regulatory and institutional framework as the major constraint to increased private investment and further growth (para. 2.3). The Government agreed with the report's findings, began to implement key recommendations and requested Bank support in achieving a full transformation of the mining sector. Thus, the Mining Sector Restructuring Project (MSRP) was identified in conjunction with the Government in FY89, during discussion of the above mentioned mining sector report. The project was appraised during September 9-28, 1990 and a post-appraisal mission visited Mexico from January 21 to February 1, 1991. Loan negotiations took place in Washington from May 8 to May 16, 1991. The Mexican delegation was headed by Mr. Jose Garcia Torres from NAFIN.

B. Project Objectives and Justification

3.4 Objectives. The main objectives of the proposed MSRP are to: a) support the Government's program to deregulate the mining sector and stimulate private domestic and foreign investment, through the establishment of an appropriate policy and institutional framework; b) build broader financial market support to the mining industry; and c) help finance the surge in demand for investment funding that is expected to result from the improved policy and institutional setting for mining operations.

3.5 Justification. In the more developed countries venture capital plays a major role in financing mining exploration and thereby sector growth. In Mexico no such market exists for small and medium scale mining enterprises. The Bank has partially filled this gap through the two PECAM operations, which made available almost US$145 million in term credit facilities to the sector; most of which were channeled through the banking system and CFM's small mining credit operation. The Bank projects were instrumental in providing SMMs with access to otherwise unavailable long-term investment financing. It has been estimated that the resources mobilized by the two projects led to a 7% increase in sector output.

3.6 Mexico's financial sector is undergoing a major reform. It has become essentially market oriented, with the Government phasing out subsidized interest rates and first-tier lending by development banks and trust funds. Moreover, initial actions to privatize the commercial banks have been taken, a process that is expected to be completed in about two years. During that period and for sometime afterwards the newly privatized commercial banks are likely to be reluctant to engage in lending to sectors with a limited track record to assess risks (for a sample of 10 major banks the mining portfolio accounted for only 0.2% of their total portfolio), in particular to a sector such as mining, which is itself undergoing major policy reforms. This situation justifies the proposed Bank loan, that would provide credit to the mining sector during the transitional period until commercial banks become actively engaged in funding mining operations. In line with present Bank policy on directed credit, this loan is expected to be the last line of credit operation for mining to Mexico.

C. Project Description

3.7 To accomplish its objectives the proposed MSRP, in addition to providing financing for SMMs, would support the following policy changes and institutional reforms in the mining sector: (i) liberalizing private sector access to land with mineral potential and releasing state-held mining reserves (paras. 2.7, 2.13); (ii) reducing barriers to foreign investment in mining enterprises (paras. 2.20-2.23); (iii) implementing a mineral rights policy that is conducive to an improved allocation of resources (para. 2.16); (iv) reforming the system of mining concessions (para. 2.14); (v) phasing out state ownership of enterprises in the mining sector (para. 2.29); (vi) modernizing the government agencies providing support to small and medium scale mining enterprises (paras. 2.25-2.27, 2.28-2.35, 2.41-2.43); (vii) establishing environmental standards for the mining sector (paras. 2.53-2.54); and (viii) phasing out direct Government financing of mining activities (paras. 2.38-2.40).

3.8 More specifically, the objectives of the proposed project would be reached through: (i) helping to implement a revised legal framework ("Reglamento" of the Mining Law) which, inter alia, liberalizes private sector access to land and provides for the release of NMRs, permits majority foreign investment in mining enterprises and establishes a modern mineral rights policy; (ii) streamlining the present system for granting and administering mining concessions; (iii) implementing a comprehensive and well focused five-year business plan for CFM, that includes a policy statement, a five-year financial plan, a business plan for its beneficiation plants and a program to deal with its problem portfolio; (iv) implementing a suitable five-year business plan for CRM, that includes a program for aerial reconnaissance, the modernization of laboratory services and the establishment of a computerized information network; (v) setting up an inter-agency work group to establish environmental standards for mining sector operations; and (vi) undertaking a program to induce commercial banks to finance mining projects, particularly in the metallic subsector.

3.9 The proposed project has a significant technical assistance component that would help improve the capabilities of DGM, CFM and CRM to perform their new roles more effectively (paras. 2.25, 2.26, 2.42 and 2.43). Important elements of the proposed MSRP include: a) the modernization of DGM's system of mining administration and control; b) two studies, one to evaluate the results from the recently introduced changes to mining regulations and the other to explore the possibility for any further policy adjustments in the future; c) the establishment of industry-specific environmental standards for mining; d) the training of CFM personnel to improve their project evaluation and supervision skills, as well as their capability to provide advice on the potential environmental impact of mining projects; and e) the upgrading of CRM's capability to generate, process and divulge geological information (see Annex 1).

3.10 The proposed loan would provide financing for: (i) a credit component of US$191.5 million, representing 95.75% of the loan, to help fund subloans to small and medium scale mining enterprises for the acquisition of fixed assets (including pollution control equipment), permanent working capital and the development of existing proven mineral reserves; and (ii) technical assistance of US$8.5 million, representing 4.25% of the loan, mainly to help fund institutional strengthening programs for DGM and CRM.

D. Loan Amount and Terms

3.11 The proposed Bank loan would be for US$200 million. The loan would have a maturity of 17 years, including 5 years of grace, and it would be made at the Bank's standard variable interest rate.

E. Financing Plan

3.12 The proceeds from the Bank loan would help finance investments in metallic and non-metallic mining subprojects for an estimated total amount of US$436.5 million equivalent. This figure includes project related technical assistance in the amount of US$11 million. Based upon the experience from PECAM II, the proposed Bank loan would be expected to finance 46% of total project costs (see table below). The balance would be covered as follows: 34% by the beneficiaries, 15% by CFM 15% and 5% by the participating financial intermediaries (PFIs). PFIs would bear the credit risk on all subprojects and would be required to gradually increase their minimum average financing contribution using their own resources to: 5% during the period from July 1, 1992 to June 30, 1993; 10% from July 1, 1993 to June 30, 1994; and 20% thereafter. Agreement to this effect was reached during loan negotiations (para. 4.1, xii).

Project Financing Plan
(Millions of U.S. Dollars)

	Mining Credit		T. Assistance		Total Project	
	US$	%	US$	%	US$	%
Beneficiaries	148.9	35.0	-	-	148.9	34.1
World Bank	191.5	45.0	8.5	77.3	200.0	45.8
Government (CFM)	63.8	15.0	2.5	22.7	66.3	15.2
PFIs	21.3	5.0	-	-	21.3	4.9
Total	425.5	100.0	11.0	100.0	436.5	100.0

3.13 Taking into consideration the different financing needs of individual subprojects and in order to allow sufficient flexibility in the application of project funds, the 50% Bank financing guideline would be applied on an average basis for subprojects as a whole rather than for each individual subproject. However, the maximum financing to be provided with Bank funds for any individual subproject would be 80% of its total cost. If the cumulative share of funding provided by the Bank is found to exceed the 50% average guideline, the ceiling on individual subprojects would be reduced temporarily. To monitor that the financing provided is in line with this agreement, CFM would inform the Bank quarterly, starting on September 30, 1991, on the funding granted to each subproject and would provide annually, starting on June 30, 1992, a composite financial plan for the project based upon actual disbursements. Agreement to this effect was reached during loan negotiations (para. 4.1, xiii).

F. Institutional Arrangements

3.14 Project Implementation. Under the Bank's previous two loans (the PECAM projects) to the mining sector a coordinating agency was organized to serve, inter alia, as a credit committee that would review a percentage of the projects presented for financing. In practice, however, the coordination and credit committee functions proved to be of little value and in the past two years the coordinating agency has become inactive. Under the proposed loan CFM would act as project coordinator and would therefore be the main interlocutor with the Bank on project implementation. Specific implementation responsibilities are outlined in the following paragraphs.

3.15 The Borrower and Guarantor. The Borrower for the proposed Bank loan would be NAFIN and the Guarantor would be the United Mexican States. NAFIN, established in 1934, is Mexico's largest development bank and is the borrower under 22 Bank loans currently in the stage of execution. NAFIN would be responsible for the establishment and management of the Special Account that would be set up for the project (para. 3.30). In addition, NAFIN would also be responsible for relending the proceeds of the Loan to the Guarantor and to CRM, as appropriate. The Guarantor would further onlend to FFM the proceeds of the loan allocated to finance the credit component of the proposed project. Presentation to the Bank of satisfactory signed and legally binding contractual arrangements between NAFIN, the Guarantor, FFM and CRM, would be a condition of loan effectiveness (para. 4.2).

3.16 Financial Position of NAFIN. NAFIN is a financially sound and creditworthy institution (see Annex 3). As described briefly below, NAFIN'S financial position has improved significantly since its reorganization in early 1989, due to: a) new operating policies, i.e. (i) focusing on low risk second-tier lending, (ii) limiting equity participation in private sector companies to 25% or less of the company's outstanding shares, and (iii) divesting itself from its holdings on public sector enterprises; and b) the sale to the Government of its huge non-performing public sector portfolio.

3.17 Until year-end 1988 NAFIN was a highly leveraged institution with a thin capital base. However, during 1989 the institution's net capital increased by about US$817 million equivalent, a consequence of the: a) merging of several trust funds, with their own resources, which NAFIN and Banco de Mexico previously administered; b) capitalization of overdue interest payments on loans to the Government; and c) surplus from the revaluation of its remaining investments. As a result, the ratio of net worth to total assets increased from 5.9% at year-end 1988 to 11.3% as of December 31, 1989. This ratio declined to 10.7% at year-end 1990 due to write-offs on its "Minera de Cananea" investment, however, it remains very satisfactory for a second tier institution.

3.18 The quality of NAFIN's first-tier portfolio, in which the institution bears the full credit risk, has also improved significantly since the reorganization. This improvement is primarily the result of: a) the sale to the Government of US$4.7 billion equivalent of non-performing loans to parastatals and public trust funds, and b) US$563 million equivalent in write-offs related to its "Minera de Cananea" and "Minera de Autlan" portfolio. Arrears as a percentage of total first-tier outstanding loans (US$ 1.2 billion equivalent) reached 5.7% as of December 31, 1990. However, NAFIN's remaining portfolio is well diversified and adequate loan loss provisions have been made. In addition, NAFIN's investment portfolio, with a book value of about US$124 million equivalent, is well diversified among 31 mostly public sector companies, several of which are being privatized.

3.19 Finally, NAFIN's profitability has also improved in recent years. Return on assets (ROA) increased from 0.21% in 1988 to 0.69% by year-end 1990, while return on equity (ROE) increased from 3.5% to 5.7% over the same period. The low return for 1990 reflects large charges for bad loans made against the year's results, otherwise ROE would have been 28.2%, i.e. about equal to the rate of inflation. NAFIN's financial margin was about 1.9% in both 1989 and 1990, slightly below the average for international money center banks.

3.20 Executing Agencies. The executing agencies for the proposed loan would be CFM/FFM, CRM and DGM. All are experienced and capable institutions that can be expected to perform adequately their respective functions under the proposed project. CFM/FFM would onlend the proceeds of the loan to PFIs, in accordance to terms and conditions satisfactory to the Bank (an analysis of the financial situation of CFM and FFM is presented in Annex 4). Agreement was reached during loan negotiations on the operating guidelines applicable to subloans (para. 4.1, vi). In addition, agreement was reached with CFM during loan negotiations on maintaining adequate staffing to discharge all its functions under the project effectively (para. 4.1, xiv). CFM would also participate in the technical assistance component of the project, along with CRM and DGM. All executing agencies would be involved in the joint annual project reviews.

3.21 Financial Intermediaries. The financial intermediaries eligible to participate in the project would be all legally established commercial banks, that are willing to comply with the following requirements: a) observe CFM/FFM's operating guidelines; b) ensure that Bank procurement and disbursement provisions are met; c) provide all reasonable project related information requested by CFM and the Bank; and d) assume the credit risk for the subprojects rediscounted with CFM/FFM.

3.22 Over the past several years all major commercial banks and many of the smaller ones have developed adequate capacity to undertake term lending operations in the industrial, agro-industrial and the non-metallic mining sectors. However, the limited experience of commercial banks in term lending to SMMs operating in the metallic subsector would require that CFM carry out initially the technical evaluation for this type of subprojects. Supervision would be performed jointly by the commercial banks and CFM. With the purpose of progressively transferring to the banks the responsibility for subproject appraisal and supervision, CFM would implement a technical assistance program to train the commercial banks' staff, as discussed above (para. 2.38).

G. Relending Terms and Conditions

3.23 Onlending Rates. The loan proceeds allocated to the credit component of the proposed project (US$191.5 million) would be onlent by FFM, through PFIs, to help fund subloans to SMMs. Subloans would be denominated in Mexican pesos or U.S. dollars, at the option of the subborrower. The cost to FFM of peso funds would be the 28-day CETES (Treasury Bills) rate and the cost of dollar funds would be the three month LIBOR (London Interbank Offered Rate) plus 0.5%, in line with Mexican internal guidelines on the transfer of external resources from the Government to trust funds. The cost to PFIs in pesos and dollars would be the respective rates plus an FFM intermediation fee, satisfactory to the Bank, which would be adequate to cover financial intermediation costs, including administrative costs, an adequate return on capital and provision for losses. For both peso and dollar denominated subloans PFIs would be free to set the lending rate to final borrowers, i.e. the interest rates charged under the proposed project would be based upon market conditions.

3.24 The loan proceeds allocated to the technical assistance component of the proposed project (US$8.5 million) would be transferred to DGM and CRM in pesos at the CETES rate. Agreement on the interest rates and fees applicable under the project, as well as on examining their adequacy during the joint annual project reviews, was reached during loan negotiations (para. 4.1, xv).

3.25 Maturities and Grace Periods. The terms for each specific subloan would take into account the economic life of the assets to be financed and the repayment capacity of subborrowers. Fixed assets subloans would have a maximum maturity of 13 years, including a grace period of up to three years; and working capital subloans would have a maximum maturity of five years, including a grace period of up to one year.

3.26 Maximum Loan Amount and Free Limit. The maximum amount of Bank financing to any individual subproject would be US$5 million equivalent. A cumulative limit of to US$10 million equivalent would apply for subloans made to any SMM, individually or together with its related companies. Based on the positive experience with the PECAM I and II operations, subprojects under a free limit of US$1.5 million equivalent would not require prior Bank approval. It is expected that about 20% of the subprojects, representing about 40% of loan resources, would be subject to prior Bank approval. Subprojects financed through subloans would have to yield financial rates of return of not less than 12%, reflecting the cost of capital in the Mexican market.

H. Procurement

3.27 Procurement of Goods and Works under the Technical Assistance Component. The participating institutions (CRM and DGM) would have the responsibility for ensuring the competitiveness, in price and quality, of the items procured and their suitability for the purpose intended. Consultant services financed with loan proceeds would be open to international recruitment, and corresponding Bank guidelines would be applied. Goods and works estimated to cost per contract: (i) less than US$50,000, would be procured under local shopping provided, however, that the aggregate amount for works does not exceed US$250,000; (ii) between US$50,000 and US$250,000, would be procured under local competitive bidding; and (iii) more than US$250,000, would be procured under international competitive bidding (ICB) according to Bank guidelines.

3.28 Procurement of Goods and Works under the Line of Credit Component. Contracts estimated to cost US$5 million equivalent or more would be procured under ICB procedures, in accordance with Bank guidelines. Contracts estimated to cost between US$1.5 million and US$5 million equivalent, would be procured through shopping procedures acceptable to the Bank, requiring at least three responsive price quotations from eligible suppliers. For contracts costing less than US$1.5 million, procurement would be done under established commercial procurement practices acceptable to the Bank. In all cases under both the technical assistance and the credit line components, a preference margin of 15% or the applicable duty, whichever is lower, may be granted to local producers under ICB contracts for goods, in accordance with Bank guidelines.

3.29 Prior Review of Procurement Decisions. Procurement documentation for all ICB contracts for goods and works would be subject to the Bank's prior review. In addition, the procurement documentation for the first three contracts for goods and works under the line of credit component, estimated to cost US$1.5 million or more but less than US$5 million equivalent (i.e. subject to shopping procedures), and the first three LCB contracts under the technical assistance component, would also be subject to the Bank's prior review.

Procurement Method

(Millions of U.S. Dollars)

Project Element	ICB	LCB	Other	N.A. a/	Total
1. Technical Assistance					
1.1 Civil Works			0.3 (0.3)	0.4 (0.0)	0.7 (0.3)
1.2 Goods	6.0 (6.0)	0.9 (0.9)		1.4 (0.0)	8.3 (6.9)
1.3 Consultants			0.8 (0.8)		0.8 (0.8)
1.4 Operating Costs			0.5 (0.5)	0.8 (0.0)	1.3 (0.5)
2. Line of Credit					
2.1 Works	0.0 (0.0)		65.0 b/ (7.0)	-	65.0 (7.0)
2.2 Goods	0.0 (0.0)		360.5 b/ (184.5)	-	360.5 (184.5)
Total	6.0 (6.0)	0.9 (0.9)	427.1 (193.1)	2.6 (0.0)	436.5 (200.0)

Note: Figures in parenthesis correspond to the amounts financed from the proceeds of the Bank loan.

a/ Government financed.

b/ Procurement would be done under ICB, shopping procedures and established commercial procurement practices acceptable to the Bank (para. 3.28).

I. Disbursement

3.30 In order to facilitate project execution, a Special Account would be opened and maintained in US dollars, with an initial deposit of US$20.0 million, representing the estimated loan disbursements over the peak four months. NAFIN, as financial agent of the Government, would manage withdrawals under the Loan, including the Special Account. Withdrawal applications would be made on the basis of statements of expenditures for contracts costing less than US$1 million. NAFIN would ensure that all supporting documentation is adequately maintained and made available for review upon the Bank's request. NAFIN would be required to submit to the Bank a monthly statement of the transactions of the Special Account, it would also be responsible for compliance with the corresponding audit requirements (see Annex 2). Only expenditures made no more than 180 days prior to the date of receipt by the Bank of the corresponding financing request would be eligible for reimbursement under the proposed Loan.

3.31 The Bank would finance 100% of amounts rediscounted by PFIs with FFM, under the line of credit component. It would also finance 100% of expenditures for consultant services and equipment, operating costs and works, under the technical assistance component. The final date for submission of subloan requests to the Bank for approval would be June 30, 1995, and the Closing Date would be June 30, 1996.

J. Retroactive Financing

3.32 Resources from loan 2546-ME were fully committed as of December 1990. It is proposed to permit retroactive financing of eligible expenditures incurred since September 10, 1990 (the date of project appraisal), up to a maximum amount of US$20 million.

K. Monitoring, Reporting and Auditing

3.33 The Bank would monitor progress of project implementation through normal project supervision and the regular exchange of views with the Guarantor, the Borrower and the Executing Agencies. In addition, agreement was reached during loan negotiations on conducting joint annual reviews of the project to evaluate overall project progress, and to discuss the need and agree on further measures to achieve the project's objectives (para. 4.1, ii). The initial joint project review would take place not later than February 28, 1992.

3.34 The coordinating agency (CFM) would prepare annual reports on the progress of the project, starting on January 31, 1992. These reports would include, inter alia, an assessment of progress in the implementation of the provisions of the new "Reglamento" of the Mining Law, the institutional development programs for the public entities that support SMMs, and the environmental standards for the mining sector. The reports would also include information on the overall status of the project (credit and technical assistance components), the project's financial situation and portfolio quality, subprojects and their expected impact, and other relevant project elements (see Annex 5).

3.35 The executing agencies (CFM and CRM) would maintain adequate records to reflect their operations and financial situation, in accordance with sound accounting principles applied consistently. DGM would only be required to maintain and submit annual audit reports of project related records. The accounts of the executing agencies including those kept for the purposes of the project, the Special Account, and the statements of expenditure, would be audited annually by independent auditors acceptable to the Bank (see Annex 2). The audit reports, with scope and format satisfactory to the Bank, including an opinion regarding the supporting documentation for disbursements based on statements of expenditure, would be submitted to the Bank no later than six months after the end of each institution's fiscal year.

L. Benefits and Risks

3.36 The proposed project would help develop Mexico's mining sector, which is believed to have strong growth potential, in an environmentally sound manner. The recent changes in the regulatory framework providing for, inter alia, increased private sector access to land and mineral rights, and for the streamlining of concession procedures and majority foreign ownership of mining firms, should result in higher investment by private domestic and foreign companies. Furthermore, the reorientation of the sector's policies and public institutions in favor of activities that directly support private mining exploration and exploitation, and the increase in commercial bank lending for mining operations that would be expected to be initiated by the project, should also lead to higher investment in the sector. Increased investment would in turn result over time in higher mining output, exports and employment. Moreover, the establishment of environmental standards for the mining industry would help ensure that the sector's development is sustainable.

3.37 Policy reversals, which would be the main concern to private investors, seem unlikely given Mexico's impressive efforts to open up and deregulate its economy. Hence the main project risks relate to issues that could adversely affect loan disbursements: a) continued low international metal prices; b) an overvalued exchange rate; and c) lower than expected commercial bank participation in lending to mining, particularly during the coming years when these banks are to be privatized. The potential negative impact of these risks is, however, ameliorated by the fact that Mexico is a low cost mineral producer, the Government has export promotion as a key objective of its economic policy and CFM/FFM has been successful in the past in attracting commercial banks to finance non-metallic mining operations. Moreover, the proposed loan amount has been based on a conservative demand estimate for financial resources. In this context, the risks faced by the project are considered acceptable.

IV. AGREEMENTS REACHED AND RECOMMENDATION

4.1 During loan negotiations agreement was reached with the Government (the Guarantor), NAFIN (the Borrower), CFM and CRM on:

(i) considering any material change in the "Reglamento" of the Mining Law that could adversely affect the objectives of the proposed project or any occurrence that would prevent its implementation, an event of default (para. 2.6);

(ii) joint annual reviews of the project to exchange views on overall project progress and to discuss the need for further measures to achieve the project's objectives. These reviews would focus, inter alia, on the: a) release of National Mining Reserves; b) institutional modernization of CFM, CRM and DGM; c) implementation of the technical assistance component; d) economic viability and overall adequacy of CFM's ore purchasing practices; e) participation of commercial banks in lending for mining projects; f) environmental standards for the mining industry; g) adequacy of interest rates and fees charged; and h) level of investment in the mining sector (paras. 2.7, 2.26, 2.27, 2.30, 2.32, 2.34, 2.39, 2.42, 2.43, 2.54, 2.55 and 3.24). The initial joint project review would take place not later than February 28, 1992;

(iii) undertaking two studies, by consultants satisfactory to the Bank, to: a) evaluate the effectiveness of the changes introduced by the new "Reglamento" of the Mining Law and b) explore alternative approaches to mineral rights allocation and payments. The terms of reference, timing and cost of the studies would be discussed and agreed upon during the first joint annual project review (para. 2.17);

(iv) the technical assistance component of the project (paras. 2.26, 2.27, 2.32, 2.43, 2.54 and 2.55);

(v) the approval by CFM's Board by September 30, 1991 of the additional loan-loss provision needed to fully write-off non-recoverable loans (para. 2.31);

(vi) the following documents: a policy statement and five-year financial plan for CFM, a program to deal with CFM's problem portfolio, a program of promotion and technical assistance aimed at increasing commercial bank lending for mining operations, a five-year business plan for CRM, and the project operating guidelines (paras. 2.33, 2.34, 2.38, 2.42 and 3.20);

(vii) presentation to the Bank by December 31, 1991 of a business plan for CFM's beneficiation plants, including a commitment to put it into effect not later than June 30, 1992 (para. 2.34);

(viii) presentation to the Bank by September 30, 1991 of the consultancy study on CFM's new organizational structure, and keeping the Bank informed of any proposed modification to CFM's organizational structure (para. 2.35);

(ix) the scope of CFM's first-tier lending, which would be limited to financing short term working capital needs of SMMs; and on the combined (CFM plus FFM) direct financing operations as percentage of total annual lending volume which would not exceed, on an annual average basis, 25% for 1991, 23% for 1992, 20% for 1993, 17% for 1994, and 15% for 1995 and thereafter (para. 2.40);

(x) the issuance of environmental standards for the mining industry, satisfactory to the Bank, by June 30, 1992 (para. 2.53);

(xi) providing the Bank a concise statement concerning the environmental impact of each subproject before any subloan is approved, and strengthening CFM's environmental capability as to be able to provide advice to SMMs on how to deal with the environmental impact of their projects (para. 2.55);

(xii) requiring PFIs to bear the credit risk on all subprojects, and on having PFIs gradually increase their minimum financing contribution using their own resources to: 5% during the period from July 1, 1992 to June 30, 1993; 10% from July 1, 1993 to June 30, 1994; and 20% thereafter (para. 3.12);

(xiii) providing the Bank information to monitor the 50% average Bank financing guideline; quarterly, starting on September 30, 1991, the funding granted to each subproject, and annually, starting on June 30, 1992, a composite financial plan based upon actual disbursements (para. 3.13);

(xiv) CFM maintaining adequate staffing to discharge all its functions under the project effectively (para. 3.20); and

(xv) the applicable interest rates and fees, and an examination of their adequacy during the joint annual project review (para. 3.24).

4.2 A condition of effectiveness would be that contractual arrangements for the transfer of loan proceeds between NAFIN, the Guarantor, FFM and CRM, which are satisfactory to the Bank, have been signed and are legally binding (para. 3.15).

4.3 Subject to the above assurances and conditions the proposed project would be suitable for a Bank loan of US$200 million to NAFIN, for a period of 17 years, including a grace period of 5 years, at the standard variable rate.

Technical Assistance Program

1. The proposed project includes a technical assistance component of US$11.0 million, of which US$8.5 million, representing 4.25% of the total loan amount, would be Bank financed. The technical assistance component would help fund: (i) the modernization of DGM's system of mining administration and control; (ii) two studies, one to evaluate the results from the recently introduced changes to mining regulations and the other to explore the possibility for any further policy adjustments; (iii) the establishment of industry-specific environmental standards for mining; (iv) training for CFM personnel to improve their project evaluation and supervision skills, and to increase their environmental knowledge and expertise and (v) the upgrading of CRM's capability to generate, process and divulge geological information (see table 1).

A. General Directorate of Mines (DGM)

2. The implementation of the new "Reglamento" of the Mining Law requires the use of modern technology and systems by DGM to achieve the goal of administrative deregulation and simplification. To this effect, the project would provide financing for the: a) implementation of a mining geodetic net, and b) automation and interconnection of DGM offices. The estimated cost of these activities is US$0.790 million (see table). In addition, the Bank would also finance under PECAM II the: a) purchase of hardware and software for the areas of Document Control, Public Registry, Cartography, Control of Obligations and Statistics, and b) training of personnel. The estimated cost for these activities is US$1.257 million, of which US$1.1 million have already been approved and are being disbursed. CFM would make loans to mining experts for the acquisition of positioning equipment, up to an aggregate amount of US$0.8 million. In addition, the Government would provide DGM the financing necessary to relocate its head office and acquire miscellaneous equipment.

3. The establishment of a mining geodetic net would simplify the preparation of the expert report that parties interested in obtaining a mining concession or assignment must present to DGM, as it would only be necessary to determine the distance and the astronomical direction between a control point and the starting point of the mining lot in question to clearly identify the same. The modernization of the positioning equipment used by mining experts to establish a lot's location is a necessary complement to the above effort. Finally, the automation and interconnection of DGM's field offices would expedite the issuance and registration of mining concessions.

4. The new "Reglamento" of the Mining Law is expected to lead to increased investment in the mining sector and to significantly increase the sector's efficiency. In order to assess the effectiveness of the recently introduced changes in the allocation system and payments for mineral rights, and to provide the analytical basis for further improvements in the regulatory framework, the project would finance two studies: a) one to evaluate the impact of the new legislation, particularly on the level of investment in mining exploration and exploitation, and b) another one to explore alternative approaches to mineral rights allocation and payments, which would include a

comparative analysis of mining policy in other countries. The terms of reference, timing and cost of undertaking the two studies would be determined at the time of the first joint annual project review.

5. A major element of the proposed project is the issuance of standards to address the major environmental problems generated by mining operations. To assist in this effort, the Bank would provide US$0.155 million under PECAM II for: a) training the working group that would draft the standards, b) a diagnosis of the environmental impact of mining operations in Mexico's main mining districts, and c) other activities directly related to the establishment of the standards. In addition, the Bank would provide US$0.150 million in financing under the MSRP for carrying out workshops and other related activities aimed at raising awareness and explaining the new environmental regulations, i.e. ensuring compliance with the same.

B. Mining Development Commission (CFM)

6. An examination of CFM's problem portfolio showed that weaknesses in the technical appraisal of projects, as well as in credit analysis and management, were a major factor behind the large number of bad loans. To help address CFM's shortcomings in these areas the proposed project would include personnel training. The nature and cost of the training program would be determined after further evaluation of the institution's specific needs and how best to meet them. CFM would finance the training program with its own resources.

7. Under the project CFM would be required to provide to the Bank a statement concerning the environmental impact of each subproject. Moreover, it would assume the obligation to give advice to SMMs on how to best deal with potential environmental problems in their operations. In order to satisfactorily fulfill these two commitments CFM needs to strengthen its in-house environmental capability, mainly through training. The various activities to be undertaken to this effect have been discussed and agreed with the Bank, and would be self-financed by CFM.

C. Mineral Resources Council (CRM)

8. The five-year business plan prepared by CRM envisions the organization de-emphasizing its role as an evaluator and developer of mineral resources and gradually becoming a modern geological survey institute. To assist in the transition process, the Bank would help finance the: a) development of a computerized information network to handle exploratory and administrative work data, b) evaluation visits to sites with mineral potential, c) purchase of laboratory equipment and general upgrading of laboratory facilities, d) purchase of cartography and geophysical equipment, and e) training of personnel. The estimated total Bank contribution to the above activities amounts to US$6.812 million (see table 1).

9. A vital element in CRM's efforts to become a modern and efficient organization is the implementation of an automated system, that will improve its technical and administrative capacity. In addition to financial

management and planning functions, the system will enable CRM to carry out specialized functions such as the creation of a geological-mining information center providing services to the public and the compilation of a technical data base. Recent consultancy advice to CRM strongly recommends the careful introduction of this system, with considerable attention placed on training.

10. With the objective of increasing the country's mining production, survey visits will be carried out at the request of small and medium scale miners. This technical assistance work will provide miners with recommendations for exploration and evaluation activities that should take place to ensure the development of more efficient mining operations.

11. Modern equipment is required to upgrade CRM's physical-chemical laboratory activities, which are vital to proving the correct assessment of contained minerals, ore grades, and the geological and mineralogical setting of mineral deposits. The present equipment is becoming obsolete and expensive or impossible to maintain. In addition, laboratory facilities will be upgraded through minor civil works to improve deficient work areas. This will enable CRM to adequately support its field activities.

12. The upgrading of cartography and drafting equipment will allow CRM to better produce maps and plans for both internal reporting, and publication and general dissemination of information. CRM's exploration programs also require the systematic carrying out of geophysical investigations to analyze and evaluate geological and mining potential. Modern geophysical equipment is needed to provide accurate geophysical information. The new equipment will also permit CRM to effectively undetake contracting assignments for third parties.

13. Training of CRM staff is essential, both within and outside Mexico, to increase professional knowledge of state-of-the-art technology and procedures. It is particularly important in relation to the implementation of the computerized management and information system, as well as in the early recognition of mineral deposits. Moreover, CRM provides an early training ground for young earth science graduates.

Table 1. TECHNICAL ASSISTANCE PROGRAM

	Beginning	Duration	Estimated Cost	Financing
			(Millions of U.S. Dollars)	
A. General Directorate of Mines (DGM)				
1. Hardware and software for the areas of Document Control, Public Registry and Cartography	under way	until Jun.91	1.057	PECAM II
2. Software for the area of Control of Obligations	under way	until May 91	0.037	PECAM II
3. Hardware and software for the area of Statistics	under way	until Jul. 91	0.082	PECAM II
4. Load of historical data base for the area of Control of Obligations	Feb. 91	5 mo.	0.051	PECAM II
5. Establishment of ecology norms and standars for the mining industry	May 91	20 mo.	0.155 0.150	PECAM II MSRP
6. Training of DGM personnel	Jan. 91	4 mo.	0.030	PECAM II
7. Purchase of positioning equipment	Jul. 91	6 mo.	0.800	GOM
8. Implementation of mining geodetic net	Jul. 91	6 mo.	0.500	MSRP
9. Automation and interconnection of DGM offices	Jul. 91	6 mo.	0.290	MSRP
10. Provision of adequate building for DGM	Jul. 91	6 mo.	0.370	GOM
11. Acquisition and renewal of miscellaneous equipment	under way	until Sep. 91	0.596	GOM
12. Two studies on the effectiveness of the changes introduced by the new "Reglamento" of the Mining Law and the possibilities for further improvement	To be defined	id	id	MSRP
Sub-Total Bank Financing Under MSRP (A).			0.940	
B. Mining Development Commission (CFM)				
1. Personnel training	To be defined	id	id	GOM
C. Mineral Resources Council (CRM)				
1. Information network	under way	60 mo.	3.697	MSRP
2. Property evaluation visits	Jul. 91	48 mo.	0.395 0.758	MSRP GOM
3. Laboratory equipment and upgrading of laboratory facilities	under way	18 mo.	1.785	MSRP
4. Cartography equipment	under way	18 mo.	0.281	MSRP
5. Geophysical equipment	under way	18 mo.	0.234	MSRP
6. Personnel training	under way	48 mo.	0.420	MSRP
Sub-Total Bank Financing Under MSRP (C).			6.812	
Unallocated Amount	To be defined		0.748	MSRP
Total Bank Financing for Technical Assistance Under the MSRP			8.500	

Auditing Requirements

A. The Executing Agencies (CFM, FFM, CRM and DGM)

The audit report should include an examination of and an opinion on the:

(a) Basic Financial Statements.
- Statement of financial position
- Statement of income (and retained earnings)
- Statement of changes in financial position, or statement of cash flow.

The following special reports should also be presented to the Bank:

(b) Compliance Opinions. Covering the loan's financial-managerial covenants.

(c) Management Letter. As a complement to the audit of the financial statements.

(d) Disclosure of the audit procedures utilized.

(e) Supplementary Financial Information. Should include a summary of: (i) the budgetary execution and (ii) the financial performance of the entity executing the project.

(f) Audit of the Project. This audit report covers the financial execution recorded in the "separate or identified accounts" for the project.

(g) Auditor's Opinion on the Certificates of Expenditures. The scope of the audit is an examination of the expenditures with respect of which withdrawals from the Loan Account were made during the fiscal year on the basis of statements of expenditure.

Note: DGM would only be required to comply with (f).

B. The Borrower (NAFIN)

In addition to (b) and (d) the following report should also be presented to the Bank:

(h) Audit of the Special Account. This audit report covers the move ment and availability of the funds in the Special Account. The scope of the audit is an examination of and an opinion on: (i) the statement of transactions and availability of funds, (ii) the accounting, administrative and control procedures, as well as the system of authorizations maintained by the Central Bank.

Financial Analysis of NAFIN

Background

1. NAFIN is the Government's main development bank for supporting the industrial sector and has been the borrower for the majority of Bank loans to Mexico, including the two previous loans to the mining industry. NAFIN is both a financial agent (FA) of the Mexican Government and a development bank. As a FA, NAFIN borrows funds from external sources (mainly the World Bank, Inter-American Development Bank (IDB) and the EXIMBANKS), and onlends these resources to public agencies (Government entities, trust funds and parastatal enterprises) to fund their operations. As a development bank, NAFIN provides resources, through a variety of credit programs, to meet the long-term credit needs of micro, small and medium-size private industrial companies. NAFIN also functions as an investment and holding company, taking temporary minority equity positions in private industrial companies. For its operations as a development bank, NAFIN relies mainly on funds from bilateral and multilateral agencies. In addition, it has started to raise, on a limited scale, long-term funds in foreign and domestic capital markets.

2. Under its bylaws, NAFIN is managed by a "Consejo de Administracion" (Board of Directors), which is composed of top level Government officials plus the institution's General Manager. The Chairman of the Board is the Minister of Finance, other members include the Ministers of Programming and Budgeting, Trade and Industrial Development, and of Energy, Mines and Parastatal Industry, the General Managers of Banco de Mexico and Petroleos Mexicanos, the Chairman of the Confederation of Industrial Chambers (CONCAMIN), and two other representatives of the private sector.

3. NAFIN has experienced a major change in the scope of its operations since it embarked in early 1989 on a reorganization program that included: a) closingdown its retail deposit-taking activities, b) discontinuing first-tier lending, c) phasing out its lending and investment activities with the public sector, and d) absorbing the functions and assets of the trust funds that rediscounted loans to the industrial sector.

Asset/ Liability Composition

4. The bulk of NAFIN's assets is concentrated on those operations in which NAFIN acts as a FA of the Government. As of December 31, 1990, NAFIN's total assets amounted to about US$14.9 billion equivalent, of which loans to the Government and Government agencies as FA accounted for 71%. In terms of currency, 70% of total assets and a corresponding percentage of the liabilities are denominated in foreign currency. NAFIN's asset composition changed between 1988 and 1990, as a result of management's decision to become a second-tier lending institution. Cash and liquid assets declined from 1.65% to 0.41% of total assets, as NAFIN closed-down its retail banking operations; and the second-tier lending portfolio increased to 6.74% of total assets as of December 31, 1990. Moreover, total assets declined by US$3.30 billion during that period, due to the acquisition by the Government of about US$4.7 billion

equivalent of NAFIN's non-performing public portfolio and the write-off of about US$337 million equivalent in loans to two mining companies,"Minera de Cananea" and "Minera Autlan".

5. NAFIN's liabilities are related mainly to loans received from multilateral agencies. Since the Mexican crisis of 1982 until recently, NAFIN was excluded from access to long-term international financial markets (the last foreign bond placement was in July 1982). The World Bank, the IDB and the EXIMBANKS continued to be the major sources of foreign funds throughout this period; however, most of these funds corresponded to loans in which NAFIN acted as a FA of the Government. From 1985 to year-end 1990 the World Bank approved 22 loans with NAFIN as the borrower, but NAFIN is the executing agency for only five of those loans. NAFIN is currently trying to diversify its sources of funds. In June 1990, for the first time in eight years, NAFIN was able to place bonds in the international capital markets (US$85 million in Eurobonds with a five year maturity). Domestic funding has been based on short-term instruments; however, in 1989 NAFIN issued succesfully long-term bonds (BONDIS). NAFIN is expected to continue to rely on the World Bank and IDB for its long-term funding needs. Table A-1 provides a summary of NAFIN's financial statements.

Capital Base

6. As of December 31, 1990, NAFIN's equity was about US$1.7 billion equivalent (including subordinated debentures). Until year-end 1989 NAFIN was a highly leveraged institution, with a very thin capital base; however, this situation has now greatly improved. The ratio of net worth to total assets has increased from 1.06% in 1986 to 6.36 % in 1990 (10.68% including subordinated debentures). Between year-end 1988 and December 31, 1990, NAFIN's capital base increased by about US$620 million equivalent, net of the deduction of about US$226 million equivalent from the write-off of its "Minera de Cananea" investment. The merger of two trust funds (FOGAIN and FONEI) that NAFIN and Banco de Mexico had previously managed off-books contributed about US$646 million equivalent, and the capitalization of overdue interest owed by the Government and the surplus from revaluation of investments added about US$200 million equivalent. NAFIN is further strengthening its capital base by setting aside 10% of its net income into the legal reserve. This practice will continue until the legal reserve is equal to its paid-in capital. As of December 31, 1990, NAFIN's capital base is very satisfactory to support the type of low risk operations that the institution intends to undertake in the future.

TABLE A-1

NACIC..AL FINANCIERA S.N.C.

SUMMARY OF FINANCIAL STATEMENTS 1985-1990
(Millions of U.S. Dollars)

	1985	1986	1987	1988	1989	1990
Total Revenues	3,178	3,133	3,445	3,131	2,930	1,276
Interest Expenses	3,027	3,013	3,183	2,808	2,528	916
Financial Margin	151	120	262	323	402	360
Operating Income	43	39	47	49	74	113
Net Income	31	28	34	38	69	110
Total Assets	15,956	16,067	17,118	18,306	16,809	15,912
(Cash & Securities)	(842)	(625)	(745)	(1,879)	(1,494)	(1,508)
(Loan Portfolio)	(14,599)	(14,917)	(15,873)	(15,395)	(13,711)	(12,900)
Total Liabilities	15,777	15,896	16,964	17,913	15,999	13,981
(Financial Debentures)	(683)	(492)	(360)	(200)	(596)	(1,775)
(Bank Loans)	(11,340)	(12,491)	(13,673)	(13,110)	(11,938)	(11,280)
(Subordinate Debentures)	(436)	(486)	(686)	(686)	(686)	(686)
Capital and Reserves	179	170	154	393	1,210	1,244
Number of Employees	-	-	-	4,586	3,457	3,291

Source: NAFIN audited financial statements, except for 1990.

Liquidity

7. Liquidity risk is not a problem for NAFIN since its portfolio, both as a FA and as an executing agency, is tied to liabilities of the same maturity. Interest rate risk is also minimal, because the entire portfolio is denominated in variable rate instruments. Moreover, since NAFIN is no longer in retail banking, it does not have to face an unexpected demand from depositors. The only liquidity risk NAFIN might face is from loan demand.

However, demand for NAFIN's funds has slowed-down recently due to high liquidity in the commercial banking system. The privatization of the commercial banking system will likely affect future demand for NAFIN's funds, as NAFIN and the Government will no longer be able to have a strong influence on the lending decisions of commercial banks. As of December 31, 1990 NAFIN held about US$1.01 billion equivalent, 6.39% of its assets, in highly liquid Government securities, primarily Certificados de Tesoreria (CETES) and Bonos de Desarrollo (BONDES). However, 5.95% of NAFIN's liabilities are in short-term instruments, mainly bankers acceptances (BAs), a proportion which is considered high for an institution concentrated in long-term lending. This is expected to be transitory.

Portfolio and Investments

8. Portfolio. Given the nature of NAFIN's operations, about 90% of its US$12.9 billion equivalent portfolio is implicitly or explicitly guaranteed by the Government. The quality of NAFIN's first-tier portfolio, in which the institution bears the full credit risk, has improved considerably since the reorganization. Up to year-end 1988, NAFIN continuously restructured and refinanced its loans to parastatal enterprises and public trust funds. These operations were very costly to NAFIN, because it funded these loans by issuing expensive bankers acceptances. To correct this situation the Government and NAFIN undertook two major transactions during 1989 and 1990. In the first transaction, known as the "Bankers Acceptances Agreement", the Government acquired US$0.9 billion of NAFIN's bankers acceptances in exchange for an equal amount of NAFIN's portfolio. In the second transaction, the Government assumed US$3.8 billion of NAFIN's restructured foreign debt, again in exchange for an equal amount of the institution's portfolio. Thus, NAFIN was able to dispose of US$4.7 billion equivalent of its non-performing portfolio, which had originated from loans made as a first-tier lender to public trust funds and parastatal enterprises.

9. In September 1989 "Minera de Cananea", a company in which NAFIN had an exposure of about US$1 billion equivalent between loans and investments, declared bankruptcy. Later in the same year "Minera Autlan" defaulted on a major loan guarantee. This serious situation has now been resolved. In mid-1990 "Minera de Cananea" was sold to provate investors for US$475 million equivalent, proceeds from the sale were used to partially offset outstanding loans and the balance was written-off against provisions that NAFIN had made during 1989 and 1990. Total NAFIN write offs, related to its loans and holdings in "Minera de Cananea" and "Minera Autlan", amounted to US$ 563 million equivalent. Existing provisions for bad loans were affected in the amount of US$337 million equivalent, and US$226 million equivalent were charged against equity.

TABLE A-2

NAFIN'S PORTFOLIO STATUS
(Millions of U.S. Dollars)

	Amount	%	Status
A. Financial Agent	9,055	70.03	Fully guaranteed by Gov.
B. Debt Service Assumed by Government	1,819	14.07	The Gov. has assumed full service of the debts.
C. Second-tier loans	871	6.74	Low risk, guaranteed by CBs
D. First-tier loans	1,185	9.16	5.7% of it is in arrears.

Source: NAFIN report on status of loan portfolio, December 1990.

10. Investments. Following its new investment policy, NAFIN will now invest only in privately held companies, and its equity participation will be limited to no more than 25% of the company's outstanding shares. As of December 31, 1990, NAFIN's equity investments were concentrated mostly in 31 public sector companies with a book value of about US$124.0 million equivalent. The investment portfolio is well diversified, the largest investment is in "Carbonifera Rio Escondido", which accounts for only 2.7% of the total investment portfolio. The Government and NAFIN have embarked on a dis-investment and privatization program. NAFIN has already divested itself from a number of firms and fully expects to recover its investments from the remaining ones.

TABLE A-3

NAFIN'S LARGEST EQUITY INVESTMENTS
(AS OF DECEMBER 31, 1989)

COMPANY	ACTIVITY	VALUE (Millions of US Dollars)	EQUITY OWNED (%)
Carbonifera Rio Escondido	Coal Mining	9.3	24.8
Mexinox, S.A.	Steel	9.0	39.7
Intermex Holding	Banking	6.2	13.7
Altos Hornos de Mexico	Steel	6.0	56.9
Fertilizantes Mexicanos	Fertilizers	4.5	59.9
Gine Komatsu	Ind. Machinery	3.1	31.5
ICA Plasticos	Plastics	3.1	24.0
Celulosa y Papel de Durango	Celulose	2.8	21.6
Total Equity Investments		124.0	

Source: NAFIN annual reports.

Financial Performance

11. NAFIN steadily improved its profitability between 1986 and 1990. Its return on assets (ROA) rose from 0.17% in 1986 to 0.39% in 1988 and 0.69% in 1990. The return on equity (ROE) also improved, rising from 4.2% in 1986 to 5.71% in 1990. The low return for 1990 reflects large charges (about US$ 615 million equivalent) made against the year's results as provisions for bad loans. Including these charges ROE for 1990 rises to 28.23%, which is about equal to the rate of inflation for the year. The improvement of NAFIN's financial performance during 1989 and 1990 is mainly a result of the: a) incorporation of FOGAIN's and FONEI's highly profitable portfolio, b) gains from transactions in the securities market, and c) disposal of its parastatal enterprises investments and non-performing portfolio. Net income, after staying around 0.20% of average assets between 1968 and 1988, increased to 0.38% in 1989 and to 0.47% in 1990. Table A-4 presents some selected financial ratios.

TABLE A-4

NACIONAL FINANCIERA S.N.C.

Selected Financial Ratios
(In Percentages)

	1986	1987	1988	1989	1990
I. Financial Structure Ratios					
1. Total Assets/Net Worth	94.30	118.9	46.5	13.88	12.20
2. Net Worth/Total Assets	1.06	0.9	2.0	7.20	8.18
3. Total Equity/Total Assets	4.00	4.9	5.9	11.28	12.68
II. Operating Expenses Ratios					
1. Operating Expenses/ Operating Revenues	98.70	98.6	98.4	97.5	91.10
III. Profitability Ratios					
1. Net Income/Total Assets (ROA)	0.17	0.20	0.21	0.39	0.69
2. Net Income/Equity (ROE)	4.20	4.04	3.51	3.64	5.71

Source: NAFIN annual reports.

Overhead Costs

12. NAFIN's overhead costs, as a percentage of average assets, increased from 0.36% in 1986 to 0.65% in 1988, and declined to 0.60% in 1990. The decline is the result of a staff reduction of about 1129 persons between 1988 and 1989. Many people retired from the institution and others decided to leave once NAFIN allowed them to keep their benefits regarding housing and car loans. As a percentage of overhead costs, salaries and fringe benefits have increased from 58% in 1988 to 80% in 1990, as a result of salary adjustments. NAFIN's salaries are now competitive with those of the commercial banking system. NAFIN's present overhead costs are not out of line with those of other Mexican development banks; moreover, its overhead costs should decrease significantly over time due to NAFIN's shift to second-tier operations, which are less labor intensive than first-tier operations.

Creditworthiness

13. The above analysis of NAFIN, focussing on the institution's financial position, quality of portfolio and profitability, indicates that during the last two years NAFIN's creditworthiness has improved as a result of: a) better portfolio quality, b) higher profitability and financial margins, c) a strengthened capital base, and d) phasing out both first-tier lending and off-balance sheet activities, and focusing on second-tier operations. It confirms that NAFIN is a financially sound and creditworthy institution.

Financial Analysis of CFM and FFM

A. Mining Development Commission (CFM)

1. Financial structure and position: CFM's total resources in Mexican pesos were reported to be equal to about US$300 million as of December 31, 1990. These resources originated mainly from CFM's paid-in capital and more recently from the reflows of the Bank's PECAM loans. CFM currently has a 98% capital to total asset ratio and operates free of debt service charges. CFM's capital structure has been diminished by almost MP$145,000 million in the past two years because it is classified as an industrial operation, rather than a financial or holding company, and must therefore take substantial write-offs for all monetary assets that are not offset by debt (the accounting adjustments are actually made by devaluing fixed assets).

2. CFM has dramatically changed the structure of its assets in the recent past. About 43% of CFM's total assets (US$130 million equivalent) are currently liquid and interest earning, up from 10% in 1988. Of these, about 60% are on deposit or in short-term paper, while the balance is on loan to FFM for reinvestment in its second-tier operations. CFM's term loan portfolio and overdue collectables amounted to 17% of total assets at the end of 1990, compared with 46% in 1988, as a result of a major provision for bad debts (see para 5). Finally, fixed assets presently account for about 25% of total assets, down from almost 40%, two years ago, i.e. prior to their downward accounting adjustment.

3. CFM's balance sheet is currently stronger and more realistically established than it has been in the past for the following reasons: a) CFM made a major loan-loss provision and wrote-off more than MPS$70,000 million in overdue and uncollectable loans that it had been carrying on its books; b) its new term lending operations in 1990 were limited to about 20% of term loan reflows, thus reducing risk while building a strong cash base; and, c) it wrote off about US$40 million (equivalent) of plant and equipment, mostly inflation gains. In short, CFM has cleaned out a substantial portion of its balance sheet and is now poised to take on the costs of decentralization and reduction of staff.

4. Operating results: CFM has suffered losses from its operations in four of the past five years. These losses have been more than compensated for by budgetary allocations in support of CFM's social lending programs, equal to about US$13 million (equivalent) in 1990. Thus, CFM has been able to report net profits in each of the past five years (Table 2). CFM's operating losses result mainly from the losses sustained by its beneficiation plants. In 1990, despite sharp increases in the plants' tolling fees to approximate market rates, CFM suffered a loss of about US$7.5 million from plant operations (inclusive of the metal buying and selling activities and overhead associated with it). These operations, established to promote artisan and small mining operations in remote provinces, are currently under study to establish a program to rationalize, close or sell plants.

5. CFM has consistently earned profits on lending operations and cash investments, as they bear no interest expenses. Its high interest income of about US$30 million in 1990 (33% return on average invested liquid assets plus loan portfolio) was adequate to offset a major loan-loss provision of US$25

million, that was taken to write off bad loans and interest accrual that past CFM administrations had continued to carry on corporate books. Considering the size and delayed timing of the provision taken, it is clear that CFM's prior years' earnings were overstated. Based upon its new policy on income accruals and provisions for bad debt, it is expected that CFM's profit and loss statements will fully reflect operating results. CFM's future profits will depend upon the pace at which: (a) the current cost reduction program reduces operating expenses below the US$20 million level reached in 1990; (b) interest income can be increased by improving the overall quality of portfolio operations through: (i) continued shifting of its portfolio reflows to FFM for investment in second-tier lending operations and (ii) tightening the criteria for lending under its reduced direct lending programs, through the creation of a credit officer system; and (c) the scope of plant operations is reduced and the efficiency of surviving plant operations is improved.

6. Cash flow from operations: CFM's cash flow results for 1990, as shown below, present a view of the outcome of its operations that is unaffected by accounting conventions and adjustments. CFM had a total inflow of funds of about US$185 million (equivalent). It received about US$23.5 million in cash from its operations and spent US$26.3 million in cash to fund these operations, the difference was funded by a cash contribution from the government. As a result of more vigorous enforcement of debt collection policy, CFM recuperated about US$136 million in outstanding debt, about 30% more than was recuperated in the prior year. CFM's lending operations were sharply reduced in 1990, reflecting its management's determination to raise the quality of its lending and the depressed state of silver prices. Thus, only about one-half of 1990's reflows were reloaned, with 71% of those funds being channeled through FFM for second tier operations.

7. Loan portfolio: In 1989 CFM's new management adopted appropriate policies on income recognition and reexamined and reclassified its loan portfolio, including the 292 loans advanced under PECAM I and II. More than 55% of the loans reviewed were found to be non-performing, most of these were overdue for more than one year and were considered not recoverable. About 35 large loans, accounting for more than half of arrears, were reviewed and found to be subjects for restructuring. Management responded to these findings by instituting an aggressive collection program, taking some write-offs and setting plans to launch a restructuring effort. By the end of 1990, with silver prices at a highly depressed US$4 per oz., it was clear that rescue efforts could not solve the problems of most non-performing loans and despite some earlier success, collections of bad debt slowed in the face of an industry wide crisis.

8. As of December 31, 1990 CFM's portfolio of loans and interest due amounted to MP$238,000 million (excluding FFM's dues to CFM), of which almost MP$100,000 million (42%) were overdue for more than six months. In line with discussions held with the Bank, CFM's Board of Directors approved an extraordinary loan-loss provision of almost MP$71,000 million in April 1991, which raised CFM's total provisions for bad debt to 86% of debt more than six months in arrears and covered about 70% of the total amounts affected. This provision is satisfactory in the context of CFM's total debt recovery program. CFM clearly has the capital strength needed to take the further provision that could be necessary, if the silver mining industry continues to suffer from highly depressed prices.

9. Measures to strengthen portfolio: To overcome the difficulties experienced with direct term lending operations, CFM sharply reduced direct term operations in 1990 and directed almost all PECAM reflows through FFM. In 1991 and beyond its main portfolio strengthening tasks will be to help commercial banks to finance sound mineral projects, while continuing to reduce its own direct lending operations. This will require that CFM: (a) improve its capability to prepare technically sound projects; (b) develop policy and technical guidelines to ensure that the projects advanced for financing are fully bankable; and (c) develop credit officers, skilled in credit and financial analysis to prepare and supervise projects from a bankers perspective. CFM's capability to take such measures would be reinforced under the proposed project's technical assistance program.

B. Trust Fund for Mining Development (FFM)

10. Financial Structure and Condition: FFM's total resources were almost US$117 million at the end of 1990, compared with its small resource base of US$11.9 million in 1985. Despite its ten-fold growth, FFM remains very conservatively structured, with a capital to total asset ratio of 53%. All of its borrowings are from CFM, that onlends reflows from PECAM I and II to FFM for rechanneling through commercial banks to the mining sector.

11. FFM's second tier lending operation is very profitable, given the unusually high financial margins that it receives, 9.5% on average assets (low-risk bearing second tier institutions often work with a spread of 2.5% or less). However, FFM's administrative plus payroll expenses are also exceptionally high for a service-based financial institution. Its operating costs of 5.7% on average assets are twice those of a commercial bank and at least 35% higher than the expense ratios that prevail in full line development finance companies. FFM has ample scope to reduce costs, margins and spreads. In 1990 it earned 22% on average assets (successful commecial banks operate on 1.5% on assets) and made a net profit of MP$66,529 million, which is equal to 37% on capital.

12. Portfolio Condition: As of December 31, 1990 FFM's total loan portfolio was equal to US$105 million, of which 85% were rediscounts of commercial bank loans to the non-metallic mining sector. All 23 participating banks are servicing their debt to FFM on time. Banks reported no subloan failures to FFM. During the first half decade of operations, FFM's predecessor made 40 direct social sector loans to cooperatives ("ejidos"). These account for about 12.5% of total portfolio and have presented continuous problems of arrearages and collection. FFM has undertaken a more aggressive program of collection aimed at reducing this problem and has written-off the uncollectables, so that its portfolio is currently in excellent shape. Its mandate to lend directly to the social sector continues, though FFM plans to reduce such lending to 10% of the portfolio.

Table 1. CFM BALANCE SHEET, 1986 - 1990
(Millions of Mexican Pesos)

	1986	1987	1988	1989	1990
I. Assets					
1. Cash and Equivalent	7,585	13,686	9,215	63,185	215,352
2. Documents and Loans Due	19,578	55,456	92,264	179,892	23,045
3. Due from Subsidiaries	7,432	18,905	36,836	14,334	153,525
4. Inventories	16,344	24,854	21,716	21,299	24,408
A. Current Assets (1+2+3+4)	50,939	112,901	160,031	278,710	416,330
5. Long Term Loans	11,012	31,831	105,423	119,928	128,677
6. Advances to Subsidiaries	3,024	760	13,643	12,428	4,763
7. Equity Investments (Subsid.)	19,414	46,800	42,064	51,764	82,831
8. Plant & Equipment	81,560	129,594	187,704	193,124	239,111
9. Other Assets	5,023	9,604	3,619	261	1,911
B. Total Assets (A+5+6+7+8+9)	170,972	331,490	512,484	656,215	873,614
II. Liabilities & Capital					
10. Due to Vendors	3,574	7,816	3,995	1,763	17,357
11. Other Short Term Dues	4,352	18,405	6,769	15,544	3,613
C. Current Liabilities (10+11)	7,926	26,221	10,764	17,307	20,970
12. Other Liabilities	40	103	109	120	20
D. Total Liabilities (C+12)	7,966	26,324	10,873	17,427	20,990
13. Paid-In Capital	139,342	228,778	343,105	468,063	559,024
14. Pecam Grant	18,862	42,973	147,370	214,432	395,299
15. Accumulated Surplus (Losses) 2/	4,802	33,415	11,136	43,707	(101,699)
E. Total Capital & Reserves (13+14+15)	163,006	305,166	501,611	638,788	852,624
III. Total Liabilities and Capital (D+E)	170,972	331,490	612,484	656,215	873,614

1/ Non-Consolidated equity holdings in non-banking subsidiaries are carried at net worth.

2/ Includes adjustments for monetary position in 1989 and 1990, in line with new accounting regulations.

Table 2. CFM INCOME STATEMENT, 1986 - 1990
(Millions of Mexican Pesos)

		1986	1987	1988	1989	1990
	1. Sale of Minerals	78,716	55,545	40,764	18,405	13,850
	2. Other Income from Operations 1/	11,265	38,060	32,441	14,815	18,182
	A. Gross Income Plant Operations (1+2)	89,981	94,505	73,211	33,220	32,032
	3. Cost of Mineral Sales	(101,608)	(51,219)	(71,723)	(16,770)	(18,659)
	4. Other Costs of Operations 1/	(28,291)	(39,429)	(29,290)	(28,399)	(28,994)
	B. Total Expenses Plant Operation (3+4)	(129,899)	(90,648)	(101,013)	(45,169)	(47,643)
I.	Net Income (Loss) Plant Operations (A-B)	(39,918)	(3,857)	(27,802)	(11,949)	(15,611)
	5. Interest Income 2/	23,479	17,396	32,897	43,698	86,441
	6. Dividend Income	17,968	21,832	25,304	19,508	13,680
	C. Gross Income Loans & Equities (5+6)	40,447	39,228	58,201	63,206	100,121
	7. Provisions for Losses or Valuation Gains 3/	11,342	22,285	270	(20,022)	(70,685)
II.	Net Income (Loss) Financial Operations (C+7)	51,789	61,513	58,471	43,184	29,436
III.	Income from Plant and Financial Operations (I+II)	11,871	65,370	30,669	31,235	13,825
	8. Costs of Administration & Other	(32,475)	(27,752)	(47,494)	(34,157)	(60,021)
	9. Misc. Income (Costs)	2,910	(3,983)	(6,435)	(0)	22,334
IV.	Profit (Loss) from Total Operations (III-8+9)	(17,694)	33,635	(23,260)	(2,922)	(23,862)
	10. Grants & Allocations	45,151	43,671	40,057	27,413	40,971
V.	Net Gain (Loss), (IV+10)	28,457	76,405	16,790	24,491	17,109
	11. Less Monetary Adjustment 4/				(68,198)	(118,788)
VI.	Net Results (V-11)				(43,707)	(101,699)

1/ Income (Expenses) from operations of beneficiation plants, mines, mills and laboratories.
2/ Interest Income for 1989 and 1990 reflects new accounting policy under which interest accruals are suspended for non-performing loans (overdue 180 days).
3/ Includes other costs for 1989.
4/ Initiated in 1989.

Table 3. FFM BALANCE SHEET, 1986 - 1990
(Millions of Mexican Pesos)

	1986	1987	1988	1989	1990
I. Assets					
1. Cash in Banks & Equivalent	864	10,064	16,471	86,424	35,085
2. Loans & Interest Due	4,056	7,249	24,953	52,704	56,477
3. Due from Subsidiaries	234	95	-	-	-
4. Other Accounts Due	1,157	404	3,807	4,043	330
5. Paid in Advance	8	44	63	14	54
A. Current Assets (1+2+3+4+5)	6,300	17,856	45,299	143,185	89,952
6. Long Term Loans	4,786	22,252	96,470	115,473	248,352
7. Equity Investment	2,230	1,228	26,856	-	-
8. Machinery & Equipment	59	477	408	673	674
9. Deferred Charges	58	95	102	1	1
B. Total Assets (A+6+7+8+9)	12,718	67,524	142,279	259,333	338,981
II. Liabilities & Capital					
10. Due to CFM	1,010	1,686	3,877	38,366	40,060
11. Other Payables	318	819	2,131	414	7,090
C. Current Liabilities (10+11)	1,328	2,505	6,008	38,780	47,151
12. CFM, long term loans	5,509	20,768	87,374	107,539	112,287
D. Total Liabilities (C+12)	6,837	23,273	93,382	146,319	159,438
13. Paid in Capital	2,911	3,644	3,644	4,944	4,944
14. Annual Allocations	491	3,408	13,923	45,066	107,874
15. Reserves to be Applied	429	27,101	196	196	195
16. Retained Earnings	2,500	10,097	31,134	62,818	66,529
E. Total Capital & Reserves (13+14+15+16)	6,330	44,252	48,897	113,015	179,542
III. Total Liabilities and Capital (D+E)	12,718	67,524	142,279	259,333	338,981

Table 4. FFM INCOME STATEMENT, 1986-1990
(Millions of Mexican Pesos)

		1986	1987	1988	1989	1990
	1. Interest & Commission Income	4,465	11,656	37,765	60,250	80,747
	2. Interest Expense	628	2,226	8,174	15,940	52,437
	A. Financial Margin (1-2)	3,837	9,430	29,591	44,310	28,310
	3. Costs of Administration & Other	767	2,098	4,167	4,173	16,884
I.	Net Income from Lending Activity (A-3)	3,070	7,333	25,424	40,137	11,426
	4. Income from Short Term Investments	208	3,501	7,965	23,583	57,619
	5. Other Income	19	195	178	195	293
II.	Financial Income (I+4+5)	3,297	11,029	33,567	63,915	69,338
	6. Provision for Debt	0	621	1,984	955	2,631
	7. Depreciation & Amort. & Other	798	309	447	143	177
III.	Net Profit for the Period (II-6-7)	2,500	10,097	31,135	62,818	66,529

Key Indicators for Project Implementation

CFM would prepare the following information:

1. Socio-economic aspects (annually):

   a) Incremental jobs and cost per job generated;
   b) Incremental output;
   c) Direct and indirect exports generated;
   d) Subproject location;
   e) Type of subproject, expansion or new;
   f) Investment in mining, private and public, domestic and foreign.

2. Lending aspects (annually):

   a) Number of subprojects financed, total investment, financing breakdown by source;
   b) Number of subprojects financed and total investment, classified by investment item (fixed assets, permanent working capital, etc.), by participating financial intermediary, by size of subloan and by type of mineral;
   c) Same information as in a) and b) for subprojects under consideration for a possible subloan.

3. Operating aspects (annually):

   a) Progress report on the implementation of CFM's and CRM's business plans;
   b) Progress report on the execution of the technical assistance program for DGM, CFM and CRM;
   c) Number of hectares released from National Mining Reserves;
   d) Number of concessions granted, by type and size.

MEXICO

MINING SECTOR RESTRUCTURING PROJECT

Estimated Schedule of Bank Loan Disbursements
(Millions of U.S. Dollars)

IBRD Fiscal Year and Quarter (Ending Date)	Quarterly Disbursements	Cumulative
1992		
September 30, 1991	27.5 1/	27.5
December 31, 1991	10.0	37.5
March 31, 1992	7.5	45.0
June 30, 1992	5.0	50.0
1993		
September 30, 1992	7.5	57.5
December 31, 1992	10.0	67.5
March 31, 1993	11.0	78.5
June 30, 1993	11.5	90.0
1994		
September 30, 1992	13.0	103.0
December 31, 1993	11.0	114.0
March 31, 1994	11.0	125.0
June 30, 1994	10.0	135.0
1995		
September 30, 1994	11.0	146.0
December 31, 1994	12.0	158.0
March 31, 1995	12.0	170.0
June 30, 1995	10.0	180.0
1996		
September 30, 1995	8.0	188.0
December 31, 1995	5.0	193.0
March 31, 1996	4.0	197.0
June 30, 1996	3.0	200.0

1/ Special Account

Selected Data and Documents Available in the Project File

A. Mining

1. Reglamento de la Ley Reglamentaria del Articulo 27 Constitucional en Materia Minera 1990. New implementing regulations of the Mining Law.

2. Programa Nacional de Modernizacion de la Mineria, 1990-1994. The National Mining Program for 1990-1994.

3. SEMIP-SEDUE Agreement to Establish Environmental Norms for Mining.

B. Institutions

1. CFM-Policy Statement and Five-Year Financial Plan.

2. CRM-Five-Year Business Plan.

3. CFM-Program to Increase Commercial Bank Lending for Mining Projects.

4. CFM-Program to Handle its Problem Portfolio.

5. CFM/FFM-Credit Regulations.

6. FFM-CFM Management Agreement.

7. NAFIN-Financial Statements, 1986-1990.

Table 1. MINING SECTOR SHARE IN OUTPUT, EXPORTS AND EMPLOYMENT, 1970 - 1990

	1970	1975	1980	1985	1986	1987	1988	1989	1990
I. Output									
(Billions of 1980 pesos)									
1) Mining GDP	40.2	48.0	62.2	75.4	74.9	78.4	76.1	75.5 p/	71.7 e/
2) Total GDP	2,340.6	3,171.4	4,470.1	4,919.9	4,738.6	4,819.5	4,888.9	5,040.9 p/	5,237.5 e/
3) Mining Share (%)	1.7	1.5	1.4	1.5	1.6	1.6	1.6	1.5	1.4
II. Exports									
(Millions of U.S. Dollars)									
1) Mining	198.7	462.9	1,296.5	905.6	967.9	1,172.5	1,410.2	1,555.9	1,526.0
2) Total	1,289.6	3,062.4	15,511.9	21,663.8	16,031.0	20,656.0	20,565.1	22,764.9	26,773.1
3) Mining Share	15.4	15.1	8.4	4.2	6.0	5.7	6.9	6.8	5.7
4) Non-Oil	N.A.	N.A.	5,070.5	6,897.1	9,723.8	12,026.4	13,853.9	14,888.9	16,669.4
5) Mining Share (%)	-	-	25.6	13.1	10.0	9.7	10.2	10.5	9.2
III. Employment									
(Thousands)									
1) Mining	110.2	138.9	182.5	213.4	212.0	217.7	224.3	252.6 p/	284.4 e/
2) Total	13,873.0	16,510.0	20,282.0	21,956.0	21,640.0	21,842.0	21,892.0	23,621.5 p/	25,487.6 e/
3) Mining Share (%)	0.8	0.8	0.9	1.0	1.0	1.0	1.0	1.1	1.1

p/ Preliminary.
e/ Estimated.

Table 2. MINING-METALLURGICAL OUTPUT, 1970-1990
(Thousands of Metric Tons)

	1970	1975	1980	1985	1986	1987	1988	1989	1990
I. Precious Metals (a)									
1) Gold (Thous. of Kg.)	6.2	4.5	6.1	7.5	7.8	8.0	9.1	8.6	8.3
2) Silver (Thous. of Kg.)	1,332.4	1,182.8	1,472.6	2,153.0	2,303.1	2,415.0	2,358.9	2,306.1	2,346.3
II. Non-Ferrous Industrial Metals (a)									
3) Lead	176.6	178.6	145.1	206.7	182.7	177.2	171.3	163.0	179.9
4) Copper	61.0	78.2	175.4	168.0	174.6	230.6	268.4	249.3	298.7
5) Zinc	266.4	228.9	238.2	275.4	271.4	271.5	262.2	284.1	322.5
6) Antimony	4.5	3.1	2.2	4.3	3.3	2.8	2.2	1.9	2.6
7) Arsenic	6.9	4.6	5.3	4.8	5.3	5.3	5.2	5.6	4.8
8) Bismuth	0.6	0.4	0.8	0.9	0.7	1.0	1.0	0.9	0.7
9) Tin	0.5	0.4	0.1	0.4	0.6	0.4	0.3	0.2	0.0
10) Cadmium	2.0	1.6	1.8	1.1	1.2	1.2	1.7	1.4	1.4
11) Selenium	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12) Tungsten	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2
13) Molibdenum	0.1	0.0	0.1	3.8	3.4	4.4	4.5	4.2	2.0
III. Foundry Metals and Minerals									
14) Coal (b)	188.1	176.8	408.5	2,440.4	3,677.6	4,251.7	4,210.8	4,243.8	4,219.8
15) Coke (b)	1,299.6	2,088.0	2,409.2	2,390.0	2,050.0	2,340.3	2,332.2	2,260.5	2,337.2
16) Iron (a)	2,612.4	3,369.3	5,586.7	5,161.1	4,817.4	4,965.1	5,564.5	5,373.1	5,327.9
17) Manganese (a)	98.6	154.2	161.0	150.6	174.4	146.4	168.6	149.9	138.9
IV. Non-Metallic Minerals (b)									
18) Sulfur	1,380.8	2,164.3	2,102.3	2,019.8	2,050.7	2,303.8	2,138.2	2,086.3	2,047.8
19) Graphite	55.6	60.8	44.5	35.4	37.8	37.9	43.8	40.2	24.9
20) Barite	319.1	300.0	269.3	467.7	321.2	401.3	535.0	324.7	305.0
21) Dolomite	474.5	348.7	378.3	318.1	376.2	361.7	340.7	469.6	482.2
22) Fluorite	978.5	1,088.8	916.5	697.4	756.8	723.6	756.1	779.4	633.8
23) Kaolin	78.5	120.4	29.5	33.0	10.1	12.8	11.6	15.7	5.4
24) Silica	355.9	519.0	728.3	976.2	893.6	1,083.1	1,081.3	1,216.4	1,298.3
25) Gypsum	1,290.9	1,255.9	1,708.9	2,366.0	2,625.2	2,457.8	2,649.3	2,898.6	2,814.4
26) Phosphorite	46.7	282.5	283.2	645.3	660.4	633.2	666.8	625.4	557.1
27) Salt	N.A.	N.A.	N.A.	5,450.9	5,926.8	6,393.2	6,965.2	6,942.2	7,135.1
28) Wollastonite	N.A.	N.A.	N.A.	2.3	0.2	N.A.	0.3	0.6	0.5
29) Celestite	N.A.	N.A.	N.A.	30.5	24.3	32.4	38.8	37.8	51.3

(a) Metallic content.
(b) Gross weight.

Table 3. MEXICO IN WORLD MINERAL PRODUCTION, 1989

Mineral	Unit	Domestic Production	World Production	Share (%)	Rank
Silver	metric tons	2,306	14,452	16.0	1
Bismuth	metric tons	1,050	2,762	38.0	1
Sodium Sulfate	th. short tons	500	2,432	20.6	1
Strontium	metric tons	91,000	244,300	37.3	1
Barite	th. metric tons	566	5,700	9.9	2
Fluorspar	th. metric tons	861	5,731	15.0	2
Graphite	th. metric tons	47	631	7.5	3
Antimony	metric tons	2,500	68,362	3.7	3
Soda Ash	th. short tons	198	34,910	0.6	3
Arsenic	metric tons	5,100	52,000	9.8	4
Mercury	metric tons	300	5,840	5.1	4
Cadmium	metric tons	1,200	21,002	5.7	5
Molybdenum	th. kilograms	4,490	115,404	3.9	5
Nitrogen	th. short tons	2,310	109,340	2.1	5
Lime	th. short tons	6,610	149,184	4.4	6
Lead	th. metric tons	163	3,400	4.8	7
Zinc	th. metric tons	284	7,140	4.0	7
Sulfur	th. metric tons	2,367	58,348	4.1	7
Manganese	th. short tons	473	26,500	1.8	8
Salt	th. short tons	8,435	209,988	4.0	8
Diatomite	th. metric tons	35	1,838	1.9	9
Selenium	metric tons	20	1,553	1.3	10
Gypsum	th. short tons	5,305	108,624	4.9	10

Source: Mineral Commodity Summaries 1991

Table 4. VALUE OF MINING-METALLURGICAL OUTPUT, 1970-1990
(Millions of U.S. Dollars)

		1970	1975	1980	1985	1986	1987	1988	1989	1990
I.	**Precious Metals (a)**	83.1	191.5	1,101.1	505.2	501.4	666.5	617.9	512.7	463.5
	1) Gold	7.1	23.4	122.9	80.3	95.8	117.8	127.0	105.2	102.3
	2) Silver	76.0	168.1	978.2	424.9	405.6	548.7	490.9	407.5	361.2
II.	**Non-Ferrous Industrial Metals (a)**	311.4	409.7	733.8	568.5	515.3	710.9	1,138.6	1,391.5	1,484.5
	3) Lead	61.8	79.4	140.5	74.7	70.2	111.1	127.6	128.1	164.0
	4) Copper	88.4	92.8	377.0	221.9	213.0	331.3	637.9	704.1	764.5
	5) Zinc	93.3	196.7	184.4	215.1	185.4	217.7	297.5	491.0	518.5
	6) Antimony	25.4	11.0	6.5	10.8	8.4	6.8	5.5	4.3	5.1
	7) Arsenic	1.0	2.1	3.8	4.2	4.3	4.5	4.6	4.4	3.7
	8) Bismuth	7.5	6.8	4.1	9.6	4.5	6.0	10.4	11.0	5.8
	9) Tin	2.1	3.0	1.1	4.8	4.6	3.1	2.5	1.9	N.S.
	10) Cadmium	16.2	10.8	10.1	2.2	2.3	3.5	22.4	20.0	11.3
	11) Mercury	11.4	2.6	0.0	2.2	2.2	2.6	3.4	N.A.	N.A.
	12) Selenium	2.2	1.8	0.9	0.6	0.2	0.3	0.3	0.3	0.2
	13) Tungsten	1.5	2.6	3.8	1.8	1.3	0.9	1.2	0.9	0.8
	14) Molibdenum	0.6	0.1	1.6	20.6	18.9	23.1	25.3	25.5	10.6
III.	**Foundry Metals and Minerals**	100.0	228.5	237.9	149.1	112.0	86.4	175.2	190.2	210.9
	15) Coal (b)	1.6	2.2	2.9	1.5	1.0	0.5	27.8	25.9	22.5
	16) Coke (b)	32.0	94.4	59.2	5.3	1.9	1.0	54.3	48.6	44.0
	17) Iron (a)	53.3	111.4	150.8	123.7	88.5	68.0	69.4	88.7	99.6
	18) Manganese (a)	13.1	20.5	25.0	18.6	20.6	16.9	23.7	27.0	44.8
IV.	**Non-Metallic Minerals (b)**	100.2	196.5	264.1	372.0	380.3	412.1	436.5	403.0	353.6
	19) Sulphur	47.2	99.9	149.7	246.1	243.3	257.7	249.2	218.7	193.6
	20) Graphite	2.8	3.0	3.3	3.3	3.6	3.8	4.6	4.2	2.7
	21) Barite	5.7	7.6	11.8	19.7	11.0	13.4	18.9	11.4	10.8
	22) Dolomite	2.2	1.7	1.0	0.1	N.S.	0.1	0.7	1.0	0.9
	23) Fluorite	32.7	71.0	83.5	55.5	56.3	56.6	63.7	65.7	53.2
	24) Kaolin	0.5	0.8	0.1	N.S.	N.S.	N.S.	N.S.	N.S.	N.S.
	25) Silica	4.2	6.2	4.7	0.6	0.2	0.4	2.4	2.5	2.3
	26) Gypsum	4.6	4.5	3.7	0.5	0.2	0.5	3.5	3.5	3.0
	27) Phosphorite	0.3	1.8	6.3	1.3	0.6	0.4	1.5	1.3	1.0
	28) Salt	N.A.	N.A.	N.A.	44.9	65.1	79.2	91.9	94.6	86.0
	29) Wollastonite	N.A.	N.A.	N.A.	0.0	N.S.	0.0	N.S.	N.S.	N.S.
	30) Celestite	N.A.	N.A.	N.A.	N.S.	0.0	N.S.	0.1	0.1	0.1
V.	**Total (I+II+III+IV)**	594.7	1,026.2	2,336.9	1,594.6	1,509.2	1,875.8	2,368.2	2,497.5	2,512.5

(a) Metallic content.
(b) Gross weight.

Table 4A. STRUCTURE OF THE VALUE OF MINING-METALLURGICAL OUTPUT, 1970-1990 (%)

		1970	1975	1980	1985	1986	1987	1988	1989	1990
I.	Precious Metals	14.0	18.7	47.2	31.6	33.3	35.6	26.1	20.5	18.5
	1) Gold	1.2	2.3	5.3	5.0	6.4	6.3	5.4	4.2	4.1
	2) Silver	12.8	16.4	41.9	26.6	26.9	29.3	20.7	16.3	14.4
II.	Non-Ferrous Industrial Metals	52.6	40.1	31.5	35.6	34.4	37.9	48.0	55.7	58.9
	3) Lead	10.4	7.7	6.0	4.7	4.7	5.9	5.4	5.1	6.5
	4) Copper	14.9	9.0	16.1	13.9	14.1	17.7	26.9	28.2	30.4
	5) Zinc	15.7	19.2	7.9	13.5	12.3	11.6	12.6	19.7	20.6
	6) Antimony	4.3	1.1	0.3	0.7	0.6	0.4	0.2	0.2	0.2
	7) Arsenic	0.2	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.1
	8) Bismuth	1.3	0.7	0.2	0.6	0.3	0.3	0.4	0.4	0.2
	9) Tin	0.4	0.3	0.1	0.3	0.3	0.2	0.1	0.1	0.0
	10) Cadmium	2.7	1.1	0.4	0.1	0.2	0.2	0.9	0.8	0.5
	11) Mercury	1.9	0.3	0.0	0.1	0.2	0.1	0.1	N.A.	N.A.
	12) Selenium	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	13) Tungsten	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.0	0.0
	14) Molibdenum	0.1	0.0	0.1	1.3	1.3	1.2	1.1	1.0	0.4
III.	Foundry Metals and Minerals	16.9	22.3	10.2	9.4	7.5	4.6	7.4	7.7	8.5
	15) Coal	0.3	0.2	0.1	0.1	0.1	0.0	1.2	1.0	0.9
	16) Coke	5.4	9.2	2.5	0.3	0.1	0.1	2.3	2.0	1.8
	17) Iron	9.0	10.9	6.5	7.8	5.9	3.6	2.9	3.6	4.0
	18) Manganese	2.2	2.0	1.1	1.2	1.4	0.9	1.0	1.1	1.8
IV.	Non-Metallic Minerals	17.0	19.1	11.3	23.2	25.0	21.8	18.5	16.2	13.9
	19) Sulphur	7.9	9.7	6.4	15.4	16.1	13.7	10.5	8.8	7.7
	20) Graphite	0.5	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.1
	21) Barite	1.0	0.7	0.5	1.2	0.7	0.7	0.8	0.5	0.4
	22) Dolomite	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	23) Fluorite	5.5	6.9	3.6	3.5	3.7	3.0	2.7	2.6	2.1
	24) Kaolin	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	25) Silica	0.7	0.6	0.2	0.0	0.0	0.0	0.1	0.1	0.1
	26) Gypsum	0.8	0.4	0.2	0.0	0.0	0.0	0.2	0.1	0.1
	27) Phosphorite	0.1	0.2	0.3	0.1	0.0	0.0	0.1	0.1	0.0
	28) Salt	N.A.	N.A.	N.A.	2.8	4.3	4.2	3.9	3.8	3.4
	29) Wollastonite	N.A.	N.A.	N.A.	0.0	0.0	0.0	0.0	0.0	0.0
	30) Celestite	N.A.	N.A.	N.A.	0.0	0.0	0.0	0.0	0.0	0.0
V.	Total (I+II+III+IV)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 5. MINING - METALLURGICAL EXPORTS, 1970-1990
(Millions of U.S. Dollars)

		1970	1975	1980	1985	1986	1987	1988	1989	1990
I.	Precious Metals	31.2	128.0	677.0	262.6	309.3	362.5	319.0	347.3	301.3
	1) Silver concentrates			N.A.	0.8	1.2	1.2	0.8	0.5	0.1
	2) Silver, bars			N.A.	261.8	308.1	361.4	318.2	346.8	301.1
II.	Non-Ferrous Industrial Metals	90.8	184.5	363.3	361.4	377.1	492.1	741.6	875.1	915.7
	3) Lead concentrates			7.7	7.5	9.6	16.8	15.1	7.7	7.3
	4) Copper concentrates			155.7	148.3	162.0	161.4	200.4	147.9	180.0
	5) Zinc concentrates			60.9	38.5	26.1	23.6	36.2	79.1	85.5
	6) Bismuth concentrates			0.8	1.2	0.5	1.6	2.5	0.0	0.0
	7) Mercury metallic			3.5	0.9	1.1	0.9	1.1	0.7	0.2
	8) Tungsten concentrates			1.9	1.2	0.7	0.8	0.8	0.6	0.6
	9) Other			16.4	30.4	27.1	51.9	53.7	34.8	34.2
	10) Copper bars			0.5	3.8	9.0	44.8	144.8	209.1	169.3
	11) Lead refined			55.5	35.1	38.0	45.5	58.9	56.1	91.7
	12) Zinc refined			46.6	59.4	53.8	60.0	93.2	147.3	137.5
	13) Bismuth refined			0.0	3.4	2.8	3.2	7.6	9.1	4.3
	14) Cadmium refined			3.0	1.0	1.0	2.6	9.9	6.2	1.6
	15) Other			10.8	30.7	45.5	79.1	117.4	176.6	203.5
III.	Foundry Metals and Minerals	0.6	9.0	5.3	10.4	12.1	11.8	13.1	15.1	8.9
	16) Manganese concentrates			5.3	9.7	10.4	9.8	10.7	12.9	8.4
	17) Coal mineral			0.0	0.0	0.0	0.0	0.0	0.0	0.0
	18) Other			0.0	0.8	1.7	2.1	2.5	2.2	0.5
IV.	Non-Metallic Minerals	59.1	125.0	250.9	271.1	269.4	306.0	336.4	318.4	300.0
	19) Sulphur			107.5	113.0	134.9	159.2	184.4	146.5	146.6
	20) Fluorspar			68.6	42.8	32.6	35.1	43.6	54.6	37.3
	21) Salt			51.2	52.2	51.7	54.9	57.5	65.9	79.3
	22) Barium Sulfate			4.7	1.3	1.0	1.6	1.1	2.6	2.2
	23) Gypsum			9.1	34.0	37.0	35.2	35.9	37.0	20.0
	24) Other			9.8	27.7	12.2	20.1	13.9	11.8	14.5
V.	Total (I+II+III+IV)	181.6	446.5	1,296.5	905.5	967.9	1,172.5	1,410.2	1,555.9	1,526.0

Table 5A. STRUCTURE OF MINING - METALLURGICAL EXPORTS, 1970 - 1990 (%)

		1970	1975	1980	1985	1986	1987	1988	1989	1990
I.	Precious Metals	17.2	28.7	52.2	29.0	32.0	30.9	22.6	22.3	19.7
	1) Silver concentrates			N.A.	0.1	0.1	0.1	0.1	0.0	0.0
	2) Silver, bars			N.A.	28.9	31.8	30.8	22.6	22.3	19.7
II.	Non-Ferrous Industrial Metals	50.0	41.3	28.0	39.9	39.0	42.0	52.6	56.2	60.0
	3) Lead concentrates			0.6	0.8	1.0	1.4	1.1	0.5	0.5
	4) Copper concentrates			12.0	16.4	16.7	13.8	14.2	9.5	11.8
	5) Zinc concentrates			4.7	4.3	2.7	2.0	2.6	5.1	5.6
	6) Bismuth concentrates			0.1	0.1	0.1	0.1	0.2	0.0	0.0
	7) Mercury metallic			0.3	0.1	0.1	0.1	0.1	0.0	0.0
	8) Tungsten concentrates			0.1	0.1	0.1	0.1	0.1	0.0	0.0
	9) Other			1.3	3.4	2.8	4.4	3.8	2.2	2.2
	10) Copper bars			0.0	0.4	0.9	3.8	10.3	13.4	11.1
	11) Lead refined			4.3	3.9	3.9	3.9	4.2	3.6	6.0
	12) Zinc refined			3.6	6.6	5.6	5.1	6.6	9.5	9.0
	13) Bismuth refined			0.0	0.4	0.3	0.3	0.5	0.6	0.3
	14) Cadmium refined			0.2	0.1	0.1	0.2	0.7	0.4	0.1
	15) Other			0.8	3.4	4.7	6.8	8.3	11.4	13.3
III.	Foundry Metals and Minerals	0.3	2.0	0.4	1.2	1.3	1.0	0.9	1.0	0.6
	16) Manganese concentrates			0.4	1.1	1.1	0.8	0.8	0.8	0.6
	17) Coal mineral			0.0	0.0	0.0	0.0	0.0	0.0	0.0
	18) Other			0.0	0.1	0.2	0.2	0.2	0.1	0.0
IV.	Non-Metallic Minerals	32.5	28.0	19.4	29.9	27.8	26.1	23.9	20.5	19.7
	19) Sulphur			8.3	12.5	13.9	13.6	13.1	9.4	9.6
	20) Fluorspar			5.3	4.7	3.4	3.0	3.1	3.5	2.4
	21) Salt			3.9	5.8	5.3	4.7	4.1	4.2	5.2
	22) Barium Sulfate			0.4	0.1	0.1	0.1	0.1	0.2	0.1
	23) Gypsum			0.7	3.8	3.8	3.0	2.6	2.4	1.3
	24) Other			0.8	3.1	1.3	1.7	1.0	0.8	1.0
V.	Total (I+II+III+IV)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 6. INVESTMENT IN THE MINING-METALLURGICAL SECTOR, 1970-1990
(Millions of U.S. Dollars)

		1970	1975	1980	1985	1986	1987	1988	1989	1990
I.	Exploration	N.A.	N.A.	39.0	25.6	15.7	16.2	23.6	31.9	42.1
II.	New Projects	N.A.	N.A.	277.5	81.5	49.1	32.0	72.3	36.9	157.6
III.	Increase Capacity and Improve Efficiency	N.A.	N.A.	161.5	172.1	78.7	32.6	37.5	99.8	190.6
IV.	Other	N.A.	N.A.	64.0	64.9	63.1	19.6	40.5	17.0	25.4
V.	Total Investment (I+II+III+IV)	80.0	240.0	542.0	344.1	206.5	100.4	173.8	185.6	415.7
VI.	Public Investment	N.A.	N.A.	N.A.	97.6	98.6	72.9	67.1	57.2	145.6
	(%)				(28.4)	(47.7)	(72.6)	(38.6)	(30.8)	(35.0)
VII.	Private Investment	N.A.	N.A.	N.A.	246.5	108.0	27.6	106.8	128.4	270.0
	(%)				(71.6)	(52.3)	(27.4)	(61.4)	(69.2)	(65.0)

Table 7. NATIONAL MINING RESERVES, 1990
(Hectares)

Assigned by Special Agreement to:		
1)	Mining Development Commission	1,185,604.5
2)	Mineral Resources Council	1,387,435.6
3)	Cia. de Real del Monte y Pachuca, S.A.	52,200.0
4)	Siderurgica Lazaro Cardenas Las Truchas, S.A.	2,372.0
5)	Barita de Sonora, S.A.	4,800.0
6)	Azufrera Panamericana, S.A.	605,473.0
7)	Compania Exploradora del Istmo, S.A.	8,379.1
8)	Comision Nacional de Energia Nuclear	96,632.2
9)	Unassigned	1,043,363.9
	Total	4,386,260.2

Table 8. LAND ASSIGNED OUTSIDE NATIONAL MINING RESERVES, 1990
(Hectares)

I.	Assigned by Ordinary Agreement to:	
	1. Comision Nacional de Energia Nuclear	49,623.0
	2. Roca Fosforica Mexicana, S.A. de C.V.	7,551.0
	3. Minera Carbonifera Rio Escondido, S.A.	37,816.1
	4. Mining Development Commission	1,804,090.6
	Total	1,899,080.7
II.	Assigned by Ordinary Request to:	
	1. Mining Development Commission	342.8
	2. Mineral Resources Council	3,505.2
	Total	3,848.0

Table 9. LAND UNDER CONCESSION TO THE PRIVATE SECTOR, 1990

Type of Concession	Size (Hectares)	Number of Titles	%	Area (Hectares)	%
I. Exploration					
	0-50	7,859	30.1	182,271.1	3.0
	51-100	2,972	11.4	242,252.6	4.0
	101-500	3,728	14.3	925,800.0	15.2
	501-1,000	441	1.7	320,626.6	5.2
	1,001-5,000	495	1.9	1,151,137.9	18.9
	5,001-10,000	99	0.4	694,755.8	11.4
	10,001-20,000	51	0.2	690,138.2	11.3
	20,001-50,000	35	0.1	1,265,805.8	20.7
	Sub-Total	15,680	60.1	5,472,787.9	89.7
II. Exploitation	0-50	7,295	27.9	119,761.8	2.0
	51-100	1,921	7.4	162,230.8	2.6
	101-500	1,193	4.6	346,156.2	5.7
	Sub-Total	10,409	39.9	628,148.8	10.3
	Grand Total (I+II)	26,089	100.0	6,100,936.7	100.0

Table 10. COST OF HOLDING A MINERAL CONCESSION FOR EXPLORATION
(1990 U.S. Dollars)

Area (Hectares)	Surface Tax 1/	First Year		Second Year		Third Year		3 Year Total for Exploration		
		Work Req.	Total Cost	Work Req.	Total Cost	Work Req.	Total Cost	Surface Tax	Work Req.	Total
10	52	93	145	279	331	559	610	155	931	1086
50	259	382	641	1238	1496	2522	2780	776	4141	4917
100	517	733	1250	2419	2936	4931	5448	1552	8083	9635
200	1034	1422	2457	4757	5791	9763	10798	3103	15942	19046
400	2069	2751	4820	9386	11455	19348	21417	6207	31484	37691
800	4138	5213	9451	18549	22687	38424	42562	12414	62287	74700
1600	8276	10411	18687	36784	45059	76397	84673	24828	123592	148420
3000	15517	18965	34482	68335	83853	142544	158061	46552	229844	276396
6000	31034	36680	67715	135184	166218	283632	314666	93103	455496	548599
12000	62069	70620	132689	267793	329862	564482	626551	186207	902895	1089102

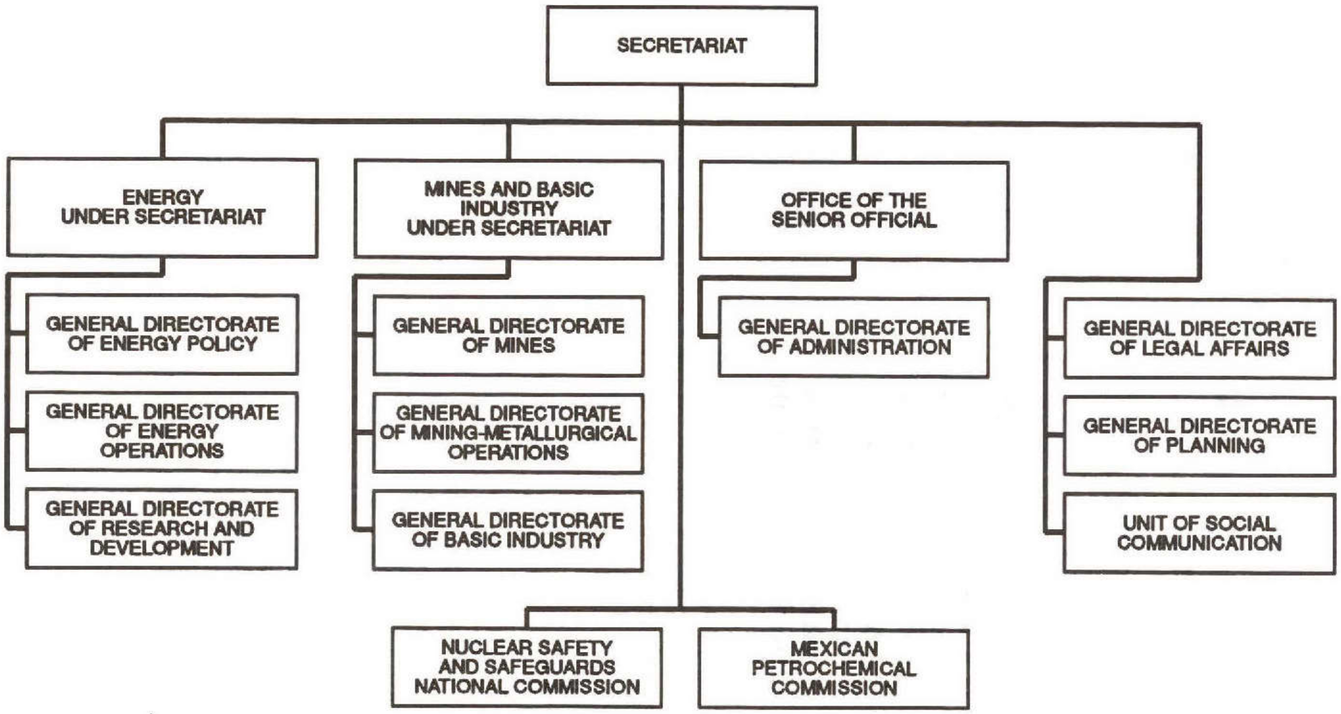
1/ Equal for all years

Table 10A. COST OF HOLDING A MINERAL CONCESSION FOR EXPLOITATION
(1990 U.S. Dollars)

Area (Hectares)	Surface Tax 1/	Work Requirement 1/	4 Year Total for Exploitation		
			Surface Tax	Work Requirement	Total
10	103	419	310	1258	1568
50	517	2254	1552	6763	8315
100	1034	4584	3103	13753	16857
200	2069	9384	6207	28151	34358
400	4138	27586	12414	32757	95171
800	8276	72414	24828	217242	242070
1600	16552	220690	49655	662069	711725
3000	31034	586182	93103	1758546	1851649
5000	51724	1241382	155172	3724146	3879318

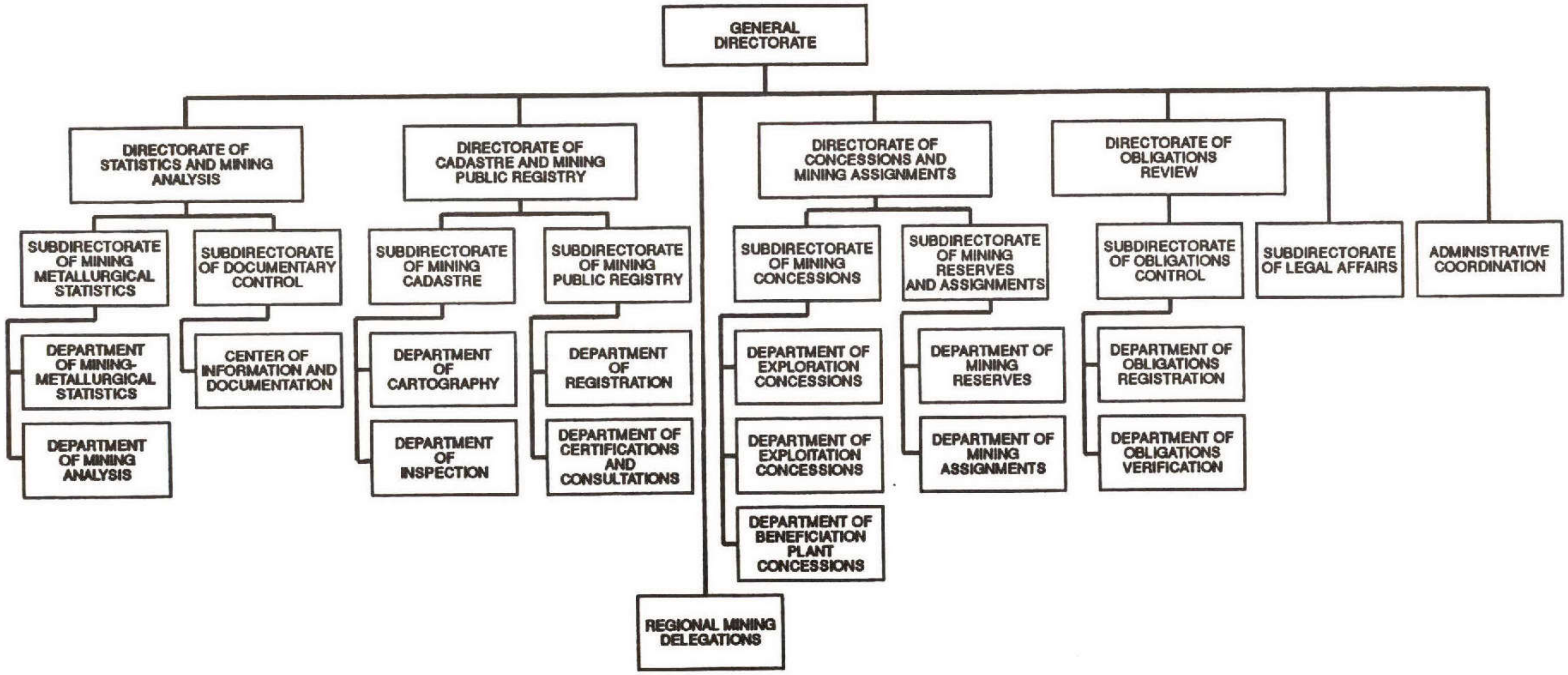
1/ Equal for all years.

TABLE 11. SEMIP ORGANIZATIONAL CHART



EK/W49112A

TABLE 11A. DGM ORGANIZATIONAL CHART



EK/W49112B

TABLE 12. CFM ORGANIZATIONAL CHART

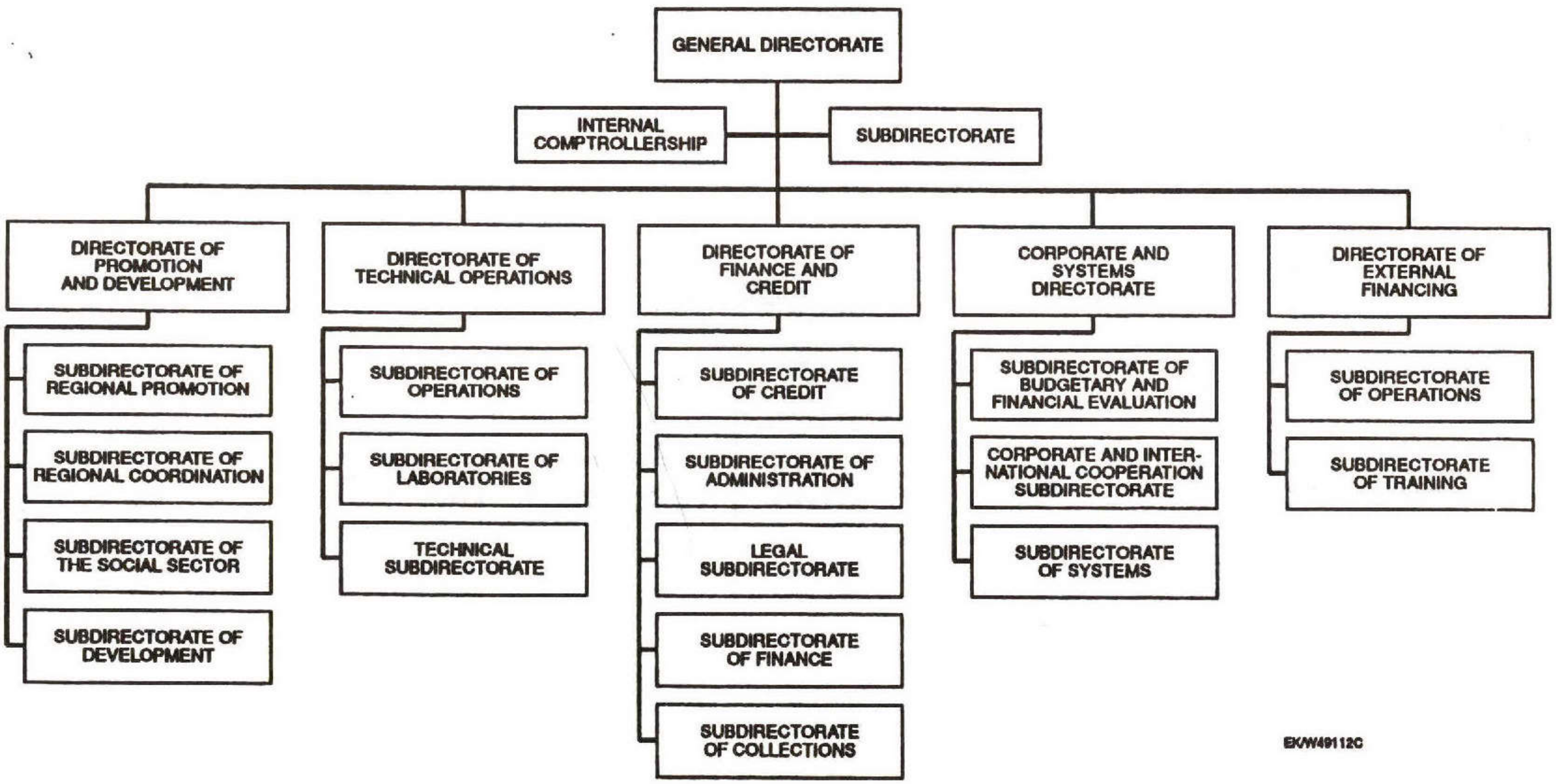
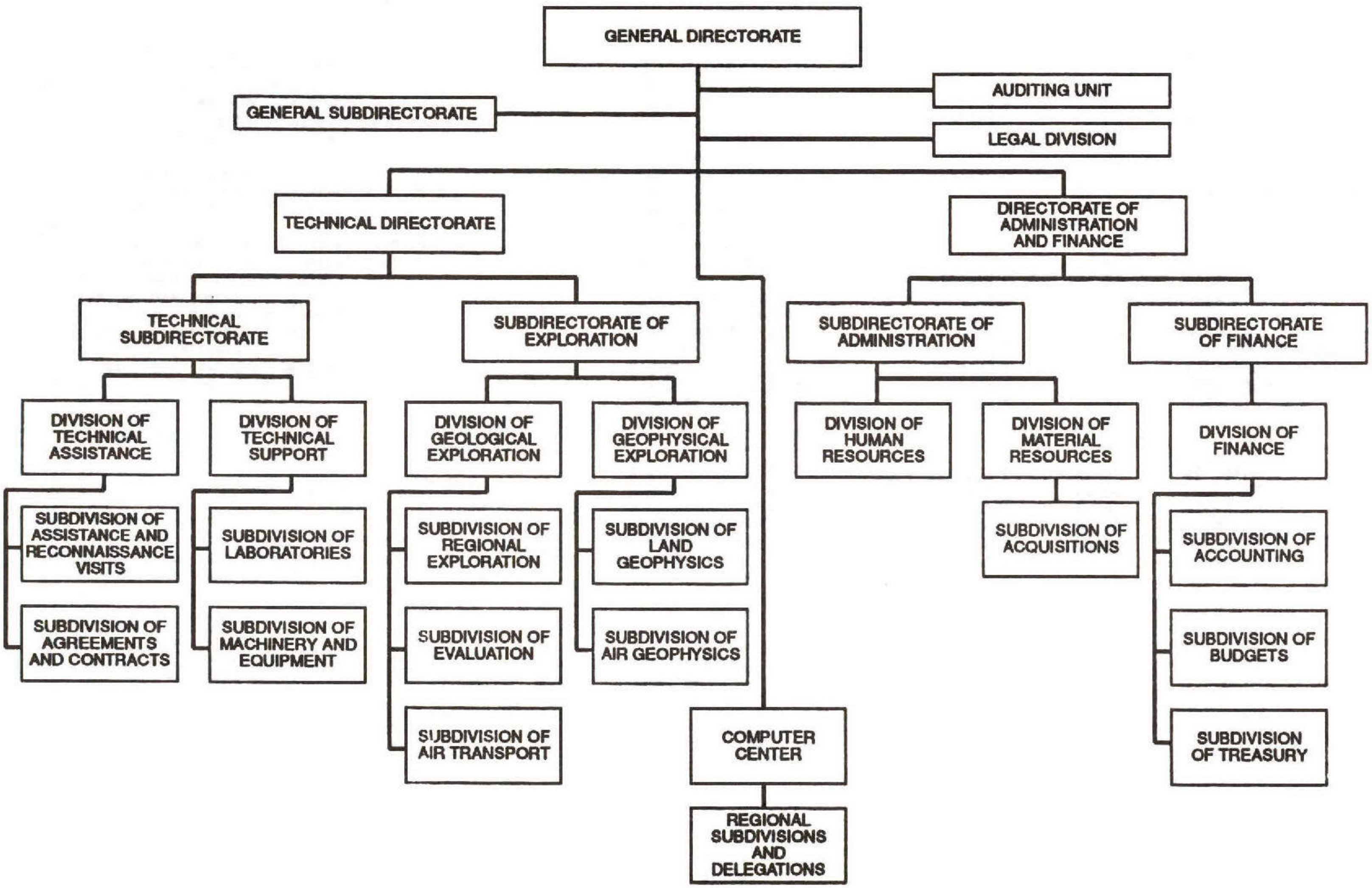


Table 13. CFM PARTICIPATION IN STATE-OWNED ENTERPRISES (AS OF JANUARY 1991)

Enterprises	Business	Equity (Mill. Mex. Pesos)	CFM Share (%)	Status
I. Majority Owned				
1. Azufrera Panamericana, S.A.	Sulfur, Brine	7,200.0	55.33	Will remain a SOE
2. Azufres Nacionales Mexicanos, S.A.	Sulfur	30.0	66.00	Sold
3. Barrenas de Acero y Aguces, S.A.	Drills	11.8	12.70	Sold
4. Cia. Cuprifera La Verde, S.A.	Copper Mineral	83.0	52.00	Dissolved
5. Cia. de Real del Monte y Pachuca, S.A.	Gold-Silver Mineral	10,826.3	99.99	Sold
6. Cia. Exploradora del Istmo, S.A.	Sulfur	960.0	51.00	Will remain a SOE
7. Cia. Minera Corzo, S.A. de C.V.	Trading	3.8	85.00	Dissolved
8. Cia. Minera Santa Rosalia, S.A.	Copper Mineral	175.8	96.32	In dissolution
9. Exportadora de Sal, S.A. de C.V.	Industrial Salt	55,000.0	51.00	Will remain a SOE
10. Exportadora e Importadora de Minerales, S.A. de C.V.	Mineral Trading	12.5	99.68	Dissolved
11. Fosforitas Mexicanas, S.A. de C.V.	Kaolin Calcination	15.0	33.33	Dissolved
12. Impulsora Minera e Industrial de Baja California, S.A.	Services	2.1	99.80	Transfered to Local Gov.
13. Inmobiliaria y Constructora Rio Escondido de Coahuila, S.A. de C.V.	Construction	29,195.8	61.02	In dissolution
14. Jalumex, S.A.	Aluminum	100.0	51.00	Dissolved
15. Macocozac, S.A.	Copper Mineral	1,343.2	99.88	Sold
16. Minera Carbonifera Rio Escondido, S.A.	Coal	191,923.9	11.54	For sale
17. Naviera de Baja California, S.A.	Transportation	0.5	87.37	Dissolved
18. Refractarios Hidalgo, S.A.	Bricks	377.1	80.11	Sold
19. Roca Fosforica Mexicana, S.A. de C.V.	Phosphoric Rock	26,528.9	99.97	Will remain a SOE
20. Sedemex, S.A.	Mineral Exploration	15.0	65.76	Dissolved
21. Sodemi, S.A.	Mineral Exploration	12.0	65.97	Dissolved
22. Transportadora de Sal, S.A. de C.V.	Transportation	12,120.0	50.98	Will remain a SOE
23. Zincamex, S.A.	Refractories	553.6	99.01	For sale
II. Minority Owned				
24. Atisa Atkins, S.A. de C.V.	Services	86.4	1.93	Sold
25. Autlan, S.A. de C.V.	Administrative Services	4,939.1	8.73	Administered by NAFIN
26. Azufres Moralar, S.A. de C.V.	Sulfur	10.8	33.00	Dissolved
27. Baja Bulk Carriers, S.A.	Transportation	500.0	50.00	Will remain a SOE
28. Comercial Carbonera, S.A.	Coal Trading	2.0	20.00	Dissolved
29. Cia. Minera Cedros, S.A. de C.V.	Gold-Silver Mineral	100.0	15.00	Sold
30. Cia. Minera Comonfort, S.A.	Gold-Silver Mineral	13.0	45.00	Sold
31. Cia. Minera de Cananea, S.A.	Copper	629,892.0	0.23	Sold
32. Cia. Naviera Minera del Golfo, S.A. de C.V.	Transportation	18,935.5	0.45	For sale
33. Consorció Minero Benito Juarez-Pena Colorada, S.A.	Iron Pellets	768.1	4.76	For sale
34. Exmex, S.A. de C.V.	Mineral Trading	7.5	15.00	Dissolved
35. Ferro Minera Mexicana, S.A.	Mineral Exploitation	20.0	25.00	Sold
36. Impulsora Minera de Angangueo, S.A. de C.V.	Lead-Iron Mineral	4.5	33.33	Transfered to Local Gov.
37. Industrias Sulfamex, S.A. de C.V.	Manganese Sulfate	3,829.0	2.91	Will remain a SOE
38. Mexicana de Cobre, S.A.	Copper Mineral	6,132.8	6.00	Sold
39. Minera Lampazos, S.A. de C.V.	Lead-Silver Mineral	57.6	32.00	Sold
40. Minera Real de Angeles, S.A. de C.V.	Lead-Silver Mineral	1,240.0	33.00	Sold
41. Minerales Submarinos Mexicanos, S.A.	Mineral Exploration	3.6	11.00	In dissolution
42. Quimica Fluor, S.A. de C.V.	Fluorhydric-Sulphuric Acid	800.0	17.00	Sold
43. Reactivos Minerales Mexicanos, S.A. de C.V.	Sodium Cyanide	10,000.0	1.04	Will remain a SOE
44. Refractarios Mexicanos, S.A.	Refractories	477.4	33.34	Sold

TABLE 14. CRM ORGANIZATIONAL CHART



EK/W49112D

Table 15. CRM BALANCE SHEET, 1986-1990
(Millions of Mexican Pesos)

	1986	1987	1988	1989	1990
I. Assets					
1. Cash and Other Liquid Assets	458.8	2,589.0	5,280.5	6,686.7	9,818.2
2. Accounts Receivable and Other Short Term Assets	653.4	6,236.3	12,059.6	19,889.1	23,125.3
3. Inventories	2,706.1	4,305.8	451.8	412.8	889.3
A. Current Assets (1+2+3)	3,818.3	13,131.1	17,791.6	26,988.7	33,832.8
4. Long Term Assets	8.2	683.5	1,155.5	2,062.7	6,680.0
5. Fixed Assets (net)	25,266.6	8,222.2	4,004.6	6,044.4	9,607.9
6. Deferred Assets	5,795.5	5,728.2	6,298.7	4,872.9	5,775.6
B. Total Assets (A+4+5+6)	34,888.7	27,765.0	29,250.8	39,968.7	55,896.3
II. Liabilities					
C. Current Liabilities	1,990.2	2,215.9	4,175.5	4,449.7	5,796.1
7. Other Liabilities	3,531.0	3,485.6	7,618.6	8,973.1	13,318.5
D. Total Liabilities (C+7)	5,521.2	5,701.5	11,794.1	13,422.8	19,114.6
III. Equity					
8. Capital Stock	582.6	2,401.2	6,859.9	8,694.6	19,993.4
9. Net Result Current Year	(2,244.8)	1,723.2	1,987.1	6,181.4	(2,243.9)
10. Other	31,029.7	17,939.1	8,609.7	11,669.9	19,032.2
E. Total Equity (8+9+10)	29,367.5	22,063.5	17,456.7	26,545.9	36,781.7
IV. Liabilities plus Equity (II+III)	34,888.7	27,765.0	29,250.8	39,968.7	55,896.3

Table 16. CRM INCOME STATEMENT, 1986-1990
(Millions of Mexican Pesos)

	1986	1987	1988	1989	1990
I. Income					
1. Investment	3,877.4	3,433.6	6,395.2	7,612.3	19,400.0
2. Operations	201.5	3,988.2	7,038.6	9,151.6	14,853.2
3. Other	493.7	879.7	595.4	1,236.1	1,449.2
A. Sub-Total Fiscal Resources (1+2+3)	4,572.6	8,301.5	14,029.2	18,000.0	35,702.4
4. Mineral Sales	2,610.2	5,817.9	1,171.3	0.0	0.0
5. Royalties	874.8	5,459.7	8,894.3	9,864.5	4,391.0
6. Contracts	25.5	51.4	231.3	4,526.6	4,510.5
7. Other	952.2	1,862.0	7,772.4	4,235.2	3,365.2
B. Sub-Total Own Resources (4+5+6+7)	4,462.7	13,191.0	18,069.3	18,626.3	12,266.7
C. Total Income (A+B)	9,035.3	21,492.5	32,098.5	36,626.3	47,969.1
II. Expenses					
8. Investment	3,789.6	4,396.9	11,186.9	9,991.3	18,119.9
9. Operations	3,719.7	6,924.5	16,383.3	19,755.2	28,762.6
10. Other	3,770.8	8,447.9	2,541.2	698.4	3,331.4
D. Total Expenses (8+9+10)	11,280.1	19,769.3	30,111.4	30,444.9	50,213.0
III. Net Result (C-D)	(2,244.8)	1,723.2	1,987.1	6,181.4	(2,243.9)

MEXICO
PRINCIPAL MINING DISTRICTS

Baja California Sur

1. El Tigre - Cr
2. San José de Castro - Mg
3. Guerrero Negro - Sal
4. El Bolero - Cu
5. San Marcos - Ca, Yeso
6. S. Hilario - P
7. San Antonio El Triunfo - Au, Ag

Sonora

8. Cananea - Cu (Mo)
9. Nacozari - Cu (Mo)
10. La Caridad - Cu (Mo)
11. Lampazos - Ag
12. Alamos - W

Chihuahua

13. Casas Grandes - Mn
14. Plomosas - Pb, Zn, Ag (U)
15. Sta. Eulalia - Pb, Zn, Ag (Sn, U)
16. Cusihuiriachi - Ag, Pb, Zn (Cu)
17. La Reforma - Pb, Zn, Ag (Au, Cu)
18. Batopilas - Au, Ag
19. Guadalupe y Calvo - Au, Ag
20. S. Francisco del Oro - Pb, Zn, Ag (Au,Cu)
21. Hidalgo del Parral - Pb, Zn, Ag (Au, Cu)
22. Santa Bárbara - Pb, Zn, Ag (Au, Cu)
23. La Perla - Fe

Coahuila

24. Hercules - Fe
25. Sierra Mojada - Pb, Cu

Durango

26. Santa María del Oro - Au, Ag
27. San José del Desierto - Cu (Mo)
28. Otaez - Ag, Pb, Zn (Au, Cu)
29. La Ojuela - Pb, Zn, Ag (Au, Cu)
30 Cuencame, Velardeña, Pedriceña - Ag, Pb, Zn (Au, Cu)
31. S. Dimas - Tayoltita - Au, Ag
32. C. del Mercado - Fe

Sinaloa

33. Cosalá - Au, Ag

Zacatecas

34. Chalchihuites - Pb, Zn, Ag, Au
35. Sombrerete - Ag, Pb, Zn (Au, Cu)
36. Fresnillo - Ag, Pb, Zn (Au, Cu)
37. Zacatecas - Ag, Pb, Zn (Au, Cu)
38. Noche Buena - Pb, Zn, Ag (Au, Cu)
39. Avalos - Ag, Pb, Zn (Au, Cu)
40. Concepción del Oro - Ag, Pb, Zn (Au, Cu)

Aguascalientes

41. Tepezalá y Asientos - Au, Cu

San Luis Potosi

42. Charcas - Pb, Zn, Ag (Au, Cu)
43. Santa María de la Paz - Pb, Zn, Ag (Au, Cu)
44. Guadalcazar - Hg (Au, Ag)

Tamaulipas

45. Zona de Llera - Pb, Zn, Ag (Au, Cu)

Guanajuato

46. Guanajuato - Ag, Au

Querétaro

47. S. Joaquín - Hg

Hidalgo

48. Zimapán - Pb, Zn, Ag
49. Molango - Mn
50. Pachuca - Real del Monte - El Chico - Ag, Pb, Zn

Michoacán

51. Tlalpujahua - Au, Ag
52. Angangueo - Ag, Pb, Zn
53. Inguaran - Cu
54. Bastam - Cu
55. Las Truchas - Fe

Jalisco

56. Pihuamo - Fe (Ba)

Colima

57. Peña Colorada - Fe

México

58. Temascaltepec - Pb, Zn, Ag (F)

Guerrero

59. Taxco - Ag, Au, Pb, Zn
60. Mezcala - Au, Ag

Oaxaca

61. Natividad - Au, Ag

Tabasco

62. Jáltipan y Minatitlán - S

Chiapas

63. Santa Fe - Cu, Au (W)

IBRD 22988

APRIL 1991

Report No. 9428-ME STAFF APPRAISAL REPORT MEXICO MINING SECTOR RESTRUCTURING PROJECT

Mr. Bell
N- 9083

Document of
The World Bank

FOR OFFICIAL USE ONLY

DRAFT
CONFIDENTIAL

Report No. P-5254-

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT LOAN

IN AN AMOUNT EQUIVALENT TO US$380 MILLION

TO

BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C. (BANOBRAS)

WITH THE GUARANTEE OF

THE UNITED MEXICAN STATES

FEBRUARY 23, 1990

CURRENCY EQUIVALENTS

On December 12, 1989 the exchange rates stood at:

US$1 = MEX$ 2620 (Controlled market)
US$1 = MEX$ 2642 (Free market)

The controlled exchange rate is currently being devalued by one peso a day.

FISCAL YEAR

January 1 - December 31

WEIGHTS AND MEASURES

1 kilometer (km)	=	0.62 miles (mi)
1 ton (t)	=	1,000 kilograms (kg) = 2,205 pounds (lb)
1 liter (l)	=	0.26 gallons (gal)

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

BANOBRAS	=	Banco Nacional de Obras y Servicios Públicos (Government owned development bank)
DFI	=	Direct Foreign Investment
FHN	=	Federal Highway Network
GATT	=	General Agreement on Tariffs and Trade
ICB	=	International Competitive Bidding
IDB	=	Inter-American Development Bank
MULTIMODAL	=	A semi public company for transportation of containers
NDP	=	National Development Program, 1989 - 1994
PACTO	=	Economic Solidarity Pact
PECE	=	Pact for Stabilization and Growth
PEMEX	=	Petróleos Mexicanos (Government-owned National Oil Company)
SCT	=	Secretaría de Comunicaciones y Transporte (Secretariat of Communications and Transport)
SEDUE	=	Secretaría de Desarrollo Urbano y Ecología (Secretariat of Urban Development and Ecology)
SHCP	=	Secretaría de Hacienda y Crédito Público (Secretariat of Finance)
SPP	=	Secretaría de Programación y Presupuesto (Secretariat of Planning and Budgeting)
TELMEX	=	Teléfonos de Mexico S.A. de C.V. (Mexico's telephone company, 51% publicly owned)
TELECOMM	=	Telecomunicaciones de México (A decentralized state entity responsible for the basic transmission network and telex and telegraph services)

MEXICO

TABLE OF CONTENTS

ANNEXES

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT LOAN

LOAN AND PROGRAM SUMMARY

Borrower:	Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS).
Guarantor:	United Mexican States.
Beneficiary:	United Mexican States.
Amount:	US$380 million equivalent.
Terms:	Repayable in 17 years, including 5 years of grace, at the standard variable interest rate.
Objective:	The proposed loan is part of a program of Bank support to the Mexican Government's plans to promote structural reforms so as to resume sustainable economic growth. The loan supports a comprehensive structural reform program in the road transport and telecommunications sectors which will improve their efficiency benefitting all users and, in particular, firms which conduct trade related business, for which communication services are an important input.
Description:	The proposed loan supports a program of deregulation in the trucking sector, and a program of privatization and regulatory reform in the telecommunications sector that will promote competition. Pricing and taxation distortions in the two sectors are to be eliminated, and the public sector institutions responsible for the oversight of the sectors are to be restructured. The loan also includes measures to improve highway safety, and to monitor compliance by trucks with air pollution standards. Under a parallel loan, technical assistance would be provided to strengthen the public sector agency responsible for the formulation of telecommunications policy and for sector regulation.
Benefits and Risks:	By providing an appropriate institutional and regulatory framework, the project is expected to spur private investment and competition, thus serving to increase the efficiency of communications services and--in the case of telecommunications--to greatly expand its coverage. Resource allocation would be improved through greater reliance on market forces for pricing and by a realignment of the fiscal treatment of the sectors. A project-related

risk relates to the Government's ability to fend off any internal political opposition to the terms or management of the deal for the privatization of the telephone company, TELMEX. Another risk is the lack of staff with experience in regulation and the chance of mistakes as a new regulatory framework for telecommunications is developed and put in place. On the macroeconomic front there is also a risk that the growth program may be put in jeopardy by declining oil prices, rising interest rates or protectionist trends in the trade policies of Mexico's major trading partners. Project related risks seem manageable, particularly since the significant upfront actions taken by the Government reflect a strong commitment to the reform process. The likelihood of derailment of the economic program is also felt to be small, given the success already achieved in economic stabilization, debt reduction and resumption of growth. In any case, the substantial conditionality of the Bank's adjustment loan portfolio provides for early warning signals on a worsening trend in domestic policy or in the country's external environment, and would thus enable the Bank to consider timely measures to protect its portfolio and longer term interests in Mexico.

Disbursements: The proposed loan would be disbursed against eligible imports in two tranches of US$190 million each. The first tranche of the loan would be available upon loan effectiveness. The second tranche would be released after December 31, 1990 upon fulfillment of specific conditions in all key areas supported under the loan and verification of the consistency of the macroeconomic policy framework. Disbursement of the loan is expected to be completed by June 30, 1991.

Retroactive Financing: US$76 million would be made available for retroactive financing of eligible expenditures incurred from November 1, 1989.

Rate of Return: Not applicable.

Appraisal Report: This is a combined President's and Staff Appraisal Report.

Schedule of
Disbursements:

US$ Million	FY90	FY91
Annual Amount	190.0	190.0
Cumulative Amount	190.0	380.0

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
REPORT AND RECOMMENDATION OF THE PRESIDENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT LOAN TO BANCO NACIONAL DE OBRAS Y SERVICIOS PUBLICOS, S.N.C.

INTRODUCTION

1. I submit the following report and recommendation on a proposed loan to Banco Nacional de Obras y Servicios Públicos, S.N.C. (BANOBRAS), for the equivalent of US$380 million in support of a program for road transport deregulation and of privatization and regulatory reform in telecommunications. The loan would have a term of 17 years, including five years of grace, at the standard variable interest rate.

2. In the latter years of the de La Madrid administration (1983-1988) the roles assigned by Mexico to the public and private sectors underwent a significant change, which is being deepened further by the Salinas administration (1988-1993). The strategy of the seventies that relied on protectionism and public sector led growth has now been abandoned, and the Government has embarked on a wide ranging program of reforms that promotes competition and reduces public sector involvement in business activities. It has also divested itself of a large number of public enterprises, while implementing policies to increase the efficiency of those still under public ownership, and has moved very far in the deregulation of trade, foreign investment, the financial sector and industry, and on the elimination of subsidies. These reforms add up to one of the most substantive and comprehensive programs of reorientation of economic policy towards reliance on market forces that have been carried out in developing countries in recent years.

3. The Bank has supported these changes and has maintained a very close policy dialogue with the Government on these matters. In June 1989 three adjustment loans, for a total amount of $1.5 billion, were approved by the Board to support the Government's programs in the financial sector, public enterprise reform and industrial sector. The proposed operation is part of a follow-up stage of adjustment which focuses on sectors of strategic importance because of their linkages to most areas of economic activity. In addition to this project, the lending program also comprises operations to support deepening of reforms in trade, public sector enterprises, agriculture and, possibly, the financial sector.

4. The proposed project would seek to extend the process of adjustment to the transportation and telecommunications sectors by supporting policies that would improve their efficiency, benefitting all users and in particular firms which conduct trade related business, for which communication services are an important input:

(a) through changes to the regulatory framework: (i) by eliminating barriers to competition in road transportation, as there is evidence that such barriers have imposed heavy costs to the economy and have failed to achieve the objectives for which they had been designed, (ii) by defining the rules for private sector participation in the telecommunications sector, promoting competition and safeguarding the interest of consumers in those areas where a private monopoly operation is warranted;

(b) improving the allocation of investments by eliminating pricing distortions: (i) in road transportation, by allowing prices to be determined in the market and adjusting the price of competing modes to marginal costs, (ii) in telecommunications, by significantly reducing cross subsidies and introducing changes to the fiscal regime to align the tax treatment of the sector with the treatment now afforded to other economic activities;

(c) assisting the Government of Mexico to develop programs to attract private investment to the telecommunications sector, so as to achieve ambitious targets of sector growth and modernization; and

(d) promoting complementary policy measures that would, in general, enhance the efficiency of road transportation and telecommunications services.

In addition, through a parallel Technical Assistance Loan, the Bank would support the institutional development of the agency responsible for the regulation of telecommunications, so as to improve its capability to discharge its functions (which would be reformulated).

5. The measures outlined above fit well with the development strategy of the Government of Mexico. As the success of Mexico's stabilization program progressively consolidates and the debt issue is being resolved, the priority of economic policy has shifted towards the attainment of sustainable growth. This objective, in the context of an economy that has been opened to external competition, will be assisted by the removal of barriers to efficiency in sectors, such as transportation and telecommunications, that play a vital supporting role to almost all business activities, and particularly trade. Improved transportation and telecommunications should facilitate factor mobility, enhance competition and assist the development of new export activities. In addition, increased investment in these sectors, spurred by a framework more favorable to the private sector, will also contribute to economic growth.

PART I - THE ECONOMY

A. Background

6. Between 1950 and 1974, Mexico enjoyed a remarkable period of high growth, low inflation and moderate external debt accumulation. Real growth averaged 6.4%, and inflation was in single digits throughout the period. This era of fiscal conservatism came to an abrupt end in the early seventies. Rapidly expanding government involvement in the economy pushed up the rate of economic growth. However, increasing government expenditure was not matched by rising public sector revenues. As a result, the inflation tax and external debt became increasingly important sources of finance. At the same time, a decline in private savings incentives (real interest rates turned sharply downward) prevented a matching increase in private savings; external debt thus increased, the increased oil revenues notwithstanding. The period of single digit inflation ended in 1973, the real exchange rate[1] started to appreciate and the accumulation of external debt accelerated above the GNP growth rate. A serious, but comparatively brief, financial and economic crisis in 1976 terminated following major oil discoveries in 1977. The ensuing prosperity lasted until 1982, when soaring domestic inflation, falling international oil prices, rising world interest rates, and massive capital flight led to a refusal by external creditors to roll over Mexico's short-term debt and forced a subsequent suspension of payments of interest on the external debt.

7. Over the 1982-88 period, economic growth ground to a virtual halt, accompanied by sharply falling living standards, deterioration of infrastructure, high inflation, and loss of investor confidence. To reverse Mexico's declining fortunes the most important changes needed were: (a) macroeconomic stability, (b) a rationalized set of incentives for private sector investment, (c) a reallocation of public spending, both to shore up a crumbling infrastructure in support of private sector-led growth and to alleviate the impact of adjustment on the poor, and (d) a medium-term financing plan capable of removing the specter of an unsustainable overhang of debt. In each of these areas, the Mexican Government has achieved notable progress.

B. Macroeconomic Stabilization

8. The onset of the financial and economic crisis of 1982 brought in its wake explosive inflationary and balance of payments difficulties whose effects had been largely repressed during the years leading up to the crisis. Initial strong fiscal and monetary adjustment efforts were alternately not sustained for a sufficiently long period (1983-85) or undermined by external shocks such as the collapse in international oil prices (1986). Inflation, rather than slowing down, accelerated, partially in response to the sharp real devaluation of the exchange rate necessitated by the 1986 downturn in the

---

1. The real exchange rate is defined as the price of foreign goods relative to domestic goods. Appreciation means a decline in this relative price.

terms of trade. The subsequent de facto targeting of the real exchange rate, together with an increase in the frequency of wage and cost adjustments, introduced an element of inherent instability into the system, culminating in a run on the peso in the last quarter of 1987 and triple-digit inflation.

9. The Government responded with the "Economic Solidarity Pact" (Pacto), an agreement between business, labor, and government which called for accelerated structural reform, further tightening of fiscal and monetary policy, a freeze of minimum wages, prices of basic public and private sector prices and tariffs, and, the cornerstone of the "Pacto", a freeze of the nominal exchange rate against the U.S. dollar. This partial freeze was extended at three-month intervals through the end of 1988, and renewed, with some certain modifications, by the new Mexican Administration under the name of "PECE" (Pact for Stabilization and Growth) through March 1990. The main adjustments brought about under PECE were catch-up increases in selected public sector tariffs and in prices of key inputs, a two-stage 15% cumulative adjustment in the minimum wage,and a daily adjustment of the exchange rate of about one peso against the U.S. dollar. On December 1, 1989 fuel prices and some utility rates were increased, minimum (but not contractual) wages were raised by 10%, and the "PECE" was further extended to the end of June 1990. However, some further adjustment of public sector prices, including a major restructuring of the rates for telephone services (para. 68), took place during January 1990.

10. On almost every target that is under direct or indirect governmental control, performance under the "Pacto" and "PECE" has been exemplary, in some instances going beyond what was originally planned. For example, public sector spending during the first half of 1989 under Mexico's new Extended Agreement with the IMF was substantially below the targeted levels, while the primary surplus was substantially above the targeted limit. In trade, the Government had originally committed to a three-year program of reforms supported by the Bank. These reforms were designed inter alia to lower the maximum import tariff to 30% ad valorem by the end of 1988. In fact, during the first month of the Pacto, December 1987, the tariff was lowered to a 20% maximum, i.e., 10 percentage points lower than originally agreed and one year ahead of schedule. Such efforts were all the more noteworthy, given the negative budgetary impact of further declines in international oil prices and increasingly high real interest rates on foreign debt throughout much of 1988-89. The shift in exchange rate policy at the beginning of 1989 was instrumental in bringing about a small real depreciation of the peso during the first six months of the year, reversing a trend toward sharp appreciation throughout much of 1988.

11. The fiscal measures, backed by the temporary exchange rate freeze and an array of formal and informal wage and price controls, have had a dramatic success in reducing the rate of inflation from 159% in 1987 to 20% in 1989. At the same time, the economy has shown encouraging signs of economic recovery, led by a strong resurgence of private investment. Industrial production was 6% higher in the first half of 1989 than in the same period a year earlier, and the economy is estimated to have grown by 3% in real terms for the year as a whole. After the announcement in July 1989 of a debt

reduction agreement between Mexico and its commercial bank creditors, real interest rates, although still high by historical measures, declined by about 20 percentage points. This sharp drop stemmed, in all likelihood, from an improved climate of confidence in economic prospects as reflected in net new private portfolio capital inflows in excess of US$2 billion in recent months.

12. The current account balance has deteriorated from a 1988 deficit of US$3 billion to an estimated deficit of US$5 billion in 1989. This is largely due to the increased imports drawn in by accelerating private sector investment and to a drought-induced decline in net agricultural exports. Manufactured export growth continues at an annual rate of about 10%.

C. Rationalized Private Sector Incentives

13. Mexico has transformed itself into one of the most open economies in the world through a trade reform supported by four Bank policy-based loans. Trade liberalization has lowered the percentage of domestic tradeable production covered by import quotas from 100% in 1984 to around 17% at present, and maximum import tariffs from 100% to 20%. Non-oil merchandise exports, which represented less than one -third of total exports in 1984, have doubled their share since then.

14. This "core" reform has been complemented by many others. Recognizing that the era of public sector-led growth had passed, the Government took a number of measures to stimulate greater private investment. In May 1989, foreign investment regulations were considerably relaxed and made more transparent. A long-standing prohibition against majority foreign ownership was removed, the fishing, petrochemical, and mining sectors were opened to foreign investors for the first time, the licensing of proposed investments under US$100 million was made automatic so long as they satisfy newly-published criteria, and approval of larger investments became automatic following a 45-day waiting period, unless the Government interposed formal objection. In addition, since 1986 the tax system has undergone a series of reforms tending to reduce the previous biases against equity finance, adjusting assets and liabilities for the effects of inflation, bringing marginal tax rates more in line with levels in major industrial countries, encouraging the repatriation of flight capital, and increasing the sanctions for tax evasion.

15. To encourage improved mobilization of domestic savings, the Government initiated process of financial market liberalization, supported by a Financial Sector Adjustment Loan from the Bank. Interest rate ceilings and credit allocation formulae were removed on commercial bank lending and credit subsidies through official development banks reduced significantly. The principal development and agricultural banks in the public sector are in the midst of significant managerial and financial restructurings, designed to consolidate institutions, clean up balance sheets, and reform lending practices.

16. To reduce the role of the public sector in production, over 750 state-owned enterprises have been sold, transferred, or liquidated from 1983

to the present and 42 more are expected to be sold or closed during 1990 The country's largest airline has been privatized and the Government has also placed in receivership, for eventual sale or liquidation, the country's largest mine. An action plan for initiating widespread deregulation has been approved. Attention is now centering on liberalizing the transport and telecommunications sectors since the efficient provision of their services are a vital input into all economic activity, particularly industrial production and exports. Liberalization will be useful not only in its own right, but also as a means of increasing the efficiency gains from industry and trade reforms.

D. Reorientation of Public Spending

17. Since 1982, a retrenchment of public expenditure has occurred, of a dimension unprecedented in Mexican terms, if not for most developing countries. Non-interest spending declined by 36% in real terms. However, the composition of the cutbacks was not ideal from the standpoint of growth. Investment expenditures were cut more deeply than current expenditures, posing the risk, now that growth seems to be underway once again, that infrastructure bottlenecks in areas such as roads, communications, and urban services, and lack of skilled manpower availability could impose severe constraints on potential growth.

18. Also, some of the gains in reducing illiteracy, infant mortality, and nutrition during the seventies are threatened by the sharp cutbacks in public expenditures for social programs. The social sector's budgetary share declined from 20% or more in the years preceding the 1982 to around 13% currently. This trend is probably unsustainable, given the already sharp reduction in real wages, widespread unemployment, and worsening inter-personal and inter-regional income disparities and for the first time in many years the 1990 budget provides for a significant increase in the social sector's share.

19. In recent years, two successive administrations have sought to soften the blow of reductions in social expenditures. Global consumer subsidies for basic food items have been replaced by less expensive, but more targeted, subsidies to the poor. In 1989 a new "National Solidarity Program" set aside US$400 million to coordinate the activities of existing agencies and to provide limited additional budgetary support for productive agriculture, infrastructure, and social programs in Mexico's ten poorest states. For example, title to 300,000 urban plots is to be regularized, 150,000 hectares of semi-arid arable land rehabilitated, and tubewells, irrigation works, and rural infrastructure extended. It is hoped that the program can be tripled in 1990. Another US$200 million is being channeled into a revitalized federal program of primary health care in 12 states. And, starting in June 1989, a program to rehabilitate 25,000 primary and secondary schools began, with an expected cost of nearly US$220 million.

20. As for the environment, it is widely recognized that the cumulative effects of past growth, combined with generations of public indifference about ecological issues, has resulted in severe degradation of Mexico's air, soil, water, and forestry resources. Mexico City is now one of

the world's most seriously polluted cities, but many other Mexican medium-sized cities suffer from significant problems too. The Salinas Administration is the first to recognize the urgency of broad-based efforts to clean up the environment and, following up on the reformulation of an urban transport project to start addressing the pollution caused by vehicle circulation, the Bank is currently involved in the preparation of a free standing project to address the air pollution problem in Mexico City.

21. Given the severe fiscal constraints, the task of rebuilding roads, bridges and other infrastructure is being met in limited ways. The greatest room for improvement lies in shifting resources at the margin away from support of activities, such as telecommunications, which could be better carried out by the private sector. This will permit increased financing of activities, such as transport infrastructure, where the state's role traditionally has been predominant, even though this is an area where private investment is also being sought. The restoration of sustainable growth will require a gradual increase in public investment over the next few years, particularly for agriculture infrastructure, the environment, transportation, energy, and the social sectors.

E. Financing Requirements and Financing Plan 1989-94

22. Mexico's total gross financing needs over the next six years amount to $51.1 billion (Table 1). This level of financing would accommodate a growth target averaging 4% provided, however, that the non-interest current account would generate a surplus of about 2.4% of GDP. At current interest rates this would lead to a cumulative current account deficit of around $23 billion (around 1.5 percent of GDP). In addition, reserves are expected to increase by $3.1 billion, as stipulated under the currently operative IMF Extended Fund Facility, raising the total to $26 billion. Total financing requirements include, in addition, the scheduled net amortization payments to commercial banks, bondholders, suppliers and holders of private non-guaranteed debt, which is currently estimated at US$18.3 billion over the same period.

Table 1: MEXICO'S FINANCING NEEDS AND SOURCES 1989-1994 (bUS$) [a]

Needs			Sources		
Current Account deficits and reserve changes :		26.2	Direct Foreign Investment		21.9
			International Financial Institutions		3.4
Net Scheduled Amortization:		18.3	of which:		
of which to:			IBRD:	4.9 [c]	
Comm. Banks	12.7		IMF :	-1.3 [c]	
Bonds	1.2		Bilaterals		2.3
Private Debt (not Guaranteed)	4.3		Subtotal		27.6
Suppliers	0.1				
Other Capital Outflow		6.6 [b]	FINANCING GAP		23.5
Total		51.1	Total		51.1

Notes:

a/ Totals may not add up due to rounding error.

b/ "Other Capital Outflows" is the bookkeeping counterpart to the current account item "imputed interest earnings on private assets held abroad."

c/ This does not include additional disbursements of US$ 950 million and US$ 600 million under the Interest Support Facilities of respectively the Bank and the IMF.

23. To meet the above needs, funding is expected to be available from net lending by bilaterals and the international financial institutions. In addition, substantial direct foreign investment (DFI) is projected to take place in response to the sound economic reforms and consistent policies of the current Government, including the recent liberalization of the foreign investment regime. However, as may be seen in Annex I, funds available from these sources fall short of gross financing needs: the financing gap is projected at $23.5 billion cumulatively over the period ending in 1994, or almost $4 billion per year. This includes amortization on commercially held debt ($12.7 billion). Therefore, the corresponding net financing required from debt service reduction, new money and return of Mexican flight capital would be $10.8 billion.

24. This scenario is sensitive to developments in the world environment. Every dollar decrease in world prices for Mexican oil costs Mexico $0.5 billion in foregone export revenues per annum. Thus if oil prices are two dollars lower than assumed, Mexico would lose up to $6.0 billion over six years.[2] The financing gap would increase correspondingly. Of course unanticipated increases in the price of oil would reduce the financing gap. Similarly, a one percentage point increase in international interest rates would increase the cumulative current account deficit by close to $6 billion over the period, with a matching increase in the financing gap. This sensitivity to international interest rates highlights the benefits of fixed interest debt instruments, such as those negotiated in the debt reduction agreement.

F. Macroeconomic Projections[3]

25. The base case starts from an assumption of moderate (1 percent of GDP) current account deficits over the next five years. This would be a significant significant improvement over the outcome in 1989, and should be possible to finance. It constitutes less than one-third of the interest due and would result in a fall in the nominal value of the debt.

26. It is also assumed that the fiscal stance will continue to be consistent with inflation targets, which means that the non-interest surplus would remain at around 6.0-6.5 percent of GDP, the level targeted in the FY90 budget, well below the 7.4 percent of GDP actually achieved in FY89. This is below consistency requirements in 1990-91, when real interest rates are likely to remain high, but above what is necessary in 1992-94 when real rates, if all goes well, should drop to a more reasonable risk premium over foreign real rates. Real rates are assumed to stay at 30 percent in 1990, to fall to 20 percent in 1991, and to 10 percent from 1992 onwards. The operational balance

---

[2] Oil export volumes are projected to remain constant for the next six years. The oil prices mentioned refer to the average price of Mexico's oil exports. Recently, this price has stayed about $3.50 US$ below the price for West-Texas Intermediate.

[3] Macroeconomic tables are attached as Annex I.

would, thus, reach near balance in 1990 (after registering a deficit of 2.3 percent of GDP in 1989) and steadily improve to 1.5 percent of GDP by 1994.

27. Per capita consumption is expected to decline slightly in real terms through 1992, before experiencing a sharp recovery in 1993-94. [4] As for public investment, it is assumed to recover gradually from 4.2 percent of GDP in 1989 to around 6 percent of GDP in 1994, enabling the Government to address the accumlated bottlenecks in the economy's physical and social infrastructure which would otherwise circumscribe growth. Private investment, which has risen from a low of 11.6 percent of GDP in 1986 to 15.8 percent in 1989 would continue to experience rapid growth over the next several years, attracted by the newly-enhanced investment climate and, later in the sexenio, by the steady decline in real interest rates. By 1994, it would have reached around 18 percent of GDP.

28. As a consequence of the rise in total investment from 17.6 percent of GDP in 1986 to nearly 24 percent projected in 1994, real growth would accelerate from -4.0 in the earlier year to a projected 5 percent by 1994. Stronger investment growth under a smaller current account deficit target requires, of course, higher private and/or public sector savings. The econometric model used suggests that private consumption, except in 1990, is likely to grow faster than GDP. As a consequence, private savings initially rise to around 17 percent of GDP in 1990, before declining by about one percent of GDP toward the end of the sexenio. Thus, virtually all of the growth in investment would have to be financed out of increased public sector saving, which would rise sharply from 2.5 percent of GDP in 1989 to a projected 8.1 percent in 1994. The long-term reforms in tax administration and in the structure of personal income and property taxation, combined with expected improvements in public sector relative prices, offer genuine reasons to expect that the required improvement in public sector revenue would actually occur.

29. Under this scenario, external debt as a percentage of GDP decreases from its peak of 77.6 percent in 1986 to a projected 34 percent by 1994. The model run suggests that the real exchange rate could pose a problem in the early years of the projection period, but after 1990 the situation improves. While a real devaluation would stimulate output growth by shifting domestic and foreign expenditure toward Mexican goods, it is doubtful whether it could, in fact, be engineered under the current stabilization framework.

30. A final comment on employment is in order. The real wage was assumed to rise at 4 percent per annum during 1990-94, after declining by an average of 5 percent annually during the 1986-89 period. According to the econometric analysis, such a rate of increase would just offset the autonomous increase in the demand for labor for the given GDP. However, with an estimated labor demand elasticity with respect to GDP projected at only 0.64,

---

[4] The projections discussed in this chapter have been generated with the help of an econometric model described in **Growth, External Debt, and the Real Exchange Rate in Mexico**, S. van Wijnbergen, Working Papers, August 1989.

employment is only expected to grow by 2.4 percent annually during 1990-91, before climbing gradually to over 3 percent at the end of the sexenio. It is not clear that this projected employment growth would be sufficient to absorb all the new entrants into the labor force, projected to growth at around 3.5 percent annually, let alone offer opportunities to the substantial backlog of the chronically unemployed.

31. In conclusion, with foreign financing now in place, the program of internal reform well-advanced, and the economy in a moderate growth mode for the past 14 months, a cautiously optimistic prognosis for Mexico's recovery in growth seems justified. Moreover, Mexico's debt indicators are projected to decline substantially. With a continuation of the Government's reform program, investing in Mexico would offer prospects of a high pay-off.

32. Despite this generally optimistic outlook, the path to recovery is not without risks, both external to Mexico (i.e. drop in the price of oil, rise in interest rates) or internal (i.e. resistance to further adjustment reforms if payoffs of past sacrifices do not materialize soon); hence under the proposed project we would intend to closely monitor the evolution of economic events and to carry out an assessment of the coherence of the medium term macroeconomic framework prior to second tranche release.

PART II - SECTORAL CONTEXT

A. INTRODUCTION

33. In the past two decades there has been a growing awareness all over the world of the negative effects of excessive regulation on private investment, productivity and growth. The original rationale for regulation had stemmed from the concern that economies of scale led to natural monopolies and that such monopolies would result in an inefficient allocation of resources. In addition, it was feared that unregulated competition could negatively affect quality and reliability (or safety) of service. However, by the seventies greater concern was being expressed that regulation limited innovation, sheltered inefficiency and led to resource misallocation. In addition, questions on the appropriate role of the state were brought up, in many cases prompted by generalized concerns about the financing of public sector budget deficits. This has been reflected in a move towards the liberalization of markets previously not open to competition, and in enhanced private sector participation in activities that had before been reserved to the public sector.

34. Mexico has been taking important steps to spur privatization and to adjust the regulatory framework in line with the considerations outlined above. Most important has been the liberalization of trade, reflected in a significant elimination of quantitative restrictions and reduction in the level and coverage of tariffs (para. 13). The Bank has supported this process through several loans and progress has exceeded the targets agreed therein, as well as commitments under GATT, which Mexico joined in 1986. Another important area of policy reform has been direct foreign investment

(DFI). The rules governing DFI were liberalized in May 1989, opening new areas for DFI, allowing majority foreign ownership and simplifying the procedures for licensing (para. 14). A third area of policy reform has been the banking system, which had been subject to quantitative credit controls that now have been lifted (para. 15). Finally, reforms in the industrial sector in general (such as reduction of domestic content requirements and investment incentives) and in some subsectors in particular (i.e.: petrochemicals) also deserve to be highlighted, as they underscore the coherence and sense of direction of the overall program.

35. Within the above general policy framework, the Government has embarked on a program to expand the role of the private sector to areas previously reserved to the public sector. The de la Madrid and Salinas' administrations have made substantial progress in the divestiture of public enterprises (para. 16), and a program to continue the disengagement process has been agreed with the Bank under the Public Enterprise Reform Loan (Loan 3086-ME). In a number of sectors hitherto reserved exclusively to government ownership, new initiatives are being undertaken to attract private sector participation and investment. For example, the Government is considering cogeneration alternatives which would attract private capital to the power sector. In water supply, private provision of water services is being tried on a pilot basis in Aguas Calientes. In urban transportation, the public bus lines serving Mexico city may be turned into cooperative enterprises. In highway construction, concessions are being given for the construction and operation of privately financed toll roads.

36. In addition to its initiatives to attract private capital to infrastructure investments, the Government has been reviewing the regulatory framework in several sectors, in which it was felt that excessive Government intervention had led to inefficiency and corruption. One such case is trucking, one of the two areas addressed under this proposed project. Related to it are bus passenger services, which are also heavily regulated. Currently, buses are given permission to operate only on specific routes, and entry to the market is highly restricted. In order to provide a permit for a service, SCT consults existing providers, which has led to a very concentrated market structure. The Goverment now intends to deregulate entry, requiring minimal formalities to change routes. In addition, the deregulation of transport services for tourism is also now under consideration. At present these services are provided through a Government monopoly, TURMEX, and the level of service is generally considered to be poor. SCT is now proposing to eliminate this monopoly and to issue permits to all interested operators. Route and tariff restrictions are to be eliminated and tour operators will be free to contract transport services. Foreign vehicles bringing in tourists from abroad will also be allowed into Mexico, which could be an important measure to promote tourism and improve the balance of payments. While outside the scope of this proposed project, the policy measures outlined above highlight the breadth and coherence of the Government's reform program.

37. The two sectors on which the proposed project focuses (road freight transportation and telecommunications) would also be the subject of major policy changes in line with, and supportive of, the broad reform

processes discussed above. Transportation and telecommunications are services on which all business activities rely, and their timely availability, quality and cost have important effects on a wide range of products and services and play an important role in facilitating trade. The proposed loan would support the Government's programs in these two sectors and would promote institutional changes to ensure the success of the program. In addition, through a parallel loan, the Bank would provide technical assistance to the telecommunications sector regulatory body.

B. ROAD TRANSPORT

38. The regulation of road freight transportation is a common practice. It is normally justified on grounds of safety, reliability of service and stability of rates. Competition in the sector is feared to be ultimately destructive of the ability of the industry to offer good service. However, there are many countries where the industry is free from most Government regulation and operates in an efficient manner. The costs of trucking regulation arise from inefficient provision of services, shifting of traffic to less economical modes, higher costs of transportation and reduction in total transportation volumes. A study conducted in the USA in 1975, before deregulation, had estimated that these costs could amount to as much as one third of the income generated in road transportation.[5] As we discuss below, the Mexican regulatory framework involved an even higher degree of interference with market forces than in the US, so that its cost could well be in such range.[6]

39. While in the past regulation may have helped the development of the road transport industry, the Government has now reached the conclusion that the regulatory framework has been defeating the purpose for which it had been conceived. Our sector dialogue during the last two or three years has been increasingly focused on this issue, developing awareness of the problems and promoting discussion on alternative ways to address them. In mid-1988 the findings of a study conducted by the Bank among industrial users, showed generalized concern with the poor quality of trucking services. The main issues to be addressed in the road transport industry and the Government's policies and actions are outlined below.

Trucking Entry Restrictions

40. In the past many restrictions to entry into the trucking industry have limited competition and reduced efficiency:

---

[5] T. Gale Moore "Deregulating Surface Freight Transportation" in A. Phillips (ed), Promoting Competition in Regulated Markets, The Brookings Institution, Washington, D.C. 1975.

[6] The Mexican Government conducted a preliminary study on the welfare cost of regulation in trucking, which estimates that it amounted to 1/2% of GNP.

(a) Federal trucking concessions. In order to provide public trucking services, trucking firms were required to obtain a concession to operate from the Ministry of Communications and Transport (SCT). The concessions, by law, were given primarily to existing concession holders and the administrative procedures for determining the need for additional service depended on the opinion of existing service providers. These procedures strengthened the position of existing firms and led to the formation of cartels.

(b) Corridor Assignments. The country was divided into eleven corridors and each trucker needed a permit to operate within a specific corridor. As a result, both truckers and shippers experienced increased costs. For the truckers, down time increased and load factors reduced as the restrictions constrained their options for backhauling and made it more difficult to match their supply with available demand. For the shippers who wanted to send cargo across corridors, indirect routing was necessary or special arrangements with higher tariffs had to be made. Furthermore, the corridor system tended to favor existing spatial concentration, since the corridors tend to radiate from Mexico City.

(c) Freight centers: Truckers, especially small operators, were originally encouraged to form freight centers so that they could take advantage of economies of scale for common services (such as the provision of spare parts, insurance and paperwork), and facilitate cargo movements. While these services are supportive of the industry, the freight centers, partly as a result of their market knowledge, in recent years limited entry and tended to form cartels in the assignment of cargo. Some freight centers adopted a roll call, first-come first-serve queuing system for truckers to be given access to cargo. As a result, shippers had little say in the selection of the trucker and the benefits of either competition or a close working relationship were foregone. Moreover, the centers were increasingly reluctant to allow return load facilities to other centers even on the same route, and opposed allowing vehicles from other routes to operate within their service area, even when transport was in short supply.

(d) Container Movements: Regulations also inhibited the efficient circulation of containers. To optimize the handling of international container movements, Multimodal, a semipublic company, was created by SCT in 1981. The company was expected to perform the role of a national freight forwarder, undertaking a host of complex services, ranging from packaging to arranging insurance and delivery.

However, in practice, as a result of Multimodal's monopoly status and partly because of its lack of expertise, which requires a detailed knowledge of shipping markets and costs, international container shipments were not handled in an efficient manner. Instead, collusion between Multimodal and the freight centers led to a system of surcharges and unofficial payments which often far exceeded the stated tariffs. More important than the shipping costs, service standards were low and deliveries often delayed. As a result, there has been a strong tendency for container traffic to be confined to the port area, thus foregoing the large potential benefits of door-to-door delivery, which is the main advantage of the intermodal technology. In addition, customs regulations did not permit containers that were temporarily brought into the country boxing imports to be used to transport domestic cargoes, which resulted in empty movements of containers and in an uneconomic utilization of their transportation capacity.

(e) Cargo Handling Concessions. SCT granted concessions for handling cargo movements at the railroad stations and border customs facilities, as well as for the drayage services to cross the border. In most cases goods could not be removed without the services of the concessionaire. As with the federal trucking concessions, entry was limited and cartels were formed, which tend to increase costs and reduce service quality.

(f) International trucking. While cargo trailers are allowed to cross the international borders and proceed to their final destination with unloading and loading, the tractors (power units) are not permitted (neither by Mexico nor by the U.S.) to cross. To undertake the exchange of trailers at the border, drayage services have developed. The regulations for these services vary depending on the cities and states involved on both sides. In most cases the Mexican drayage firms are allowed to bring and take trailers across the US border within a commercial zone which is usually limited to the urban area at the border. The US drayage operations, on the other hand, are generally more restricted; sometimes they are not allowed to cross the border areas or to pickup return loads. Besides the increased costs of exchanging power units and drayage services, customs delays in the clearance of goods are often experienced on both sides. An additional difficulty has been that the high-growth "maquiladora" (in-bond assembly) industries have not been permitted to transport their own products in their own private fleet, which led to inefficiency and higher costs.

(g) State Restrictions. Besides the Federal regulations, some states have restrictions which affect intrastate movements of cargo. In some cases, concessions are required for specific cargo and/or route movements on state highways. A review of state regulations in Chihuahua, Jalisco, Puebla, Veracruz and the state of Mexico generally indicates that state regulations do not, in general, pose major issues as intrastate traffic is not very significant in comparison to interstate transport. However, state regulations do affect the movement of some agriculture, forestry and construction industry products.

<u>The Government program to eliminate trucking entry restrictions</u>.

41. The recently issued National Development Program (NDP) for 1989-1994 outlines the general policy framework under which the Government expects to achieve its objective of modernization in the road transport industry, so that the quality of services may be improved and costs reduced. The basis of the program is that private investments and competition would be encouraged and the development of multimodal transportation would be pursued. In accordance with the NDP, on July 6, 1989, the Government signed an agreement with the private sector which spelled out sector objectives and mutual commitments to modernize the road transport industry. Subsequently, on July 7, 1989 new regulations governing trucking and inter-modal transport were approved by decree.

42. The main points of the new regulations, that address the entry issues raised above, are:

(a) <u>Federal trucking Permits</u>: The public service notion, which was behind the concept that trucking operations require a concession, has been abandoned. Entry requirements have been eliminated and clear guidelines have been provided for obtaining permits. The trucker need only to prove his identity and vehicle ownership to get a permit, which is easy to obtain. This will allow an increase in the number of truckers that may engage in public transport and allow the legalization of an estimated 20,000 truckers that were operating outside the previous system. From August through December 1989 over 8500 permits have been granted (i.e.: about three times the number issued during 1986-1988). Also, own-account operators are now allowed to transport third party cargo.

(b) <u>Route assignments</u>. The corridor restrictions have been eliminated and trucks have been freed to transport interstate cargo throughout Mexico. Direct shipments between former corridors are permitted without additional costs and truckers are free to offer their services throughout the country.

(c) <u>Freight centers</u>. Truckers do not have to belong to freight centers to obtain cargo and shippers are free to use the trucker of their choice. The freight centers no longer control cargo shipments and certify the shipment bill of lading.

(d) Container movements. The new regulations allow containers to be transported without Multimodal's services and entry into the provision of inter-modal services (under which the transporter is fully responsible for door-to- door shipments) has been opened up. Six new firms have already obtained permits to provide these services and applications from six additional firms are currently being processed. In addition, in January 1990 restrictions on the use of international containers for the transport of domestic cargo were lifted. This is expected to increase container utilization and, hence, efficiency.

(e) Cargo handling concessions. In January 1990 new regulations were issued to allow open entry to the provision of cargo handling services at railroad stations and customs facilities. These regulations forbid giving exclusive rights for the provision of these services and provide flexibility for rate charges. Operators with federal trucking permits will automatically be allowed to provide cargo handling services in federal areas (railroad stations, customs and border crossings).

(f) International trucking. Discussions under GATT are taking place between the USA and Mexico on border trade issues and a fourth meeting was held in January 1990. The new regulations issued in January 1990 allow open entry for the provision of drayage services (which also includes border crossings) so that the present cartels are being broken. In addition, the "maquiladoras" are now allowed to transport their own products in their own trucks accross the border.

(g) State Restrictions. SCT is planning to sign agreements that will cover road transport in the areas of freight, passenger and tourism with every individual state where this is warranted, in order to eliminate state transport restrictions. The Federal Government will provide local carriers with permits to operate on the Federal network and, in exchange, the States will adjust their regulatory framework to the deregulated Federal one. While the states have autonomy to regulate intrastate transport, the elimination of state regulations would be in line with federal policy.

Official Trucking Tariffs

43. In the past, the official trucking tariffs, set by SCT, were not monitored too closely and hence did not represent, in practice, a major

interference with market forces. While formally the tariff was legally set and not negotiable, in practice some flexibility existed, especially in the form of discounts for large powerful users and, conversely, surcharges for powerful truckers. The tariffs, which were classified into five rate categories and fixed on a countrywide basis, often bore little or no relationship with the costs for a specific shipment. Thus, supply tended to be more available in some areas and less in others, depending on the relationship of the tariffs to costs.

44. In July 1989 regulations were issued which allowed "official" tariffs to be regarded as maximum rates. It then became legal to negotiate individual rates taking into account the specifics of the goods to be transported, provided they did not exceed the maximum official rate. Also a 15% surcharge on rates on imported goods was eliminated. More recently, in January 1990 the tariff ceilings were also eliminated, as well as the application rules that set values for, among other services, pick up-delivery, cargo insurance, exclusively served customers, empty back-hauls and warehouse spaces. Therefore, now rates may be freely negotiated between the trucker and the customer.

Automotive Industry

45. The automotive industry, consisting of auto, truck, and bus and parts producers, faces numerous regulations which greatly increase the effective costs of vehicle purchase and maintenance. In line with the government's previous import substitution policies, protection in the form of high tariffs and numerous import quota restrictions exist. For automotive production, the effective protection is currently estimated at about 50%, compared with the 15% average for the manufacturing industry as a whole. In addition, all producers must comply with domestic component restrictions which vary depending upon whether production is for the domestic or export market. Furthermore, the number of lines and models which producers may manufacture is limited. Foreign ownership of domestic auto parts firms is also limited to 40%. Only the "maquiladoras" which produce auto parts for export are exempted from the above regulations.

46. The automotive industry issue is being addressed under the Industrial Sector Policy Loan (ISPL), approved in June 1989, under which the Bank and the GOM agreed on an action plan to deregulate the automotive sector. In compliance with this commitment, on December 11, 1989 the GOM published two decrees which represent a major step forward in the liberalization of the sector and which exceed substantially the actions required under the ISPL. The regulations governing the automotive industry have been changed to ensure that truckers will be able to purchase units of international quality at international prices and starting with model year 1991 the import of tractor trailers will be allowed (starting in 1992 also heavy trucks) if domestic prices exceed the international level. In addition, restrictive regulations on the organization of truck production, such as national integration requirements, compulsory incorporation of domestic components into vehicles and the majority national ownership requirement have been eliminated. The plan calls for:

(a) opening up the import of buses in January 1990 and of automobiles, light and medium trucks, beginning with the 1991 model year; and

(b) gradual reduction of domestic content requirements for the vehicles listed above and for auto parts, and progressive removal of quantitative restrictions on auto part imports.

Highway Safety and Environment

47. While on economic grounds a convincing case may be made that most regulations which restrict entry and limit price competition should be eliminated, there is an economic rationale for safety, environmental and cargo loading controls, based on the externalities that they cause. The total number of road fatalities in Mexico is estimated to be about 15,000 per year and a rough estimate made by the Bank in 1987 indicates that the proportion of the number of persons killed on Mexican highways to the number of accidents was six times higher than in Sweden.

48. A particular safety concern is the size and heavy loads of the cargo truck fleet. Overloaded axles of trucks cause severe damage to highway pavements, which increases the risk of accidents and results in premature road life and high maintenance costs. The cost of the resultant damages caused to bridges and to pavements is borne by the highway authority, and the increased cost of accidents have to be met by the community. While little data is presently available, axle overloadings are suspected to be most serious on roads connecting major port areas, where cargoes are concentrated and heavy industries are located.

49. SCT's road safety policy, outlined in the 1989-1994 national program for transport modernization, seeks to substantially reduce the number of traffic fatalities and injuries. However, although much good work is being done by various agencies to improve road safety, coordination is weak and policy objectives are not well known. While an accident data collection system exists, collection, storage and analysis require improvement so that the data for the entire country is presented in a consistent way and subsequent action programs formulated.

50. At present, Mexico lacks an adequate inspection system for motor vehicles. The present system allows potentially dangerous vehicles to use the public roads, and at least 7% of the accidents are due to vehicle factors, such as bad tires and brakes. However, it would be of little value to invest in expensive testing facilities and to employ a large number of inspectors if there is no confidence on the results that such system would deliver. Furthermore, at a time when the size of the public sector is being reduced, the merits of such an option became questionable. Hence, an alternative which would be better suited to present circumstances would be to require mandatory insurance against third party claims, which would promote over time better monitoring of the conditions of vehicles and of driver behavior.

51. Another problem related to security, and which business firms report to be a major concern, is loss and damage to cargo. At present, the trucker's responsibility for cargo loss is limited to only Mex$ 800/ton (US$0.31) and provides little incentive to care for the cargo. A further regulation indicates that the shipper can insure his cargo by paying the trucker a fixed rate of 3 mills per declared value. The fixed rate does not take into account the type of product shipping risks, which are independent of the cargo value. Regulations which would fix a reasonable level of responsibility to the trucker and allow free negotiations for increased coverage are recommended.

52. Regarding the environment, the key concern is with air pollution, paticularly in the Mexico City metropolitan area. The Bank will provide assistance to address the problem through Loan 2824-ME (which was amended in January 1990 for this purpose) as well as through a proposed free standing project which is now in an advanced stage of preparation. At present SEDUE and SCT are drafting norms to control bus and truck noise and air pollution, requiring periodic inspections which would be conducted by private service stations. In addition, programs to improve the quality of fuels are under way.

Pricing, Cost Recovery and Taxation

53. Sector cost recovery: If transportation is to be used in the most efficient way, users should face charges that adequately reflect the true cost of the mode chosen. In this context, a study conducted by the Bank indicates that while overall road costs are being recovered there are cross-subsidies between automobiles and trucks. In other words, trucks have not been paying for the costs which they cause to the highway network. This result was essentially due to the relatively low domestic price of diesel fuel, which in November 1989 was Mex$ 445/lt (US$0.65 /gallon), above the international border price but not enough to allow adequate cost recovery. On December 1, 1989 the price of diesel was increased by 5.6% but we estimate that to achieve satisfactory cost recovery from trucks further measures would still be required. These could involve some additional increase in the price of diesel and/or an increase in direct taxes or license fees paid by truckers. If the Government were to rely only on a diesel price increase, the increase required would be about 12% in real terms over the December 1989 level.

54. Railroad tariffs. Also related to the issue of market pricing, is the present structure of railroad tariffs, since trucks compete with the railroads for traffic. In general, the tariffs charged by the railroads for the transportation of key commodities fall short of long run variable costs. This should be corrected to avoid a misallocation of traffic between trucks and the railroads. This issue is being addressed under the Railway Sector Loan (Loan 2575-ME), which requires the alignment of tariffs with long-term variable costs. However, the constraints placed by the ongoing stabilization program to public sector price adjustments have resulted in a build-up of distortions over the past two years.

55. Income taxation. Because of a special provision, the Mexican transport sector was exempt from income taxes as well as from value added and ownership taxes. Instead, since 1966 truckers were required to pay a direct tax which was a fixed amount per operated vehicle. The amount varied according to the type of vehicle and the kind of service it provided but on average was very small and, as a result, revenues obtained from this tax were minuscule. Not only did this cause a distortion in the pricing and allocation system, it was a major loss of tax revenue since the transport sector accounts for about 7% of GDP.[7] The exclusion also presented an avenue for tax evasion, since a manufacturer could start a trucking operation to escape corporate income taxes. Within the 1990 budget that was approved by Congress, the exemption of the trucking industry from income taxes, value added and ownership taxes was eliminated. This action thus closes a large loophole in the tax structure.

Road Maintenance and Efficiency

56. Closely related to the pricing and taxation issue is the amount of expenditures on road maintenance, since the condition of the roads directly influences costs and tariffs. About 20% of Mexico's 45,000 km long Federal Highway Network (FHN) is badly deteriorated, mostly due to inadequate maintenance over the past several years. The backlog of deferred maintenance is estimated to be over 50% of the federal highway network (i.e.: about 25,000 kms). The problem is expected to increase in severity, particularly as the funds currently allocated to maintenance fall far short of estimated needs. During the 1987-89 period routine maintenance was carried out only on about 20% of the FHN. Furthermore, to add to the difficulty, for budget management reasons the funds released to SCT often arrive during the second half of the calendar year while the main maintenance and construction period during the dry season occurs during the first half of the year.

57. In discussions, SCT has indicated that maintenance has the highest priority in the use of their resources. However, an analysis of SCT's expenditures during the 1983-88 period indicates that only about half of their expenditures were spent on maintenance and rehabilitation activities. The remainder of SCT's resources were spent on new construction and on widening existing roads. While new construction and widening can provide acceptable returns, numerous studies both in Mexico and other countries have indicated that maintenance activities (preservation of the existing roads) show the highest returns and are the best use of limited resources. SCT's approved budget for 1990 projects maintenance expenditures to decrease in both absolute (in constant pesos) and relative terms. However, a request is currently being considered to increase the maintenance budget by about 50%.

.[7] In October 1989, the Bank estimated that a large revenue potential from taxing truckers under the general income tax regime was not being tapped. Mexico - Tax Reform for Efficient Growth, Yellow Cover, October 2, 1989.

Reorganization of SCT

58. As a result of the steps already taken and the future steps proposed, many of the past regulatory functions of SCT are being eliminated or reduced, particularly within the General Directorate of Land Transport and Tariffs. To ensure the efficient use of personnel and reduce the temptation that regulations creep back through the back door, underutilized staff will need to be reduced and/or transferred to other more productive activities. During 1989 SCT already took some actions (including a reduction in personnel of about 150 people, suppression of a department and reassignment of its staff, and reformulation of the functions of two other departments) and is now undertaking the preparation of a reorganization plan, which would address this issue.

C. THE TELECOMMUNICATIONS SECTOR

59. In recent years the telecommunications sector has been the focus of worldwide attention. The success of a recent Bank seminar in Asia[8] testifies to the growing interest in management and restructuring options for the sector. Following the break-up of AT&T in the USA, and the move towards privatization and a more competitive environment (as well as innovative concepts in regulatory practice) in the UK and other large industrialized countries (such as Japan, France, Germany, Netherlands and Australia) there has been a widening interest in the potential of sector reforms. The underlying technological and economic forces of change are by now clearly visible in developing countries.

60. As noted in the IBRD book mentioned above, in most developing nations telecommunication services are provided by the public sector. Often quality of service is poor and there is a large unmet demand. Sector investments, constrained by overall ceilings on total public sector investments, fall short of needs and rates tends to be influenced more by political factors than by financial and economic considerations. At the same time, technologies are in a process of constant change, costs are dropping and the uses of telecommunications in business are expanding. The inability of the sector to respond to demand is a major challenge faced by the developing world, and Mexico is no exception.

The Mexican Telecommunications Sector

61. TELMEX has a monopoly on telephone service. Until 1972, TELMEX was controlled and managed by the private sector and still today 49% of its stock is publicly traded (both in the Mexico and in the New York stock exchanges), while the other 51% is held by the Government. TELMEX is run as a government enterprise, and its tariffs, investment decisions, finances and

---

[8] B. Wellenius, P. Stern, T. Nulty and R. Stern (editors), Restructuring and Managing the Telecommunications Sector, The World Bank, Washington D.C., May 1989.

Stuart let's get this

management are constrained by the same factors as in other parastatal enterprises. SCT is responsible for telecommunications sector policy and regulation. The latter includes licensing of private networks, approval of customer premises equipment, and planning, administering and monitoring the use of the radio spectrum. Until late 1989, SCT also had direct operational responsibility for the provision of some services (mainly telex, data transmission, operation of a sizable, but antiquated, microwave network, a modern but underutilized domestic satellite system, and a network of maritime coastal stations).

62. Mexico's present telecommunications system is a major constraint to economic growth, particularly industrial production and export activities. There are over 1.5 million applications for telephone service awaiting installation (and many more potential subscribers that do not bother to apply given known long delays in obtaining service)[9]. Telephone service is also of poor quality, unreliable, and heavily congested (it is virtually impossible to get through during peak business hours). In the recent past, TELMEX has installed about 230,000 lines per year, which barely keeps up with the growth of demand. More advanced services (e.g., facsimile, data transmission, cellular telephony, access to time-shared data processing and data banks) are only in their infancy. Given Mexico's drive to open its economy, it is becoming increasingly important to ensure that business firms operating throughout Mexico have access to state-of-the-art telecommunications and information services, and that households gain access to markets and business activities through a more effective basic telephone infrastructure.

Sector Issues

63. Senior government and TELMEX officials have given much careful thought to the four key sets of issues that need to be addressed in order to overcome the above deficiencies:

(a) What role should the private sector play in telecommunications? In particular, how can the huge investments required to expand and modernize services be funded? And what functions should remain with the government?

(b) To what extent, and how, should competition be developed?

---

[9] Mexico's 5.3 connected telephone lines per 100 inhabitants is somewhat less than the average for Latin America (about 6) and well below other newly industrialized countries (e.g., Korea 15, Singapore 30). Only 18% of Mexican households have a telephone (compared with about 40% in Spain). Furthermore, there are large imbalances among states (e.g. 11 lines per 100 inhabitants in the Federal District compared with 3 lines per hundred in the states of Mexico, Veracruz and Michoacan) and between urban and rural areas.

(c) What would be an appropriate regulatory framework? In particular, what should be the price and tax regime? How can the required regulatory capacity be developed? And,

(d) How can the conflict of interest between the government's regulatory functions and its operating responsibilities be reduced or eliminated?

These issues are linked to broader aspects of the Government strategy which, as noted earlier, seeks to spur private sector development and non-traditional exports and reduce public sector participation in business activities where the public sector does not have a comparative advantage or very clear rationale for its involvement.

64. Private Sector Role. There is now a widespread perception, which the Bank shares, that under private ownership TELMEX would face less constraints in mobilizing funds and operating as an efficient business than it does as a parastatal enterprise. In addition, in the context of appropriate sector policies it would be more responsive to changing market requirements and technological opportunities. There is also the idea that ownership of a substantial proportion of TELMEX stock by a foreign operating company would bring in expert telecommunications management to steer TELMEX towards more efficient commercial operation. In order to prepare TELMEX for sale, on October 1989 the Secretary of Finance (who is responsible for handling the placement of TELMEX shares) was appointed as chairman of the Board and a new director general took over as chief executive. Furthermore, in January 1990 a Mexican investment bank, "Banco Internacional" was appointed to handle the sale. As a first step, "Banco Internacional" has been requested to assess alternative sale options and to formulate a sale strategy.

65. Competition. The Bank also shares the view that new private service providers should be allowed to enter the market under a regulatory framework which limits Government intervention as much as reasonably feasible. Such competition would help meet outstanding and new demands, particularly for advanced business services where innovation and responsiveness, rather than scale and scope, are the key determinants of performance. Competition would also press TELMEX to accelerate network growth, improve the quality of its services, and contain costs.

66. Policy decisions are required, however, on the competitive supply of services, participation of monopoly entities in the competitive segments, and relations between both. Unfettered competition would result in wasteful duplication of facilities, loss of benefits due to excessive network fragmentation, and dilution of surplus funds needed to complete the basic national telecommunications infrastructure required for economic development reasons.

67. Regulation, Pricing and Taxation. As the state moves out of the business of providing telecommunications services, it becomes necessary to revise the policy and regulatory framework and build up a public regulatory capability. First, regulatory objectives suited to a mix of private

competitive and monopoly services need to be clearly established. Second, the role of pricing as a means to ensure efficient allocation of resources must be recognized and principles developed to set prices in such cases where market mechanisms may be inadequate. Third, areas where disagreement between affected parties may arise must be identified and processes established to resolve disputes and ensure fairness in decision making. Finally, transparency and accountability must be brought into the picture to attract public trust and support for the proposed changes. The extent and pace at which Mexico can build up effective, trustworthy regulation will be a key factor in the success of privatization and competition.

68. A critical area for regulatory improvement is that of pricing policy and tariffs. Until January 1990, installation charges were very high, monthly network access and local usage charges were very low, and tariffs on international calls (especially to the USA, which accounts for about 90% of the traffic) were extremely high. These price distortions induced excessive use of some facilities while penalizing others (especially burdening international business activities with prices that are several times those of Mexico's foreign competitors or partners). In January 1990 cross subsidies were significantly reduced, with some charges for domestic calls increasing as much as twelve times and rates for international calls dropping by about 35%. However, as TELMEX is privatized, it becomes of increasing importance to establish a process for the periodic adjustment of tariffs that reflects the objective of promoting efficiency, while ensuring an adequate level of profitability[10]. Considerable progress has been made in this regard and the Government is currently considering international price benchmarks and price-cap mechanisms, which is in line with the prevailing thinking in the USA, UK and other countries that have moved towards privatization.

69. Until recently, taxation issues were also a major issue. Telephone users had to pay a tax (inclusive of VAT) which ranged between 22% and 72% (depending on the type of service). On average, TELMEX suscribers paid more than 50% in taxes, which was the highest of a group of 76 countries studied by the Bank. Over the past several years, while the Government did provide funds for investment to TELMEX, the sector remained a net contributor of funds to the Treasury. It is estimated that in 1989 the net transfers (all taxes minus funds provided for investment) from TELMEX to the Government amounted to the equivalent of about US$640 million. It was increasingly felt, however, that as the sector was opened to competition, telephone taxes had to be reconsidered to avoid misallocation of resources. Applying VAT to telephone services is perfectly justifiable (indeed necessary to avoid distortions). So is taxing income under the same rules and applying the same rates as for other business activities. On this basis the tax regime was substantially realigned in January 1990. The new regime does provide for a

---

[10] Often the marginal cost of providing telecommunications services is lower than average cost (mainly due to economies of scale and technological innovation). Thus deviations from efficient prices may be required to ensure full cost recovery and generation of operating surpluses to sustain rapid expansion and modernization.

tax on revenues (in additon to VAT and income taxes), but this new tax (which replaces the old tax on telephone users) is a major improvement. It allows for a substantial investment credit and may be deducted from income taxes, so it may reasonably be expected that its financial impact on TELMEX will be negligible but it will serve to reduce accounting profits, and hence avoid a large increase in employee participation in profits. The recently enacted price and tax changes, coupled to a phasing out of Government contributions by the time that TELMEX is privatized are expected to result in TELMEX payments to the Government of about US$754 million in 1990.[11] In the medium term, increased private participation in the sector will result in system growth and increased fiscal revenues, so that by 1994 these would rise to about US$1,460 million.

70. There are also areas of essentially technical (as distinct from economic) regulation that need attention. Management of the radio spectrum, a scarce natural resource, is already antiquated and ineffective; with the advent of more private networks and service providers, this may prove an intractable bottleneck unless extensively modernized. Maintenance of national fundamental technical plans (for signalling, numbering, etc, required to facilitate interconnectivity among national network segments and with international standards) is currently the responsibility of TELMEX; as TELMEX is privatized, and competition develops, this function must be taken over by an entity that is independent of the operator.

71. Lastly, there is the need to concentrate in a single agency a number of regulatory functions now dispersed between several. In particular it would be advisable to consolidate the tariff oversight and rate setting function, in which SCT, SHCP and, in some way SPP, are now presently involved. This would automatically take place once TELMEX becomes private, as the role currently played by SHCP and SPP, arises from the "public" nature that TELMEX now has.

what are they?

72. Divestiture of SCT's Operations. An essential element of sector reform must be separating operational activities under SCT from its policy and regulatory responsibilities. This would substantially reduce the risk that SCT would seek to protect its own business activities at the expense of overall sectoral development. It is also essential to give adequate assurances to private investors (particularly those expected to buy TELMEX)

11 If the Government's shares in TELMEX are sold (as presently envisioned), the windfall effect on Government finances should also be taken into account. TELMEX's net book value is about US$3.3 billion. Based on the current price of TELMEX shares traded in the Mexican stock exchange, the Government's holdings in the company would be worth over US$2 billion, but now that prices have been substantially aligned with economic costs it is expected that such value will rise significantly. In this context the pace of divestiture is likely to have significant financial implications and one of the key objectives of the strategy that the Government, with the assistance of investment bankers, is now developing is to obtain the best possible deal, while meeting the other objectives of the divestiture process.

why not direct to a pte co?

that state operations will not be used as a tool for arbitrary interference in the market. To achieve this, the Government has decided to reorganize SCT's operations under an autonomous state enterprise, TELECOMM, subject to the same rules and regulations as any private operating entity, and without further Government financial support.

The Government's Telecommunications Program

73. The Government has decided that a major effort to step up the pace of telecommunications development is required, and has set as a goal an investment program of about US$10 billion over 6 years (1989-1994), which would allow increasing the telephone density from about 5.3 lines per 100 inhabitants (end 1988) to 8.5 (1994). The Government is willing to take action on the issues outlined above and is quite advanced in implementing a far reaching program of reforms,[12] of which the following key aspects deserve to be highlighted:

(a) Privatization: Privatization of TELMEX, announced by the President several months ago, is the center piece of the Government's telecommunications reform plan and is well underway. Although a firm plan and timetable have not yet been defined (para. 64), within 1990 "Banco Internacional" expects to transfer administrative control of TELMEX to private owners and to initiate the sale of remaining Government-held shares in the national and international markets.[13]

(b) Competition: Concurrently, competition will be widely encouraged, including development of private user networks interconnected to the public network, cellular telephony (mainly for mobile service but also as alternative to TELMEX's fixed telephone service), supply of customer premises equipment (e.g., telephones, PABXs, fax and telex machines), provision of information services, and eventually long-distance and international voice and data transmission. Franchises for cellular services in Mexico City have been awarded, and invitations to bid have been issued for franchises in the rest of the country (with a large response from prospective suppliers, as by January 1990 over 100 bids had been received for the country's eight regions). These franchises are scheduled to be awarded by late March 1990.

---

12 "Programa de Modernización de las Telecomunicaciones"; SCT, September 1989.

what is it? No timetable, acc to 73 (a)

13 This is an ambitious schedule which may understimate the complexity of putting together such a complex deal and developing a political consensus over its various aspects.

(c) Regulation, Tariffs and Taxes: A new franchise contract for TELMEX, and rules and regulations for competitive services, have been drafted but a final decision on some important provisions is still pending. TELMEX tariffs have been substantially restructured (January 1990) increasing on average by more than 70% and significantly reducing cross subsidies (para. 68) and, while there is still room for some fine tuning, the present tariff structure would allow TELMEX to internally finance about 80% of its 1990 investment plan. And;

Check

(d) Divestiture of SCT's Operations: While SCT will retain and develop its policy and regulatory responsibilities, all its telecommunications operating functions have now been transfered to a new decentralized state enterprise, TELECOMM[14], and a competent management team has been appointed to run it. TELECOMM is positioning itself to play a role in stimulating competition by starting up new operations, mainly directed to business users, through joint ventures with domestic and foreign private investors, operators and suppliers, as well as other modalities.

74. Finally, the collective contract with TELMEX's union was successfully renegotiated in April 1989, overcoming long standing problems that had limited management's freedom to run the company as a business. However, while in the case of road transport most of the important steps have already been taken, in the telecommunications sector some important reforms still have to be implemented. such as?

That's it for labor issues??

PART III - BANK STRATEGY

A. Government Strategy

75. After six years of falling per capita income and a protracted stabilization and adjustment process, the Government's main objective is the restoration of sustainable economic growth. To achieve this objective, macroeconomic stability had to be consolidated and the burden of the country's external debt overhang had to be credibly reduced so as to restore investor confidence. The ongoing stabilization program, (para. 9), has brought down inflation from an annual 159% to about 20% and the debt rescheduling has also been satisfactorily resolved. Based on an agreement reached with commercial banks in July 1989, a financing package--supported by the IMF and the Bank--,

---

14 Presidential decree of November 17, 1989. Some of the services taken over by TELECOMM are likely to be privatized soon, e.g. the small packet-switched network and the telex service. SCT's reservations network, also small, established in 1985 as a decentralized agency, would be privatized directly; a decree to this effect is being drafted.

why not now?

which will provide new money and significant debt reduction has now been subscribed (an interest support loan for US$1.26 billion was submitted to the Board for approval on January 30, 1990, see report No. 5235-ME, which discusses in detail the debt agreement between Mexico and the commecial banks).

76. The Government has stated that growth must be private sector based, with the Government playing a supportive role by providing incentives for private sector investment and reallocating public spending to improve public infrastructure, alleviate poverty and solve long-neglected problems of the environment. To eliminate the anti-agriculture bias in the incentive and trade regime, the Government has resolved to adjust sector policies in agriculture, where reforms in the past have been lagging behind industry. To prevent inadequate service levels from becoming a bottleneck for renewed growth, infrastructure policies will assign priority to the rehabilitation and maintenance of existing infrastructure (power, water, transportation, irrigation, etc.) and, where feasible, private sector investment will also be sought. The Government is also committed to equitable development and is emphasizing social sector programs, including health, nutrition, education, and rural development, and the budget for 1990 already includes a sizeable increase in the share of resources assigned to these sectors. These programs would be targeted to the truly needy, to reduce the social cost of adjustment and to address issues of structural poverty. On the environment, the Government has launched a major initiative to tackle high priority problems which have been affecting increasingly the health and living condition of the country's people and its economic growth potential.

B. Bank Assistance Strategy

77. Given such a comprehensive and balanced Government strategy, the Bank has a major role to play. Our assistance strategy is based on the highly successful partnership that the Bank has built up with the Government over the last few years. On the one hand, through the policy lending in support of structural reforms and increased sector investment lending it undertakes, the Bank would give a signal of confidence that the inflow of external capital necessary for growth will be forthcoming. At the same time, adjustment lending and credit enhancement by the Bank in support of the 1989-92 financing package are helping relax Mexico's resource constraint that is stifling growth, thus playing a major catalytic role in the process of breaking out of the macroeconomic and financial bind in which the country finds itself. That is the main rationale for sustained high levels of Bank lending with a robust conditionality. After FY91, as the conditions for growth have been restored, lending would shift away from adjustment lending to growth-oriented sector investment lending and to social and environmental projects.

78. In support of the Government's program to consolidate macro economic stability and to restore growth, the Bank's strategy would pursue the following objectives: (a) consolidation of the stabilization effort; (b) support of incentives for efficiency/private sector led growth, including the necessary infrastructure investments, particularly in transport, power, agriculture and urban services; (c) poverty alleviation/improved social

services; (d) environmental protection; and (e) secure continued access to external resources.

79. The above outlined assistance strategy and sectoral objectives will be implemented with the help of sustained high levels of Bank lending to Mexico over the medium term, which would be maintained at US$2 billion per year. Such high levels of new commitments would, of course, hinge on the maintenance of a consistent macroeconomic environment and on the depth and quality of Mexico's further structural reforms. As 58% of the Bank's past lending to Mexico has been in support of adjustment since 1986, including lending in FY87-89, it is the Bank's intention to cut back on quick-disbursing adjustment operations and, in a manner consistent with the requirements of the recovery of economic growth, focus on sector investment operations which are designed to support agreed investment programs in high priority sectors. To keep resource transfers at adequate levels, the Bank and the Government are currently reviewing the requirements of time slice financing, which would be an essential feature of the sector investment operations. To help achieve the stated objectives of the Bank's country assistance strategy, the policy content of the proposed lending program, in more specific terms, would be directed at: fiscal issues, financial sector efficiency, domestic deregulation, trade and export development, subsidy control and pricing issues, improved public sector and parastatal enterprise management, decentralization and deconcentration of the public sector, social welfare and poverty programs, and environmental measures. Proposed lending levels at US$2 billion per year, plus additional US$950 milion of the FY90 interest support loan, would increase the Bank's exposure by US$5.85 billion by 1994 and, for the expected blend of quick disbursing and investment operations, increase Mexico's share in the total of the Bank's disbursed and outstanding loans to 11.1% by FY93.

C. Bank Rationale for the Proposed Loan

80. One of the ways to provide incentives for private sector development is to improve the regulatory framework, reducing interference with business decisions and eliminating a source of corruption. Actions taken by the Government actually go far beyond the agreed policy targets of the Industrial Sector Policy Loan, which includes as a second tranche release condition preparation of an action plan deregulating trucking. As already discussed (para. 42), elimination of route restrictions and freight centers, and liberalization of container movement have already taken place and deregulation of the automotive industry also is ahead of the agreed schedule (para. 46). In the case of telecommunications, the Bank played an important role in helping to shape the Government program, which goes far beyond what had been envisioned only one year ago. The privatization of TELMEX, one of the largest parastatals in Latin America, and the opening up of the telecommunications market to private (including foreign) investment are unprecedented steps in Mexico. These measures, and the additional actions proposed under the project, would make transportation and telecommunications services much more efficient and supportive of the Government's privatization and export drive. They, therefore, justify the Bank's assistance to the Government's adjustment program in transportation and telecommunications.

Furthermore, the depth and comprehensiveness of the adjustment efforts that Mexico is undertaking and the short run costs that such efforts are occasioning--particularly the increase in imports caused by the process of privatization and deregulation (at a time when access to external financial markets is still very constrained)--justify a significant level of adjustment lending and provide the basis for having framed the proposed operation as a sector adjustment loan.

D. Transportation

81. In trucking deregulation, the proposed project would monitor the implementation of measures already announced, and would promote additional measures, as outlined below:

(a) Open Entry: Much progress has already been made in providing open entry into the transport industry by replacing restrictive concession requirements by a simple and open system of permit awards, eliminating corridor and freight center restrictions, opening access into cargo handling and drayage services and introducing competition in the movement of containers. Concerning state regulations, we would request the preparation of a plan of action by Board Presentation under which the Government would seek agreement with every state where this is warranted to deregulate trucking within its jurisdiction. Improvement of customs operations, which would have a high economic significance for international trade and trucking, would be sought under an Export Promotion Project which is now being prepared.

(b) Official Tariffs: On this important issue, all the actions that the Bank sought have been already taken, as tariffs are now freely negotiated by the truckers and their customers.

(c) Highway Safety and Environment: While highway safety is an important concern in its own right, in the future attention to safety will be particularly important since the issue may be used as a justification for the reintroduction of trucking industry regulations. To improve highway safety, we would seek:

(1) the strengthening of the interagency group responsible for coordinating safety policies and their implementation, by Board presentation and the presentation of a satisfactory action plan to improve road safety as a condition of second tranche release;

(2) the preparation of a proposal for mandatory liability insurance against third party claims (which would promote greater private sector involvement in improving safety, including better monitoring of the

condition of vehicles) by Board presentation and its enactment by second tranche release; and

(3) the initiation, by Board presentation, of a study to: (i) collect information on the actual situation concerning vehicle sizes and loadings (Phase I), (ii) analize policy options, and (iii) recommend measures to enforce vehicle size and weight regulations (Phase II). The completion of Phase I of the study and initiation of Phase II would be a condition of second tranche release.

(4) To provide an incentive for truckers to care for the transported cargo, we would seek, by second tranche release a substantial increase (from about US$0.31/ton to more than US$200/ton) in the limits of the trucker's responsibility for cargo damages and loss, together with an indexing system to keep the coverage up-to-date.

(5) To address the air pollution caused by trucks, by second tranche release, we would seek the issuance of satisfactory regulations requiring mandatory periodic inspection of trucks to monitor compliance with federal emission standards, such inspections to be conducted through private service stations.

(d) Pricing, cost recovery and taxation:

(1) The analysis of cost recovery from truckers indicates that they have not been paying for the maintenance and improvements costs which they cause to the road network. One of the main reasons has been that the price of diesel did not include an adequate surcharge through which to recover costs. This distorsion has now been partially corrected, but further actions are still necessary to achieve a satisfactory level of cost recovery. By Board Presentation we would seek a satisfactory policy statement and action program to achieve full cost recovery. For second tranche release full cost recovery should have have been achieved; in December 1989 prices this would require an increase of 12% in the price of diesel fuel, or a lower percentage if combined with increases in direct taxes paid by truckers; and

(2) To ensure that the distribution of cargo between competing modes (road and railway) is conducted on the basis of the "right" price signals (which is necessary to ensure an efficient allocation of investment resources between the modes), as a

condition of Board presentation the Government should furnish a satisfactory program of adjustment of FERRONALES rates; which should include targets for each of the key commodities that are transported by railway.[15] For second tranche release FERRONALES should have made satisfactory progress in adjusting the rates for the transportation of selected commodities and goods, which account for most of the traffic.

(e) Highway maintenance: Since 1982 Mexico has been facing a mounting shortfall in highway maintenance, which will be reflected in increased operating costs for trucking in the coming years. To help address this problem, in 1987 the Bank made a US$135 million loan to finance a Highway Maintenance Project but the achievements so far have been very modest. Within a framework of fiscal discipline, much more can be done to address this problem than at present. Under the proposed project, as a condition of Board Presentation we would seek a general policy declaration on the priority of maintenance expenditures over new construction and a decision from the Government to increase by Mex$ 200 billion (i.e., about 50%) SCT's 1990 budget for highway maintenance activities. Compliance with the expenditures commitment and receipt of a satisfactory budget proposal for CY91 (which should provide, at least, for maintaining in real terms the proposed 1990 level) would be a condition of second tranche release.

(f) SCT reorganization: By Board presentation, we would request the preparation of an action plan to reassign, train and--when appropriate--reduce or transfer SCT's road transport regulatory staff. We would monitor satisfactory implementation of the plan by second tranche release.

---

15 At negotiations we would propose achievement by December 31, 1990 of the following targets for the ratio of the average tariff to the long run variable cost:

- Sugar cane : 0.85 (up from 0.63 at present);
- Coal: 0.90 (up from 0.76 at present);
- Iron ore: 0.85 (up from 0.69 at present);
- Limestone: 0.90 (up from 0.74 at present);
- Cement: 0.90 (up from 0.74 at present); and
- Waste paper and cartons: 0.90 (up from 0.76 at present).

Commitment to achieve a ratio of 1.0 for each of the key commodities listed by December 31, 1991 would also be sought.

E. Telecommunications

82. In the case of telecommunications, the Bank has an opportunity to play a valuable role at a critical juncture, when changes of a scope that would have been impossible to envision only a year ago are now being undertaken. We have a strong base to start from. First, a good high-level dialogue on policy matters has built up from 1988, and the Government's economic team and now also SCT appear keenly interested in the views of Bank staff and consultants. Second, SCT and SHCP recognize that, should the Bank endorse the package of sector reforms and implementation plans, this would add confidence to potential (especially foreign) investors interested in TELMEX. Third, and perhaps most importantly, the Government is eager that the Bank help them in the critically important initial stages of reform implementation. The latter includes developing an effective regulatory process. Lastly, loan conditionality would add a degree of stability to the package of agreed reforms and initial implementation plans.

83. The Bank still needs to examine before Board presentation a number of key aspects on which the Mexican proposals are only now being developed. These include, particularly, the proposed new TELMEX franchise agreement and the proposed regulations for licensing networks and services, which together with the TELMEX franchise, will be the main legal instrument to implement the Government's competition policy.

84. Though the progress achieved in the past few months towards developing new policies and defining the desired structure for the sector has been excellent and the key political commitments have been made, a comprehensive plan for the implementation of the proposed sector reforms is not yet fully in hand (para. 64). SHCP has taken firm control of the process of selling TELMEX and has appointed the investment bank that will advise them and conduct the sale, but a firm plan and timetable are not yet available. SCT is drafting the new franchise agreement and regulations for competition. Regarding development of sector regulation, SCT is acutely short of experienced staff and resources to address this critically important component of reform at an appropriate level and pace. As for TELECOMM, further clarification is still required on what will be its role in the context of a mainly privately-owned, and increasingly financially competitive sector.

85. An effective regulatory process and the necessary institutional adjustments can only be built up over time and as experience develops among all major players. For example, price regulation for those services that TELMEX will continue to provide on a monopoly basis is likely to require development of cost accounting by TELMEX and related guidelines by SCT. If price cap regulation (as used in the U.K. for British Telecom and in the U.S. for ATT) is the route to be chosen, it will still be necessary to review the caps from time to time, at which time the profitability (or lack thereoff) of TELMEX will need to be taken into account. If international benchmarks are used (which is an option also under study, see para. 68), it is inevitable that at some point in time these will have to be revised in light of actual financial results in the Mexican context. Whether and how to factor in the

attainment of quality standards in the pricing formulas, is an issue that has not yet been settled. Even some of the formal changes (i.e.: devise dispute resolution procedures, including controversies over access and pricing) cannot be rushed. Although the current telecommunications law gives the government enough latitude to proceed with the planned reforms, at some point it will be necessary to prepare new legislation better suited to the new policies, but this may well be several years from now.

86. The conditionality that is proposed for the telecommunications sector may be summarized as follows:

(a) Privatization. Satisfactory progress towards the divestiture of TELMEX would be a condition of Board presentation. This would include the following Government actions: (i) furnish to the Bank a satisfactory draft franchise (approved by the Government) to be used in the negotiations with potential investors (including a definition of the pricing regime), (ii) engagement of foreign investment banking firms to assist the Mexican investment bankers officially in charge of the placement (already appointed) by acting as agents in the main world markets, and (iii) presentation of a satisfactory program and timetable for handling the privatization of TELMEX. As a condition for second tranche release, there should be satisfactory further progress in the privatization of TELMEX, including: (i) execution of a satisfactory franchise agreement that provides a definition of the pricing regime and specifies the service, quality and investment obligations of TELMEX, and (ii) the sale of shares as necessary to transfer administrative control of TELMEX to private investors.

(b) Competition. Prior to Board presentation, the Government should issue satisfactory regulations governing the licensing of networks and services.

(c) Regulation. Prior to Board presentation, consultants to assist SCT to strengthen its regulatory capacity should have been engaged. Prior to second tranche release, a satisfactory regulatory action plan, that takes account of the consultants's recommendations should have been furnished to the Bank.

(d) Divestiture of SCT's Operations. Prior to Board presentation, a statement of TELECOMM policy and objectives should have been published. Before second tranche release, a business plan for TELECOMM, including investment and financing plans until 1994, should be furnished to the Bank.

PART IV - THE PROPOSED LOAN

A. Background

87. The Bank has had a close involvement with Mexico's transportation sector, dating back to the first highway project, approved in 1960. In that context, concerns about the net benefits of the regulatory framework for trucking were periodically raised and were topics of discussion during the annual reviews that took place under two Highway Sector Projects (one of which is still underway) and extensive sector work was conducted over a period of time spanning at least 15 years. Under the Industrial Sector Policy Loan, approved in June, 1989, it was agreed that the Government would conduct a comprehensive study to identify and remove impediments to competition and efficiency in the trucking sector and before second tranche release would complete the study and agree upon a plan of action for its implementation. However, this was just one of a number of issues that the project addressed, and it was not envisaged that the actions to be taken would be as far reaching as is now being proposed.

88. The Bank's dialogue on telecommunications issues has not been as close, but over the years we have periodically fielded missions to keep in touch with sector developments. In a succession of short missions from mid-1988, the Bank produced an issues and options paper which opened up the discussion with senior government officials, followed by a proposed "minimum package" of sector reforms, which was also handed to the outgoing administration. This set the framework for the current programs, which go significantly beyond what had been envisioned under the minimum package. More recently, the Bank prepared a paper on issues in the implementation of the sector reforms proposed by the Government, and has been informally reviewing and discussing sector policies, TELMEX's franchise, and the process of privatization.

B. Loan Objectives, Benefits and Risks

89. The proposed loan is part of a program of Bank support to the Mexican Government"s objectives of promoting private sector development and increasing the efficiency and effectiveness of public sector institutions so as to enable the resumption of economic growth. The loan supports a program of reforms in two sectors (road transport and telecommunications) which have in common that they both provide a vital service to business activities in general and to external trade in particular. By providing an appropriate institutional and regulatory framework, the project is expected to spur competition, thus serving to increase the efficiency of communications services and--in the case of telecommunications--greatly expand its coverage. Resource allocation would be improved through greater reliance on market forces, and (in the case of monopolies) on economic criteria for pricing.

90. The project would be cofinanced by IDB, which is expected to recommend a loan of $200 million to its Board. IDBs processing is expected to parallel that of the Bank; they would substantially rely on our appraisal and

would propose equal conditionality. Coordination between the two institutions has been close. Meetings have also been held with staff of OECF (Japan), which expressed some interest in learning about the project; no commitment however has been received from them and a follow-up is planned to confirm their interest.

91. The project would be supported by a parallel free standing technical assistance (T.A.) loan for telecommunications of US$22 million equivalent. The T.A. loan would finance consultants to prepare plans for developing SCT's telecommunications regulatory capacity, including management and monitoring of the radio spectrum, as well as long term experts, training and equipment (computer hardware and software, and radio monitoring facilities) required for the first two years' implementation of these plans. The technical assistance loan would also support TELECOMM in its start-up phase.

92. At negotiations, agreement would be sought on the contents of a policy letter which should cover the issues still outstanding. A proposed policy matrix is attached (Annex V).

93. If the objectives outlined above are achieved, the benefits accruing from the project will be significant: the quality of road transportation will improve and costs will drop, benefitting users in general and particularly those which make more intensive use of transportation, such as those engaged in foreign trade; competition in various telecommunications services should result in better quality services to consumers and greater receptivity to technological change, both of which should improve the ability of Mexican firms to communicate with and compete in world markets; private ownership of TELMEX should remove present financial and other constraints to a faster pace of sector growth, rapidly expanding availability of telephone and more advanced services; greater reliance on market mechanisms for price setting should improve resource allocation and eliminate a source of corruption; finally, improved regulation and enforcement of safety and environmental standards and of weight loads should bring about benefits to large segments of the population.

94. There are, however, risks which also deserve to be highlighted. First, it is important to ensure that the divestiture of the Government's controlling interest in TELMEX is "well" handled, since this is the largest parastatal to be privatized and all aspects of the operation will be particularly scrutinized by opponents to the Government's privatization policies. Errors in this respect could jeopardize subsequent privatization attempts in other sectors. Second, the Government does not now have staff with adequate experience to regulate public utilities, and the regulatory framework is still in an inception stage. The Bank and the Government should resist the urge to rush into solutions that have not been adequately thought through. Third, there are practical and financial limits to the pace at which investments in telephone services may proceed, even under private ownership. The Government should avoid developing undue expectations, which later may result in disappointment with the result of privatization.

95. The risks discussed above seem manageable, and are outweighed by the benefits of the proposed course of action. Of greater significance, however, may be the risks that either for external or internal reasons Mexico may be unable to stay the course of economic reforms. But even if that were to occur, which today does not appear too likely (even though there are still many uncertainties), the policy reforms that the proposed project would support would have a good chance of staying in place and yielding substantial benefits to the economy.

C. The Borrower, the Guarantor and Project Implementation

96. The Government has designated BANOBRAS as the borrower of the proposed loan, in line with its function as Mexico's official financial agent for infrastructure sector loans. The loan would be guaranteed by the Mexican Government, and SCT would be responsible for project implementation.

D. Disbursements, Procurement, Administration and Auditing

97. The loan would be released in two tranches, of US$190 million each. The first tranche would become available upon loan effectiveness, and the second tranche after December 31, 1990 and upon the fulfillment of specific conditions for tranche release. The closing date of the proposed loan would be June 30, 1991.

98. The loan proceeds would be relent on terms and conditions satisfactory to the Bank, and will be used to reimburse 100% of the foreign cost of eligible imports (on the basis of a positive list that would be agreed during appraisal/negotiations[16]) up to US$380 million.

99. Retroactive financing, up to US$76 million (20% of the loan), for expenditures incurred since November 1, 1989, would be available. Both private and public sector imports would be eligible for financing.[17] Individual contracts under $5 million each would be awarded on the basis of

---

16 The appraisal mission requested that BANOBRAS prepare an analysis of sector imports (including both direct and indirect imports) in the recent past, with adequate identification of those imports that were financed externally under terms that exceeded one year. If such analysis were to show that elligible imports would be insufficient to meet the quick-disbursing objective of the loan, the fallback option would be to use a negative list. In this regard, it should also be noted that IDB is expected to follow the same disbursement arrangements as the Bank for its proposed cofinancing. The analysis is to be furnished to the Bank in early March, before negotiations.

17 Under the adjustment loans that were approved by the Board on June 1989 the Bank conducted a review of public and private sector procurement practices and found them to be acceptable. Since the time elapsed since that review was short, for this operation we conducted an update based on a representative sample of firms, which verified that our prior assessment remains valid.

the normal procurement practices of the purchaser. Individual contracts above US$5 million would be procured on the basis of ICB, following Bank guidelines. The Borrower would be responsible for maintaining loan accounts and for the preparation and submission of withdrawal applications. Disbursements would be made on the basis of statements of expenditure from Banco de Mexico detailing individual import transactions in each relevant period, and their eligibility under the proposed loan. Applications for withdrawal will be consolidated and submitted in amounts of not less than US$5 million. Audits of the supporting documentation for statements of expenditure used for disbursement will be carried out annually by independent auditors acceptable to the Bank. The audit reports would be submitted to the Bank within six months of the end of the fiscal year.

E. Board Presentation and Conditions of Tranche Release

100. As conditions for Board presentation the Bank would seek:

(a) preparation of a plan of action to enter into trucking deregulation agreements with all states where this may be warranted (para. 81(a));

(b) actions to improve highway safety (para. 81(c)):

(i) strengthening the interagency group to coordinate safety policies by including the participation of SCT's directorates for preventive medicine, land transport, federal highway police, technical services, highway maintenance, and public campaigs as well as other agencies interested in road safety;

(ii) presentation of a proposal for mandatory liability insurance against third party claims; and

(iii) initiation of a study, inter alia to collect information on vehicle sizes and loadings;

(c) actions to improve pricing and cost recovery (para. 81(d)):

(i) satisfactory policy statement and action program to achieve full cost recovery from truckers; and

(ii) program of adjustement of FERRONALES rates for key commodites;

(d) receipt of a satisfactory policy statement regarding highway maintenance, as well as a decision to increase by Mex$ 200 billion the 1990 budget for maintenance expenditures (para. 81(e));

(e) presentation of a satisfactory action plan to reorganize SCT's functions in the trucking sector (para. 81(f));

(f) satisfactory progress in the divestiture of the Government shareholdings in TELMEX. This would include receipt by the Bank of a satisfactory draft franchise and of a program and timetable for handling the privatization of TELMEX, and engagement of foreign investment bankers to assist the Mexican investment bankers handling the placement of TELMEX' shares (para. 86(a));

(g) issuance of satisfactory regulations governing the licensing of telecommunications networks and services (para. 86(b)),

(h) engagement of consultants to strengthen SCT's regulatory capacity in the telecommunications sector (para. 86(c); and

(i) publication of a statement of TELECOMM policy and objectives (para. 86(d)).

101. Loan effectiveness would be conditional upon BANOBRAS entering into contractual arrangements with the Government for relending the proceeds of the loan which are satisfactory to the Bank.

102. Second tranche release would be contingent upon:

(a) satisfactory assessment of the medium term macroeconomic framework (para. 32);

(b) actions to improve road safety (para. 81(c)):

(i) completion of Phase I of the study on vehicle sizes and loadings and initiation of Phase II,

(ii) presentation of a satisfactory action plan to improve road safety;

(iii) enactment of mandatory liability insurance against third party claims; and

(iv) increase to not less than US$200/ton the limit on truckers responsibility for cargo damages.

(c) actions to address the air pollution caused by trucks (para. 81(c)): issuance of regulations requiring periodic inspection of trucks (to be conducted through private service stations) to monitor compliance with environmental standards;

(d) actions to further improve transport pricing and cost recovery (para. 81(d)):

(i) satisfactory compliance with commitments to achieve full cost recovery from trucks through increase in the price of diesel fuel and/or direct taxes borne by truckers, and

(ii) satisfactory progress in adjusting FERRONALES rates for cargo transport to long run variable costs;

(e) compliance with commitment to increase highway maintenance expenditures during 1990; presentation of a satisfactory budget proposal (at least maintaining in real terms the proposed 1990 level) for highway maintenance for FY91 (para. 81(e));

(f) satisfactory progress on the reorganization of SCT's road regulatory functions (para. 81(f));

(g) execution of a satisfactory franchise (including a definition of the pricing regime, service, quality and investment obligations of TELMEX) and sale of Governments shares in TELMEX as necessary to transfer administrative control of the company to private owners (para. 86(a));

(h) presentation of a satisfactory action plan to strengthen SCT's regulatory capabilities in telecommunications (para. 86(c)); and

(i) presentation of a satisfactory business plan (including financial and investment programs through 1994) for TELECOMM (para. 86(d)).

PART V - BANK GROUP OPERATIONS

A. Sectoral Composition of Bank Lending

103. As of September 30, 1989, Mexico had received 118 loans from the Bank, amounting to US$13.7 billion net of cancellations and terminations; of these, 79 loans, totalling US$5.9 billion, were fully disbursed and US$3.8 billion remained undisbursed. The Bank's exposure was US$7.5 billion on a cash basis. The sectoral composition and policy content of past lending, as well as the design of major new lending operations, are discussed below for key areas of the Mexican economy in which the Bank has been active over the years.

Agriculture

104. Because of the crucial importance of agriculture for the one-third of the country's population living in rural areas, some 27% of the Bank's past lending has supported agricultural development, and nine operations are currently under supervision. The Bank's lending program in agriculture is aimed at: (a) helping correct the incentive regime in

agriculture through gradual reductions in input subsidies and export controls; (b) promoting more efficient and rational use of natural resources supported by improved technologies and services; (c) generating employment-intensive investments in rural areas and effective assistance to small farmers; and (d) creating an integral framework for sound rural development. To support these goals, the Bank made a US$300 million Agriculture Sector Loan in FY88, and in FY90 has made two loans, one for investment for agricultural marketing and storage facilities, and the other for forestry development. Additional operations are planned to support further policy adjustment in agriculture, rehabilitation of the irrigation infrastructure, including improved cost recovery and maintenance operations, and for food security and poverty alleviation.

Trade

105. About 12% of past Bank lending has been for trade, and two loans remain under supervision. Two trade policy loans of US$500 million each were made in FY87 and FY88 in support of the Government's sweeping trade reforms. These operations supported the reduction of non-tariff barriers (quotas and official reference prices) and rationalization of the tariff system (reduced levels and dispersion). The Bank supported the development of non-oil exports through two export development operations in FY83 and FY87. These loans were intended to strengthen the supply response by Mexican industry to the new trade policy signals. A US$500 million Industrial Sector Policy Loan in FY89 is supporting additional trade measures designed to liberalize imports and rationalize the incentive regime in key subsectors. Further trade reform measures are under consideration, which would strengthen the temporary import regime, provide further support to indirect exporters, assure automatic access to finance by exporters under the various credit programs, streamline financial and administrative procedures, and seek further reductions in export controls.

Industry and Finance

106. Some 28% of the Bank's lending has supported industry, and currently eleven projects are under supervision. The Bank's lending strategy for industry, covering small-and medium-scale industry, mining, the capital goods industry, industrial restructuring and technology development, is designed to support industrial restructuring, regulatory reform, clarification of foreign investment rules, and export promotion to assure a vigorous supply response to trade liberalization and increased international competitiveness. Recent Bank operations, including an US$500 million Industrial Sector Policy Loan and an US$500 million Parastatal Enterprise Reform Loan in FY89, provided support for policy reform in industry, for the more efficient management and privatization of public enterprises, restructuring of the fertilizer, steel, automotive parts, textile, and flower sectors, and other key private industrial subsectors demonstrating a capacity for undertaking integrated restructuring operations. In the financial sector, the Bank's operations have supported the strengthening of competition and the restructuring of financial intermediaries. An adjustment operation in FY89, the US$500 million Financial Sector Adjustment Loan, has been providing support for the liberalization of

the financial sector, elimination of forced lending to the Government at subsidized rates, increasing competition among banks and brokerage houses and improving regulations in the banking sector.

Infrastructure and Energy

107. Lending for transportation, power and water accounts for 22% of the Bank's total in Mexico, with 13 projects currently under supervision. Lending for infrastructure is focussing on institutional development (including attracting private funding to the sector), decentralization, more efficient public investment allocation, and improved cost recovery. Recent Bank loans supported urban transport and the power and ports sub-sectors. In the power sector, special importance was attached to the achievement of financial self sufficiency through improved pricing policies, to least-cost expansion planning and to the consideration of environmental factors in project selection and project implementation. In transportation, emphasis was placed on obtaining more realistic user fees and deferring all but the highest-yielding investment projects so as to permit a minimum of budgetary outlays. Proposed loans would support the Government's initiatives for private sector development, decentralization, cost-based pricing, and managerial improvements. Loans are at an advanced stage of preparation for water supply and sewerage, urban transport, and power.

Housing and Others

108. The Bank has lent some 11% of its total for tourism, urban development, housing and vocational training. Currently three housing loans are under supervision. Government housing programs are designed to improve cost recovery. A Second Housing Finance loan under execution is supporting graduated loan cost recovery linked to the income of final borrowers, thus ensuring a reduced drain on the budget. A follow up project, focusing on low-income beneficiaries, has recently been approved.

Social Sectors and Environment

109. The Bank is assisting the Government in redesigning public health, education, and human resource programs to make them more cost effective and targeted to meet the needs of the poor. A proposed health project would support decentralizaiton measures, finance new primary health facilities, and strengthen professional services. Similar initiatives are being pursued in education and nutrition. A pilot project in execution is improving the well-being of women in low-income areas. It includes the provision of piped water, health and educational services training for productive activities, and credit for launching new microenterprises. These targeted operations would be followed by broader programs, once the institutional conditions and capacity for project implementation can support a larger Bank presence.

110. The Bank is also preparing an air pollution operation in the Federal District, which would tackle urban transport related causes, and has amended an ongoing loan to support immediate relief measures requiring investments. With strong Government commitment, other future operations would

address industry related causes of air pollution in the Federal District, technical assistance for investment evaluation and institutional strengthening in the environmental area and strengthened environmental components in investment loans. As soon as the policy framework and suitable institutional arrangements are in place the Bank would consider loans for sector-wide environmental programs in support of remaining policy issues.

B. IFC Operations

111. The IFC has worked with the Bank to: (i) identify private sector investment opportunities likely to thrive in the current climate of growth-oriented adjustment and greater integration with the world economy; and (ii) assist in strengthening the country's capital markets through economic sector work and venture capital operations. As of September 30, 1989, the IFC had invested US$1,059 million in 38 companies in Mexico, of which US$745.9 million had been sold, repaid, or cancelled.

PART VI - COLLABORATION WITH THE IMF

112. Bank/IMF collaboration has been close over the years, especially since 1982, when the Fund supported the Government to help address the underlying causes of the economic crisis. Since that time, the Government has benefitted from an extended arrangement of SDR 3.4 billion, a special emergency drawing for SDR 291 million after the 1985 earthquake, a stand-by for SDR 1.4 billion in 1986 and, in 1989, for an SDR 2.8 billion extended arrangement rhrough 1992 and a drawing of SDR 453 million under the compensatory financing facility. Extensive consultations have taken place between Fund and Bank staff concerning Mexico's economic situation and prospects, covering fiscal, monetary, financial and exchange and interest rate policies.

113. Since the approval by the Fund's Board of the current extended arrangement on May 26, 1989, consultations have continued between the two institutions to monitor macroeconomic performance, adjustment measures and further structural reforms in light of the requirements of the objectives of the Government's agreed growth oriented program. To date the Mexican Government has purchased under the extended arrangement an amount equivalent to SDR 489.5 million, based on June 1989 economic performance until September 1989--which is according to schedule. A Fund mission has recently visited Mexico City to conduct a review of developments in late 1989 and policy intentions and prospects for 1990.

114. IMF financial contributions to Mexico's debt reduction program would be made under the SDR 2.8 billion extended arrangement in the form of set asides and through a proposed augmentation of the arrangement in an amount equivalent to 40% of quota, which the Board has not yet approved. The release of set asides for the enhancement of discount bonds and approval for the proposed augmentation of resources are dependent on an adequate financing package and understanding with the Government on key policies for 1990. Set asides under the extended arrangement and resources to be made available from

the augmentation of the arrangement would amount to a total of SDR 1.3 billion, which is roughly equivalent to US$1.7 billion Of this total amount, US$1.21 billion is expected to be released in early 1990, assuming that the recent review mission's findings will be positive, as current performance would seem to indicate, and the Board approves the augmentation and the acceleration of the set asides which would be available during the course of 1990. Thus, the IMF too would front load all set asides from 1990 under the extended arrangement. The equivalent of some US$443 million would be available early in 1991 and 1992, after the scheduled regular consultations have taken place. Together with other resources available after January 1990, this component of the Fund's credit enhancement would be funded from a commercial bank bridge loan.

RH:mmo
02/22/90r

MEXICO

MEXICO - ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

Proposed Policy Matrix

Objectives	Actions Already Taken	Actions to be Taken	Timing
I. SCT			
1. Improve the institutional arrangements, organization, staffing and training for regulatory activities within SCT.	. A modernization unit has been set-up to undertake the reorganization.	. Develop an action plan to reorganize SCT's functions in the trucking sector (including layoff of redundant staff).	. Board presentation.
		. Satisfactory progress in reorganization above.	. Second tranche.
	. TOR have been drafted for consultants to assist in developing a program to strengthen SCT's capabilities to regulate the telecommunications sector.	. Consultants have to be engaged to strengthen SCT's regulatory capacity in the telecommunications sector.	. Board presentation.
		. Satisfactory action plan to strengthen SCT's regulatory capacity should be furnished.	. Second tranche.
II. Road Transport			
2. Eliminate regulatory barriers to competition and efficiency.	. Eliminated system of concessions. . Eliminated system of route restrictions. . Eliminated system of freight centers. . Eliminated Multimodal's monopoly on multi- modal transport. . Eliminated restrictions to access into cargo handling and drayage services.		

	. Eliminated restrictions on "maquiladoras" to own and operate their own trucks. . Eliminated restrictions on return loading of international containers.		
		Preparation of a plan of action to enter into trucking deregulation agreements with all states where this is warranted.	. Board presentation.
3. Allow trucking prices to be determined by market forces, and eliminate distortions on costs.	. Eliminated 15% surcharge on imported goods. . Eliminated system of tariff ceilings. . Eliminated preferential tax treatment for truckers.		
		Policy statement and action program to achieve full cost recovery from truckers.	. Board presentation.
		. Achieve full cost recovery from truckers.	. Second tranche.
4. Ensure that the price of competing mode (railways is based on economic criteria).		. Program of adjustment of FERRONALES rates for key commodities.	. Board presentation.

	. Achievement of agreed targets in adjusting FERRONALES rates for key commodities to long run variable costs.	. Second tranche.
5. Improve allocation of highway expenditures.	. Satisfactory policy statement on highway maintenance.	. Board presentation.
	. Increase SCT's budget for maintenance expenditures in 1990 by Mex$ 200 billion.	. Board presentation.
	. Comply with commitments above and submit budget proposal for 1991, at least constant in real terms over proposed 1990 level.	. Second tranche.
6. Improve quality and enforcement of necessary regulations for safety, weight controls and environment.	. Strengthen group to coordinate safety policies.	. Board presentation.
	. Present satisfactory action plan to improve road safety.	. Second tranche.
	. Start study to correct information on vehicle sizes and loadings.	. Board presentation.
	. Complete Phase I of study above and initiate Phase II.	. Second tranche.
	. Present proposal for mandatory liability insurance against third party claims.	. Board presentation.

		. Enact proposal for mandatory liability insurance against third party claims and increase to US$200/ton the limit on truckers responsibility for cargo damages.	. Second tranche.
		. Issue regulations requiring periodic inspection of trucks to monitor compliance with environmental standards.	. Second tranche.
III. Telecommunications			
7. Promote increased private sector participation and competition in telecommunications.	. Public announcement of policy goals in sector, including promoting competition and privatizing TELMEX.		
	. Engagement of investment bankers to assist in sale of TELMEX's shares.	. Satisfactory progress in divestiture of TELMEX:	
		a) receipt of satisfactory draft franchise, and of program and timetable for handling privatization of TELMEX and engagement of foreign investment bankers to assist in handling sale;	. Board presentation.
		b) execution of a satisfactory franchise agreement and sale of Government shares so as to transfer administrative control of TELMEX to private hands.	. Second tranche.
	. Awarded concessions for cellular telephony in Federal Discrict and initiated bidding for concessions in rest of the country.		

		. Satisfactory regulations governing the licensing of telecommunications networks and services.	. Board presentation.
8. Improve resource allocation in the market for telecommunications services.	. Rates were adjusted in January 1990, reducing cross subsidies and increasing average level by 70%. . Tax treatment of sector has been realigned.		
9. Improve the efficiency of sector institutions.	. Decree setting up TELECOMM has been issued, and SCT's operating functions have been transfered to TELECOMM.	. Publish a statement of TELECOMM policy and objectives.	. Board presentation.
		. Furnish satisfactory business (including investment and financing) plan for TELECOMM.	. Second tranche.
IV. <u>Macroeconomic Management</u>			
10. Macroeconomic consistency.		. Satisfactory assessment of the medium term macroeconomic framework.	. Second tranche.

STATUS OF BANK GROUP OPERATIONS IN MEXICO 1/

A. Statement of Bank Loans
As of September 30, 1989
(US$ million)

Loan No.	Fiscal Year	Borrower	Purpose	Amount less Cancellations	Undis-bursed
	79 loans fully disbursed			5,939.60	
1706-5	1979	NAFIN	Irrigation	81.80	15.14
1858-5	1980	NAFIN	Irrigation	64.40	14.85
2262	1983	NAFIN	Agricultural Marketing	115.00	1.07
2281	1983	BANOBRAS	Third Water Supply	100.30	21.16
2325	1983	NAFIN	Third Sm/Med Industry	175.00	0.13
2331	1983	BANCOMEXT	Export Development	350.00	2.58
2428	1984	BANOBRAS	Highways	200.00	84.52
2450	1984	BANPESCA	Ports	56.30	38.31
2526	1985	NAFIN	Chiapas Agric. Dev.	58.00	41.21
2546	1985	NAFIN	Sm/Med Scale Mining II	105.00	23.69
2559	1985	NAFIN	Vocational Education	81.00	17.18
2575	1985	BANOBRAS	Railways V	300.00	142.62
2612	1986	BANOBRAS	Low Income Housing I	150.00	18.80
2658	1986	NAFIN	Proderith II	88.30	71.15
2665	1986	BANOBRAS	Earthquake Rehab	400.00	26.98
2666	1986	BANOBRAS	Municipal Strengthening	40.00	36.31
2669	1986	BANOBRAS	Solid Waste Pilot	25.00	19.07
2745	1987	BANCOMEXT	Trade Policy Loan I	500.00	10.53
2746	1987	NAFIN	Industrial Recovery	150.00	27.86
2747	1987	NAFIN	Technology Development	48.00	32.48
2777	1987	BANCOMEXT	Export Development II	250.00	22.93
2824	1987	BANOBRAS	Urban Transport	125.00	93.18
2837	1987	NAFIN	Agricultural Credit	400.00	12.58
2858 3/	1987	NAFIN	Sm/Med Industries IV	100.00	100.00
2859	1987	NAFIN	Agricultural Extension	20.00	16.95
2875	1987	BANOBRAS	Highway Maintenance	135.00	125.00
2876	1988	NAFIN	Manpower Training	80.00	58.28
2916	1988	NAFIN	Steel Sector Restruct.	400.00	335.42
2918	1988	NAFIN	Agricultural Sector Loan	300.00	201.99
2919 3/	1988	NAFIN	Fertilizer Sector Loan	265.00	265.00
2946 3/	1988	BANOBRAS	Ports Rehabilitation	50.00	50.00
2947 3/	1988	BANOBRAS	Housing Finance	300.00	300.00
3047 3/	1989	NAFIN	Industrial Restructuring	250.00	250.00
3083 3/	1989	NAFIN	Hydroelectric Development	460.00	460.00
3085	1989	BANCOMEXT	Financial Sector Loan	500.00	250.00
3086	1989	NAFIN	Public Enterp Restruct	500.00	250.16
3087	1989	NAFIN	Industrial Sector Policy	500.00	253.27
3101 3/	1989	BANOBRAS	Water, Women & Dev	20.00	20.00
3115 3/	1990	NAFIN	Forestry Development	45.50	45.50
		Total		13,728.20	
		Of which has been repaid		3,358.83	
		Total now outstanding		10,369.37	
		Amount sold : 92.34			
		Of which has been repaid: 92.34		0.00	
		Total now held by Bank 2/		10,369.37	
		Total undisbursed			3,755.90

1/ The status of the projects listed in Part A is in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

2/ Prior to exchange adjustment.

3/ Not yet effective.

MEXICO

B. Statement of IFC Investments
As of September 30, 1989
(US$ Million)

Fiscal Year	Obligor	Type of Business	-----Original Approvals--------- Loan	Equity	Total
1958/59	Industrias Perfect Circle, S.A. /a	Industrial Equipment	0.80	0.00	0.80
1958	Bristol de Mexico, S.A. /a	Aircraft Engine overhaul	0.50	0.00	0.50
1961	Aceros Solar, S.A. /a	Twist Drills	0.30	0.00	0.30
1962/5/6/8	Fundidora Monterrey, S.A. /a	Steel	2.30	21.40	23.70
1963	Tubos de Acero de Mexico	Stainless Steel Pipes	0.90	0.10	1.00
1963	Quimica del Rey, S.A. /a	Sodium Sulphate	0.70	0.00	0.70
1964/66	Industria del Hierro, S.A.	Construction Equipment	0.00	2.00	2.00
1970	Minera del Norte /a	Iron Ore Mining	1.50	0.00	1.50
1971	Celanes Mexicana, S.A. /a	Textiles	12.00	0.00	12.00
1972	Promotora Papel Periodicos, S.A. de C.V. /a	Pulp and Paper	0.00	/b	/b
1973/79	Cementos Veracruz, S.A.	Cement	15.90	0.00	15.90
1974/81	Cancun Aristos Hotel	Tourism	1.00	0.30	1.30
1975/78	Mexinox, S. A.	Stainless Steel	12.00	3.20	15 20
1978/81/83	Papeles Ponderosa, S.A.	Pulp and Paper	10.70	5.00	15.70
1978	Tereftalatos Mexicanos, S.A.	Petrochemical	19.00	0.00	19.00
1979/81/86	Hotel Camino Real Ixtapa, S.A.	Tourism	0.00	4.20	4.20
1979/83	Empresas Tolteca, S.A.	Cement	168.00	7.90	175.90
1979	Conductores Monterrey, S.A.	Electrical Wire & Cable	18.00	0.00	18.00
1980	Industrias Resistol, S.A.	Particle Board	25.00	0.00	25.00
1980	Vidrio Plano de Mexico, S.A.	Flat Glass	114.90	0.00	114.90
1980	Minera Real de Angeles, S.A.	Mining	110.00	0.00	110.00
1980	Corporacion Agro-industrial S.A.	Agri-Business	11.30	3.00	14.30
1981/86	Celulosicos Centauro, S.A.	Pulp and Paper	59.50	0.00	59.50
1983	Capital Goods Facility /a	Capital Goods Financing	100.00	0.00	100.00
1984/87	Metalsa, S. A.	Auto Chasis	8.00	1.40	9.40
1984	Proteison, S.A. de C.V.	Agri-Business	2.00	0.80	2.80
1984	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemical	16.40	0.00	16.40
1986/88	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and Paper	10.00	3.10	13.10
1986	Agromex Phase I (AESA)	Veg and Fruit Processing	1.50	0.50	2.00
1987	Industrias Sulfex, S.A. de C.V.	Chemical & Petrochemical	2.00	0.50	2.50
1987	Sealed Power de Mexico	Auto Assembly	9.00	0.00	9.00
1987	Crescent Market Aggregates	Construction Material	37.00	0.00	37.00
1988	Spasco, S.A. de C.V.	Cement	46.00	0.00	46.00
1988	Salumi, S.A. de C.V.	Food and Food Processing	20.30	2.00	22.30
1988	Polimar (ABS), A.S. de C.V.	Petrochemical	14.50	0.00	14.50
1989	Grupo Femsa/Visa	Consumer Goods Conglamorat	80.00	27.60	107.60
1989	Banca Serfin	Development Finance	60.00	0.00	60.00
1989	Cementos Mexicanos	Cement & Const Materials	68.00	0.00	68.00
	Gross Total Commitments		1059.00	83.00	1142.00
	Less Cancellations, Terminations, Repayments and Sales		745.90	37.80	783.70
	Total Commitments Now Held by IFC		313.10	45.20	358.30
	Total Undisbursed (Including Participants)		94.05	0.08	94.13

/a Investments which have been fully cancelled, terminated, written off, sold, or repaid.
/b US$25,000.

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS

SECTOR ADJUSTMENT PROJECT

SUPPLEMENTARY LOAN DATA SHEET

SECTION I: Timetable of Key Events

(a)	Time taken by the country to prepare the loan	3 months
(b)	Appraisal mission:	January 1990
(c)	Completion of Negotiations:	April 1990
(d)	Planned date of effectiveness:	June 1990

SECTION II: Special Bank Implementation Actions

None

SECTION III: Special Conditions

(A) The following are conditions met since appraisal:

(i) Presentation of a plan to enter into trucking deregulation agreement with state governments (para.81(a));

(ii) Actions to improve highway safety (para.81(c)):

(a) strengthening of interagency group;

(b) presentation of proposal for mandatory liability insurance against third party claims;

(c) initiation of a study to collect information on vehicle sizes and loadings;

(iii) Actions to improve pricing and cost recovery (para.81(d)):

(a) presentation of action program to achieve full cost recovery from truckers;

(b) program of adjustment of FERRONALES' rates for key commodities;

(iv) Increase SCT's 1990 budget for highway maintenance by 50% (para.81(e));

(v) Action plan to reorganize SCT's functions in the trucking sector (para.81(f));

(vi) Satisfactory progress in the divestiture of the Government's shareholdings in TELMEX, including receipt of a draft franchise and of a program and timetable for the sale of shares, and engagement of investment bankers (para.86(a));

(vii) Issuance of regulations governing the licensing of telecommunications networks and services (para.86(b));

(viii) Engagement of consultants to strengthen SCT's regulatory capacity in the telecommunications sector (para.86(c)); and

(ix) Publication of a statement of TELECOMM policy and objectives (para.86(d)).

(B) The following would be a condition for loan effectiveness: BANOBRAS should have entered into contractual arrangements with the Government for re-lending the proceeds of the loan which are satisfactory to the Bank (para.101).

(C) The following are conditions of second tranche release:

(a) satisfactory assessment of the medium term macroeconomic framework;

(b) actions to improve road safety

  (i) completion of Phase I of the study on vehicle sizes and loadings and initiation of Phase II:

  (ii) presentation of a satisfactory action plan to improve road safety;

  (iii) enactment of mandatory liability insurance against third party claims; and

  (iv) increase to not less than US$200/ton the limit on truckers responsibility for cargo damages.

(c) actions to address the air pollution caused by trucks (para.81(cc)); issuance of regulations requiring periodic inspection of trucks (to be conducted through private service stations) to monitor compliance with environmental standards;

(d) actions to further improve transport pricing and cost recovery (para.81(d)):

  (i) satisfactory compliance with commitments to achieve full cost recovery from trucks through increase in the price of diesel fuel and/or direct taxes borne by truckers: and

  (ii) satisfactory progress in adjusting FERROVALES rates for cargo transport to long run variable costs:

(e) compliance with commitment to increase highway maintenance expenditures during 1990; presentation of a satisfactory budget proposal (at least maintaining in real terms the proposed 1990 level) for highway maintenance for FY91 (para.81(e));

(f) satisfactory progress on the reorganization of SCT's road regulatory functions (para. 81(f));

(g) execution of a satisfactory franchise (including a definition of the pricing regime, service, quality and investment obligations of TELMEX) and sale of Governments shares in TELMEX as necessary to transfer administrative control of the company to private owners (para.86(a));

(h) presentation of a satisfactory action plan to strengthen SCT's regulatory capabilities in telecommunications (para.86(c)); and

(i) presentation of a satisfactory business plan (including financial and investment programs through 1990) for TELECOMM (para.86(d)).

Sr. Barber Conable
Presidente
Banco Mundial
1818 H Street
Washington, D.C. 20433
U. S. A.

Estimado señor Conable:

El Gobierno de México solicita que el Banco Mundial considere el otorgamiento de un préstamo en apoyo de su programa de modernización del transporte y las telecomunicaciones, que está delineado en el Plan Nacional de Desarrollo 1989-1994.

El plan establece que se actualizará el marco normativo e institucional a fin de mantener las atribuciones de autoridad del Estado para modernizar, elevar la eficiencia y la calidad de los servicios, así como para fomentar la competencia y evitar la aparición o persistencia indebida de monopolios.

Autotransporte de Carga

En este contexto, el 6 de julio de 1989 se aprobó un nuevo reglamento para el autotransporte federal de carga que permite la libre entrada al mercado del autotransporte y elimina diversas regulaciones que limitaban el funcionamiento eficiente de este mercado. Simultáneamente, se aprobó un nuevo reglamento para el transporte multimodal internacional que abre las puertas a la competencia en este importante sector de actividad. Se está trabajando en la preparación de medidas adicionales que promoverán una mayor eficiencia en tareas auxiliares al autotransporte, tales como la carga y descarga de camiones y las labores de estibaje, a través de la desregulación e incentivos para la competencia en estos mercados. Otras regulaciones que interfieren con el eficiente funcionamiento del mercado del autotransporte, tales como la fijación de tarifas máximas y limitaciones a que las maquiladoras cuenten con sus propios camiones, serán próximamente eliminadas. Se permitirá el retorno con carga de los contenedores internados transitoriamente al país, lo que facilitará la mejor utilización de los mismos. También, se procurará celebrar convenios con cada uno de los estados a fin de que adequen su normatividad al esquema que el Gobierno nacional está impulsando. Finalmente, se están tomando medidas para ajustar y adecuar la organización institucional de SCT a la nueva política para el autotransporte de carga.

Las medidas arriba expuestas redefinen el marco jurídico en el que opera el autotransporte de carga y serán apoyadas por diversas acciones en otros compos para coadyuvar al logro del objetivo final: la modernización del transporte para asegurar que los productores mexicanos cuenten con un servicio eficiente y de calidad.

Entre las medidas adicionales, merecen especial atención los esfuerzos que se contemplan para conservar y rehabilitar la infraestructura carretera. En particular, se asignará prioridad presupuestaria al mantenimiento y rehabilitación de la red habiéndose acordado que, a partir de este año, se asignará no menos de la mitad del presupuesto total (incluyendo lo de EyPFISC) para carreteras federales a mantenimiento y rehabilitación. Esta decisión se complementa con la intención del Gobierno de atraer inversión privada al sector carretero, a través de concesiones para la construcción y operación de autopistas y puentes, lo que permitirá liberar recursos para atender otras necesidades prioritarias, en particular mantenimiento de carreteras.

Se procurará que la distribución de cargas entre el autotransporte y el ferrocarril obedezca a consideraciones económicas, ya que ello permitirá el uso más eficiente de la capacidad de transporte instalada y permitirá la mejor orientación de las inversiones, públicas y privadas, que se hayan de requerir en el futuro. Para esto, sujeto al marco establecido por el PECE, se procederá a ajustar las tarifas para el transporte de carga por ferrocarril para que converjan a los costos variables de largo plazo a la mayor brevedad posible. Asimismo, se ajustarán periódicamente los precios del combustible diesel y otros cargos que pesan sobre el autotransporte de carga a fin de que el autotransporte contribuya a la recuperación total de los costos de mantenimiento y renovación que ocasiona a la red carretera. Recientemente el Congreso de la Nación aprobó reformas al régimen impositivo aplicable al autotransporte, alineándolo con el régimen general, promoviendo así una mayor equidad en el sistema.

Especial preocupación merece la seguridad en las carreteras y se preveen medidas destinadas a mejorarla. La mayor inversión en mantenimiento coadyuvará al logro de este objetivo. Paralelamente se promoverá legislación para requerir, en forma obligatoria, que los autotransportistas contraten seguros de responsabilidad civil contra terceros. Esta disposición desarrollará un incentivo de mercado para que los autotransportistas se interesen en mantener sus vehículos en buenas condiciones de seguridad, ya que es de esperar que las primas de seguro guarden relación con el historial de accidentes de los asegurados. En el mismo sentido, se aumentará al equivalente de US$200 por tonelada el nivel de responsabilidad del autotransportista por daños a la carga, lo que se deberá reflejar en un trato más cuidadoso, y se dejará librado a la negociación entre las partes la prima por seguro adicional (que actualmente es fija), lo que permitirá tomar en cuenta las características de la carga transportada. Las medidas expuestas se complementarán con acciones que el mismo Gobierno adoptará para promover la seguridad, habiéndose ya constituido un grupo coordinador de todas las agencias involucradas en esta tarea y contratado consultores para desarrollar programas de inspección de vehículos y control de sobrecargas.

Telecomunicaciones

En el sector de las telecomunicaciones la modernización y expansión de los servicios requerirá de inversiones muy altas y el Gobierno ha tomado la decisión de atraer la participación del capital privado al sector, lo que evitará distraer recursos fiscales necesarios para atender las necesidades en otras áreas, tales como salud, educación y vivienda. En este contexto cabe destacar la decisión de vender la participación del Estado en el capital accionario de TELMEX, empresa cuya administración y financiamiento serán en el futuro inmediato de total responsabilidad del sector privado. El Gobierno de México está consciente que el cambio tecnológico permite hoy la creciente competencia en los servicios de telecomunicaciones y el marco regulador se adecuará para permitir y fomentar la competencia en todos aquellos campos en que ello resulte viable. Así se prevee que múltiples empresas podrían desarrollar los servicios de transmisión conmutada de datos, de teleinformática, telefonía celular y otros. Se espera que los concursos que ya se iniciaron para otorgar concesiones para telefonía celular en diversas zonas del país sean adjudicados a muy breve plazo.

A fin de adecuadamente proteger el interés público en el caso de aquellos servicios telefónicos que serán provistos en condiciones monopólicas, el Estado deberá desarrollar su capacidad regulatoria y se han contratado consultores y se preveen programas de asistencia técnica y adiestramiento para apoyar a las unidades responsables de esta tarea. En el campo tarifario el Estado se limitará a fijar tarifas para aquellos servicios ofrecidos en condiciones monopólicas; en estos casos las tarifas se fijarán en base a criterios económicos, procurándose asegurar una rentabilidad razonable a los prestatarios del servicio. El Estado también regulará las tarifas y condiciones técnicas de interconexión entre los servicios monopólicos y competitivos.

Para evitar posibles conflictos de interés entre el Estado en su función de formulación de política y regulación de los servicios y sus funciones como prestador de servicios de telecomunicaciones todas las responsabilidades operativas que continúan a cargo del Estado han sido transferidas a una empresa recientemente constituída, TELECOM, que operará como un organismo desconcentrado. Se buscará que esta empresa opere con total autonomía financiera y que cuente con agilidad para responder a los desafios del avance tecnológico, siendo posible que en el futuro mediato se considere la privatización de algunos de los servicios que le están siendo asignados, si se percibe que ello mejoraría la calidad y cobertura de los mismos.

Atentamente,

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

BASIC MACROECONOMIC INDICATORS

Table 1

	1950-59	1960-70	1971-76	1977-82	1960	1965	1970	1976	1980	1981	1982	1983	1984	1985	1986	1987	1988 p/
Growth Rates:																	
GDP	5.9%	7.0%	7.4%	6.6%	8.1%	6.5%	6.9%	4.2%	8.3%	8.8%	-0.6%	-4.2%	3.6%	2.6%	-3.8%	1.5%	1.1%
GDP deflator	8.0%	3.5%	15.3%	29.9%	4.9%	2.3%	10.9%	19.6%	26.7%	26.0%	60.9%	90.5%	59.1%	56.7%	74.3%	139.3%	103.8%
Inflation Rate (December/December)	..	..	..	..	..	..	4.8%	27.2%	29.8%	28.7%	98.8%	80.8%	59.2%	63.7%	105.7%	159.2%	51.6%
GDP per capita	2.5%	3.5%	3.1%	3.7%	3.1%	3.0%	3.1%	1.2%	5.4%	5.1%	-3.1%	-7.6%	0.8%	-0.1%	-1.4%	0.4%	-0.9%
Consumption per capita	3.3%	4.2%	2.9%	3.8%	-1.0%	1.2%	1.4%	1.7%	4.9%	4.8%	-1.4%	9.1%	0.2%	-0.6%	-7.7%	-0.9%	-2.2%
Real Industrial Wages	1.3%	5.1%	4.0%	-1.1%	1.7%	6.9%	0.6%	10.6%	-4.4%	1.2%	1.9%	-26.0%	2.9%	1.8%	-19.2%	-4.5%	-10.0%
Investment-Savings (as % of GDP):																	
Total Investment	16.2	19.6	21.9	25.2	16.0	20.5	22.8	22.3	27.2	27.4	22.9	20.8	19.9	21.9	18.4	18.6	20.3
National Savings	14.1	17.5	18.8	21.3	13.4	18.5	19.8	18.5	22.7	21.9	19.3	24.4	22.3	22.6	17.2	21.4	18.7
BoP Current Account	-2.1	-2.1	-3.1	-3.9	-2.6	-2.0	-3.0	-3.8	-4.5	-6.5	-3.6	3.6	2.4	0.7	-1.3	2.8	-1.6
BOP (million US$):																	
Current Account	(181)	(479)	(2,304)	(6,458)	(324)	(403)	(1,068)	(3,409)	(8,717)	(13,846)	(6,220)	5,418	4,239	1,237	(1,673)	3,967	(2,901)
Exports of Goods & Non Fact. Services	988	1,964	6,030	18,692	1,372	1,989	2,745	6,841	22,902	29,047	26,167	27,179	30,133	27,609	21,875	27,814	29,075
Net International Reserves (end period)	379	591	1,261	2,169	459	575	820	741	4,004	5,035	395	3,678	6,767	3,051	2,924	9,933	1,773
External Sector Indicators (percent):																	
Exports GNFS real growth rate	5.7	5.2	7.9	9.9	1.2	3.8	-5.8	16.6	6.2	11.5	21.7	13.7	5.7	-4.5	3.2	9.8	2.0
Oil Exports real growth rate	..	..	23.3	49.9	..	..	..	..	71.6	29.5	31.3	5.6	1.1	-5.8	-9.4	-0.3	3.2
Non-Oil Exports real growth rate	..	..	0.8	2.5	..	..	..	..	-1.8	9.2	-16.2	37.9	23.5	-4.8	38.5	31.9	-12.0
Exports GNFS nominal growth rate	9.7	8.2	18.0	27.4	3.9	16.7	0.0	12.7	56.4	28.8	-9.9	3.9	10.9	-8.4	-20.8	26.2	5.3
Exports of GNFS/Current GDP	15.4	9.3	8.0	12.3	11.4	7.8	6.5	7.1	10.7	10.4	15.3	19.0	17.4	15.4	17.3	19.6	16.5
Imports GNFS real growth rate	4.4	5.7	9.4	9.6	2.9	3.8	10.1	1.0	31.8	17.8	-37.9	-33.7	17.8	11.0	-12.4	4.5	34.8
Imports GNFS nominal growth rate	11.8	8.5	19.5	21.0	15.3	4.7	21.1	-0.8	55.2	30.2	-40.8	-36.1	28.0	13.8	-11.7	5.7	45.2
Imports of GNFS/Current GDP	16.6	11.4	9.5	12.0	13.9	9.6	9.0	9.3	13.0	12.9	10.3	9.4	9.6	10.5	12.5	12.2	14.2
Resource Balance/Current GDP	-1.2	-2.1	-1.5	0.3	-2.6	-1.8	-2.5	-2.2	-2.3	-2.6	5.0	9.6	7.8	4.9	4.7	7.4	2.3
Terms of Trade Index (1980 = 100)	95.7	68.6	83.5	104.9	68.7	66.1	69.4	75.3	100.0	97.4	84.8	77.4	76.1	72.0	51.4	57.3	56.2
Real Exchange Rate Index (1980=100) b/c/	116.3	108.3	106.2	111.3	113.9	106.5	104.6	108.3	100.0	90.7	134.3	137.5	114.0	111.7	145.9	161.4	122.4
Foreign Debt Indicators : a/																	
Total DOD (Million US$)	..	3,514	11,240	55,128	..	2,212	4,956	22,177	57,378	78,215	86,019	92,964	94,822	96,875	100,876	109,292	100,298
Public DOD	..	2,298	7,546	31,561	..	1,457	2,186	17,834	50,160	68,098	78,011	78,257	78,612	81,130	85,951	93,734	92,840
Private DOD d/	..	1,216	3,694	23,567	..	754	2,770	4,343	7,300	10,200	8,100	14,800	16,298	15,745	15,103	14,148	7,458
Total DOD/Exports GNFS (%)	..	146.5	211.1	311.3	..	111.2	180.5	324.2	250.5	269.3	328.7	342.0	314.7	350.9	461.1	395.8	345.0
Total DOD/Current GDP (%)	..	13.0	16.4	37.0	..	10.2	12.9	23.3	29.5	31.3	50.4	62.5	54.0	53.1	77.6	77.4	56.8
Debt service MLT (Million US$) e/	..	563	1,275	8,128	..	488	691	2,230	7,890	8,532	9,410	11,422	11,275	10,572	8,620	8,736	9,641
Debt service MLT/Current GDP(%) e/	..	2.1	1.9	5.2	..	2.1	1.8	2.3	4.1	3.4	5.5	7.7	6.4	5.8	6.6	6.2	5.5
Debt service MLT/Exports GNFS (%) e/	..	24.0	24.9	45.0	..	24.5	25.2	32.6	34.5	29.4	36.0	42.0	37.4	38.3	39.4	31.6	33.2
Interest MLT (Million US$) e/	..	133	552	3,669	..	87	216	1,083	3,880	4,818	6,169	6,594	7,380	7,616	6,176	6,302	6,554
Interest MLT/Exports GNFS (%) e/	..	5.6	10.2	19.5	..	4.4	7.9	15.8	16.9	16.6	23.6	24.3	24.5	27.2	28.2	22.8	22.5
Interest MLT/Current GDP (%) e/	..	0.5	0.8	2.4	..	0.4	0.6	1.1	2.0	1.9	3.6	4.4	4.2	4.1	4.8	4.5	3.7
Memorandum Item:																	
PSBR(as % of GDP)	-0.7	-3.0	-6.9	-10.0	-2.7	-0.9	-3.5	-9.2	-7.0	-13.7	-15.9	-8.2	-8.5	-9.6	-16.0	-16.1	-12.3
Primary Balance (as % of GDP)	..	..	..	..	..	0.0	-1.4	-4.6	-2.5	-7.6	-6.4	4.8	5.5	4.4	2.1	5.0	6.4
Inflation Adjusted Balance (as % of GDP)	..	..	..	..	..	-1.1	-3.6	-8.5	-5.0	-11.2	-10.9	-5.1	-0.6	-4.5	-6.1	0.4	-4.2
M4/GDP (as % of GDP)	15.0	22.7	29.1	27.9	16.8	21.8	30.7	26.5	21.3	27.8	28.7	27.0	27.0	27.0	29.4	27.0	27.0
Monetary Base (growth rate)	10.7	14.8	31.9	55.1	1.0	12.2	10.7	29.6	41.2	45.1	90.4	58.1	54.1	17.5	47.7	70.3	42.3

a/. It refers to 1965-70.

b/. As measured by relative wholesale price indexes.

c/. An increase in the index means real depreciation.

d/. Private Non-Guaranteed.

e/. It includes only External Public Debt.

ANNEX V
Page 2 of 2

Table 2

MEXICO
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT
KEY ECONOMIC INDICATORS (US$ BILLION)

	Actual					Projected				
	1985	1986	1987	1988 p/	1989 e/	1990	1991	1992	1993	1994
GDP	2.7	-4.0	1.4	1.1	2.7	3.0	3.8	4.4	5.0	5.0
GDP/Capita Growth Rate	-0.1	-1.4	0.4	-0.9	0.7	1.0	1.8	2.4	2.9	2.9
Consumption/Capita Growth Rate	-0.8	-7.7	-0.9	2.2	1.3	-1.0	0.8	-0.4	3.0	3.0
Total DOD (US$, Bill)	96875	100876	109292	100298	99354	94413	96853	96343	95997	95852
DOD/XG&NFS	350.9	461.1	395.8	345.0	298.2	255.3	235.1	214.3	193.8	174.1
DOD/GDP	53.1	77.6	77.4	56.0	49.5	45.4	44.7	41.3	37.7	34.2
Debt Service (US$, Bill)	15292	12956	12182	15564	14494	12809	12460	12201	12010	12048
Debt Service/XG&NFS	55.4	59.2	44.1	53.5	43.5	34.6	30.5	27.1	24.2	22.1
Debt Service/GDP	8.4	10.0	8.5	8.8	7.2	6.2	5.8	5.2	4.7	4.3
Interest/XG&NFS	36.8	38.1	29.3	30.9	29.3	22.1	19.3	17.8	16.3	14.7
Interest/GDP	6.1	6.4	5.7	5.1	4.9	3.9	3.7	3.4	3.2	2.9
Gross Investment/GDP	21.9	18.5	18.6	20.3	21.2	22.5	23.4	25.4	25.5	24.9
Change of Stocks	2.7	0.9	0.2	1.8	1.2	1.2	1.2	1.2	1.2	1.2
Private	1.7	0.8	-0.2	1.3	0.6	0.6	0.6	0.6	0.6	0.6
Public	1.0	0.1	-0.2	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Fixed Capital Formation	19.2	17.6	18.9	18.5	20.0	21.3	22.2	24.2	24.3	23.7
Private/GDP	13.2	11.6	13.4	14.1	15.8	16.8	17.3	18.9	18.5	17.7
Public/GDP	6.0	6.0	5.5	4.4	4.2	4.5	4.9	5.3	5.8	6.0
National Savings/GDP	22.6	17.2	21.4	18.7	18.8	21.6	22.2	24.4	24.5	24.1
Gross Private Savings	19.5	16.0	13.6	18.2	16.4	17.2	15.3	16.9	16.3	16.0
Gross Public Savings	3.1	1.2	7.9	0.5	2.5	4.4	6.9	7.5	8.2	8.1
Gros Domestic Savings	26.8	23.3	26.0	22.6	22.6	24.2	26.0	27.0	26.9	26.3
Exports of G&NFS Real Growth Rates	-4.1	3.2	9.8	2.0	5.1	5.7	5.7	5.9	6.0	6.0
Non-Oil Export of G&NFS Growth Rates	-2.2	1.0	12.5	0.8	0.6	7.4	7.3	7.4	7.4	7.4
Exports/GDP	15.4	17.3	19.6	16.5	16.6	17.8	19.0	19.3	19.5	19.6
Imports of G&NFS Real Growth Rates	11.0	-12.4	4.5	34.8	15.9	4.9	6.9	6.3	6.5	6.4
Imports/GDP	10.5	12.5	12.2	14.2	15.2	16.1	17.4	17.8	18.0	18.2
Current Account (US$, Bill)	1237	-1673	3966	-2901	-4626	-1794	-2478	-2455	-2442	-2335
Current Account/GDP	0.7	-1.3	2.8	-1.6	-2.3	-0.9	-1.2	-1.1	-1.0	-0.8
Resource Balance/GDP	4.9	4.8	7.4	2.3	1.4	1.7	1.6	1.5	1.5	1.4
Terms of Trade (1985=100)	-1.2	-30.9	14.1	-10.5	3.8	-0.0	-0.0	-0.0	-0.0	-0.0
Primary Balance/GDP 1/	5.0	3.4	4.9	5.8	7.4	6.5	6.5	6.5	6.5	6.0
Operational Balance/GDP 1/	-3.9	-4.9	2.5	-4.4	-2.3	-0.7	1.4	1.6	1.8	1.8
Memorandum Item										
Oil price (US$ per barrel)	25.4	11.9	16.2	12.2	15.0	15.8	16.5	17.1	17.8	18.5

1/ In addition, the government expects to raise 0.4% of GDP in 1989 through assets sales.
Source: Mexican Authorities and Bank staff estimates

nations. The MMMF helps the recipients expand their training and skills, better preparing them to assume positions of leadership in their fields in both the urban and rural sectors. Thus they contribute to the development process and help improve the lives of women and children in Third World nations. The MMMF scholarship project supports the Women in Development program of the World Bank by promoting studies and projects in this increasingly vital area.

Non-profit corporation

The MMMF is incorporated as a District of Columbia non-profit corporation to carry out fund-raising and other activities relating to the award of the MMMF educational scholarships; Sukriye Karaosmanoglu is its current President and Rosemarie Wapenhans Vice President. The entire capital, collected through donations and fund-raising activities, is invested with only the interest used for the scholarships. All donations are tax free in the United States.

From initial donations of $1,000 the Fund has, in the past 10 years, grown to $247,117 (as of June 1990). During this decade, the Fund has awarded a total of $65,500 in grants. The first award of $3,000 was given in 1982 to a pediatric nurse, who is now training rural nurses in nutrition and child care in Liberia. In 1990, the MMMF awarded three scholarships of $6,000 each, and two further scholarships in the same amount were donated by the Asia Region of the Bank, making a total of five scholarships this year. Since 1982, 14 women from such diverse countries as Nigeria, Nepal, Burundi, China, India and the Philippines have received MMMF scholarships.

Contributions to the Fund come from many sources: memorial donations, individual contributions, and the proceeds of activities planned by the MMMF Board members such as raffles, an international cookbook, the annual Champagne Ball, foreign currency collections and the International Arts and Crafts Fair. Of all these sources, it is the Fair which is the major contributor, beginning with $22,250 in 1986, followed by $26,000 in 1987, $29,300 in 1988 and $33,500 last year. Since it is the major contributor, the International Arts and Crafts Fair's Co-chairmen, Carla Scearce and Kari Wolden, need the continuing and generous support of us all.

IFC

Mexico: Back in Business After Brady

by Mark Kirk

Of the countries at the receiving end of the Brady Plan, which has benefited most? A look at IFC's investments last year gives a clear answer: Mexico.

Mexico is where the developing country debt crisis began eight years ago. When the government announced in August 1982 that it could no longer meet its debt service obligations, new external financing for Mexican industry dried up overnight. And for the rest of the decade it was almost impossible to obtain long-term voluntary bank loans for Mexican projects, however profitable (and economically beneficial) they were. IFC continued to be an active lender, but syndicated loans were a thing of the past. The commercial banks, embroiled in the wearying process of sovereign debt restructuring, obligatory new money lending, and, eventually, debt forgiveness, were hardly looking for more Mexican assets.

But things are now changing fast. Having taken their Brady Plan medicine, the banks are now looking at a very different Mexico, one with a manageable foreign debt and a government embarked on fundamental economic reform. Trade liberalization, privatization and investment deregulation have become basic tenets of government policy. And large-scale private sector projects are getting under way again.

A banner year

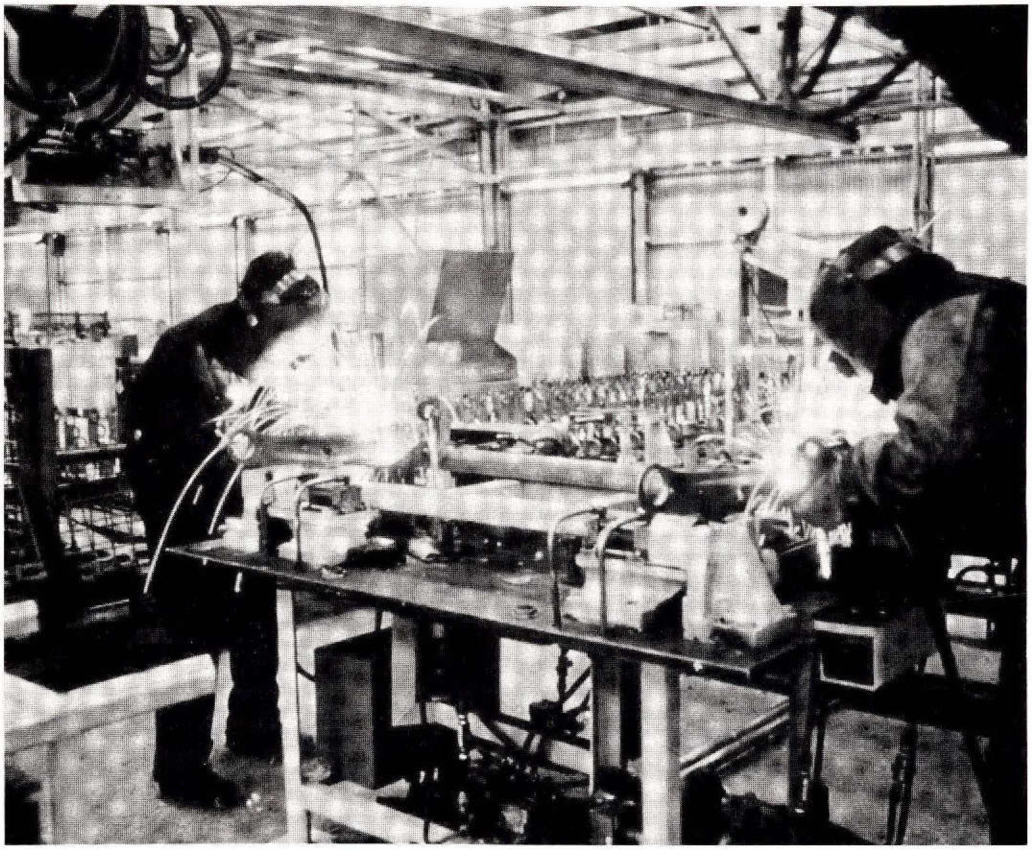
Even without the banks, FY90 was a banner year for IFC's business in Mexico. Loan and equity approvals reached over $200 million, making Mexico the year's number one recipient of IFC money. (India was second, with $147 million.) At a recent press conference in Mexico City to present IFC's 1990 Annual Report, Richard Frank, Vice President for Finance and Planning, said that "IFC's record level of investments, both for our account and jointly with commercial banks, are proof that conditions in Mexico are right for business." Helmut Paul, Director of Investments for Latin America and the Caribbean I, added that "the opening up of the Mexican economy by the Salinas administration tells us that future prospects are even brighter."

Banks are beginning to share IFC's interest in projects. By acting as lender of record, IFC offers banks participating in its loans a protective umbrella which, although not a guarantee, considerably dilutes the country risk. Banks can thus focus on the quality of IFC projects, and, increasingly, they like what they see. So, indeed, do bank regulators in many industrialized countries. In most western European countries and Japan, banks are not now obliged to make provisions for country risks when they are participating in IFC project loans.

Largest new money

In FY90, IFC syndicated over $30 million in voluntary new money loans for Mexican companies; not an enormous sum, but market perceptions were still predominantly negative. This year, the Corporation will do far more. A single loan syndication of over $100 million has already been completed for a major Mexican industrial group—the largest new money project financing seen in Mexico since before the debt crisis. Several other very large private sector projects are in IFC's FY91 pipeline, and could involve hundreds of millions of dollars of syndicated bank lending.

The two IFC syndicated Mexican loans last year are typical of the Corporation's project financing. IFC mobilized $18 million from banks to support its own $35 million investment in Grupo Condumex, a major cable and wire producer, to finance a $128 million expansion program in fiber optics and telephone, computer and auto cable. IFC also raised $18 million, alongside its own investment of $27 million, to finance Mexico's first polypropylene resins plant. This is a $108 million project by Indelpro, a Mexican company partly owned by U.S. and Italian shareholders. Both projects have considerable export potential. In Mr. Paul's words, "These two projects validate our belief that many sound Mexican compa-



Metelsa, a Mexican producer of automotive parts and borrower of IFC.

nies have high-quality products that can compete on the international market or on the Mexican market with little or no protections from imports."

Currency swap

IFC also designed some innovative programs tailored to the needs of Mexican borrowers. For example, last year IFC provided the first currency swap for a Mexican bank, designed to remove the exchange risk from a DM40 million loan granted by DEG (the German government development finance company) to Banca Serfin. By taking the swap risk, IFC has enabled the Mexican bank effectively to fund itself in dollars rather than Deutsche Mark, to the direct benefit of Banca Serfin's local private sector clients.

For small- and medium-sized Mexican companies, which cannot normally borrow directly from IFC, the Corporation set up two bank intermediary loan facilities. One was a $60 million credit line to Banamex, which will onlend to companies engaged in restructuring and efficiency improvement programs. The other was a $20 million credit line to Bancomer, for onlending to Mexican companies in the in-bond processing ("maquiladora") sector.

Grupo Primex and Petrocel

Two well-established Mexican industries also received direct IFC finance last year. The Corporation invested $20 million in Grupo Primex, to help with the company's $57 million program to increase PVC production from 80,000 to 200,000 metric tons per year. IFC also lent $32 million to Petrocel, to support the company's $100 million program to expand polyester feedstock production.

In the future, IFC's particular focus will be on building easier access by Mexican companies to the international financial markets. "This will allow us to mobilize substantially more external resources for Mexican businesses," says Mr. Frank. "Recent developments in Mexico are full of promise. IFC is excited about its role in the country's economic recovery."

Editor's note: Mark Kirk is with IFC's Public Relations Unit.

Post Mortem

by Chris Parel

"Whatever games are played with us, we must play no games with ourselves but deal in our privacy with the last honesty and truth." —Ralph Waldo Emerson

The *Wall Street Journal,* the *Economist,* the *Observer,* the *Washington Monthly.* The Cato Institute, the *Washington Post* and *Washington Times*—Dr. Irwin spreads through the media like a virus. The *Times* (U.K.), the *Spectator,* the *World Development Forum, Stern, Bonn General-Anzeiger,* the *Cincinnati Enquirer* (and we thought they were only interested in art...)

The "last honesty and truth" of the matter is that there is just enough truth in the accusations to make us take a long look at ourselves, and that's good. But it is spread very thin over Dr. Irwin's allegations. Dr. Irwin really missed the point. A forceful rebuttal from the Bank was published by the *Post* and made this eminently clear, but we felt Irwin's allegations should be studied more deeply.

In the end, the best way to answer half-truths is with the truth. We would not like to see Bank policies held hostage to the media and the pronouncements of a former staff member. So let's fix what needs to be fixed, put Dr. Irwin behind us and get on with the business of the Bank. Part of fixing is setting the record straight. On October 5, the SA sent the following "Letter to the Editor" to the *Washington Post.*

MEXICO: Stock Market Updated On:Thursday, August 16, 1990

August 16, 1990

SUBJECT: Operation of, and prospects for, the Mexican stock market.

SIGNIFICANCE: The stock market is, and will remain, a barometer of Salinas's success in restoring private sector confidence.

ANALYSIS: Since the Salinas administration took power, the stock market has been one of the indicators of confidence in the Mexican economic situation: the performance of the market has been one of the most impressive in the world. The current situation -- with oil prices higher than those expected in the government's projections -- should help offset one of the potential weaknesses of the Mexican economy, namely its external trade sector. This should increase the stability of the Mexican economy in the medium term (providing the recent rise is maintained), buttressing the performance of Mexican equities. However, if oil prices rise too sharply, this may accentuate a downturn in the US economy, with adverse effects on Mexico's non-oil trade and the wider economy.

Last year the stock market rose by 83% in dollar terms. In the first six months of this year it has grown by 45%. However, the market can be extremely volatile. The crash of 1987 was followed by a currency devaluation that deepened the decline caused by markets falling elsewhere. In dollar terms the index of the Mexican exchange fell from nearly 250 to 50. The current value is around 230. The Mexican market has nonetheless proved to be a good long-term investment, although, as always, timing is all important:

-- Since 1980 it has outperformed a dollar investment by almost 60%.

-- From May 1988 to May 1990 it outperformed a dollar investment by more than 110%.

Operation of the market. Shares on the exchange can only be traded through brokerage firms -- banks are not allowed to trade, nor are foreign security firms. However, foreign investment in brokerage firms is now allowed, although only on a minority basis. The three top brokerage houses command around 45% of the market.

There are no market makers, and trade is done on a "matched-bargain" basis. Trading is done on a "floor", although the new stock exchange building has a computer that records all transactions. There are around 200,000 individual and legal entities with accounts in the market.

Mutual funds, offering differing portfolios of shares and other instruments, have become increasingly popular, providing better returns than government bonds (which are also traded in the market) in recent years. Other instruments traded on the exchange include PEMEX Petrobonds, commercial paper and 'banker's acceptances'. The last two have become major sources of finance for larger companies.

Market valuation. The price-earnings ratio in April of this year was 9.5, compared to 14 in the United States and 40 for Japan. The ratio was just under 5 in 1988. The price-book value ratio was 1.2, compared to 2 in the United States and 3.6 in Japan. The same ratio stood at 0.7 in 1988.

In July of this year, the capitalisation of the share market was nearly 42 billion dollars, equivalent to around 25% of GNP. Of the total value, 8.2 billion dollars (19%) was accounted for by TELMEX; 2.2 billion dollars was in BANAMEX, and 1.6 billion in BANCOMER, both government-owned commercial banks. The government owns a majority of the shares of these three enterprises, although it is in the process of selling them.

Regulation and taxation. The stock market is regulated by the Finance Ministry, the National Securities Commission and the Central Bank. After the 1987 crash there was much criticism of the performance of these public agencies, and efforts have been made to tighten up regulation.

Under Mexican fiscal law, capital gains are exempt from taxation. Cash dividends are taxed at a rate of 10%. Individuals' interest income is taxed at 21% on the first 12 percentage points of interest, with the remainder exempt. No tax is payable on government bonds owned by individuals.

Foreign investment options. Foreign investors can invest in Mexican securities in three ways:

-- Purchasing free subscription shares. This is done through "B" shares, which give foreigners the same rights as Mexican investors. These are limited to no more than 49% of the total number of shares in a company.

-- Purchasing "A" shares. These were formerly reserved to Mexicans, but can now be obtained by foreigners through a fund that gives the buyer only the pecuniary rights of the share. The fund recently opened by Nacional Financiera, the government development bank, has already received 542 million dollars. The stocks in most demand have been those of Kimber, Group Alfa, Cementos Apasco, and Grupo Desc.

-- Buying Mexican shares on foreign stock exchanges. Currently there are few Mexican companies quoted abroad. The Mexico Fund, consisting of a portfolio of the more important companies registered on the Mexican stock exchange, is quoted on the New York Stock Exchange. Several new funds are about to be launched. Some of the launches have, however, been postponed because of the Middle East crisis. Some Mexican companies, like TELMEX, have issued American Depositary Receipts (bundles of their own shares) that are traded on NASDAQ in the US.

Prospects. In the short run, the Mexican stock market is expected to move sideways. Profits from some of the larger firms have been lower than expected, and some otherwise attractive investments face medium-term problems (for instance, CEMEX, the huge cement producer, recently lost an anti-dumping claim in the US). But many sectors are undervalued. Mineral company shares, for example, do not yet reflect recent increases in the prices of a range of metals. A number of shares that are traded abroad are also currently slightly undervalued. TELMEX, for example, has been following Wall Street, and is thus cheap in Mexico.

Looking at the index as a whole, the Mexican market can be expected to outperform other markets in the medium term, providing:

-- oil prices stabilise at a moderately high level; and

-- the government manages to retain control over the budget, and interest rates do not have to rise -- ie, providing inflation in Mexico remains stable at around 20% (per year).

CONCLUSION: So long as the President performs well, so too should the bolsa: conversely, a severe market setback would also be a political setback.

Keywords: LA/C, Mexico, economy, equities, foreign investment

DESINCORPORACION DEL SECTOR PARAESTATAL

Diciembre 1982 - Septiembre 1990

Stuart - pls. see me about this table - Thx - S.

PROCEDIMIENTO	CONCLUIDAS	EN PROCESO	AUTORIZADAS
Liquidación	225	79	304
Extinción	139	15	154
Fusión	76	11	87
Transferencia	29	2	31
Venta al sector Social o Privado	199	95	294
L.F.E.P. — min owned	66	--	66
TOTAL	734	202	936

DESINCORPORACION DEL SECTOR PARAESTATAL

Diciembre 1988 - Septiembre 1990

PROCEDIMIENTO	CONCLUIDAS	EN PROCESO	AUTORIZADAS
Liquidación	51	79	130
Extinción	19	15	34
Fusión	4	11	15
Transferencia	4	2	6
Venta al sector Social o Privado	43	95	138
L.F.E.P.	18	--	18
TOTAL	139	202	341

FUENTE: COMISION INTERSECRETARIAL DE GASTO FINANCIAMIENTO.
UNIDAD DE DESINCORPORACION.

Santa

PRIVATIZATION IN MEXICO

POINTS FOR PRESENTATION

November, 88

J. Nellis

CECPS

1. MEXICO CREATED A PE SECTOR IN THE 1920s. BY 1930 -- 12;

1940 -- 57

1950 -- 158

1960 -- 259

1970 -- 491

1976 -- 845

1982 -- 1155

2. ALL KINDS OF ORGANIZATIONS ARE CLASSIFIED AS ONE SORT OR ANOTHER OF "ENTIDADES PUBLICAS." THESE INCLUDE THE GIANT OIL COMPANY, PEMEX, THROUGH PUBLIC UTILITIES, TO A LARGE NUMBER OF INDUSTRIAL, COMMERCIAL AND MANUFACTURING FIRMS, FINANCIAL INTERMEDIARIES AND TRUST FUNDS (FIDECOMISOS), DOWN TO SERVICE AND PROMOTIONAL ORGANIZATIONS, SPORTS AGENCIES AND THE LIKE. STILL, BY 1982 MEXICO HAD ONE OF THE LARGEST PE SECTORS IN THE WORLD, IN TERMS OF NUMBER OF ORGANIZATIONS, CONTRIBUTION TO GDP (14 %), CONTRIBUTION TO GROSS FIXED CAPITAL FORMATION (30%), AND CONTRIBUTION TO EMPLOYMENT (4.4%). GOVT. TRANSFERS TO THE SECTOR AS A WHOLE -- EVEN

AFTER TAKING INTO ACCOUNT THE MASSIVE CONTRIBUTIONS TO GOVT. REVENUE OF PEMEX -- CAME TO MORE THAN 3% OF GDP. THESE TRANSFERS WERE COMPOSED OF FUNDS TO COVER INVESTMENTS (WHICH MAY HAVE BEEN LEGITIMATE STATE EXPENDITURES, DEPENDING ON THE USES TO WHICH THE INVESTMENT FUNDS WERE PUT); FUNDS TO COVER OPERATING LOSSES, AND FUNDS TO COVER DEBT SERVICING. THE LATTER TWO NON-PRODUCTIVE USES OF GOVT. FUNDS CONSTITUTED, AND STILL CONSTITUTE, THE PROBLEM.

3. IN THE SEXENIO OF M. DE LA MADRID, 1982-1988, MEXICO UNDERWENT A SERIES OF ECONOMIC AND FISCAL CRISES FROM WHICH IT HAS YET TO ESCAPE. DEBT DEFAULT THREATENED AS EARLY AS 82; DECLINES IN OIL REVENUES, HISTORIC HIGH INTEREST RATES, CAPITAL FLIGHT AND RAMPANT INFLATION HAVE ALL LED TO ZERO OR NEGATIVE GROWTH, INCREASED UNEMPLOYMENT AND DECLINING LIVING STANDARDS. RESPONSE HAS BEEN DRAMATIC. ON THE FISCAL SIDE, MEXICO HAS CARRIED OUT AN UNPARALLELED PROGRAM OF EXPENDITURE REDUCTION AND REVENUE RAISING, WHICH, WITH SPECIFIC REGARD TO PE SECTOR, REDUCED TRANSFERS BY ONE HALF; THEY NOW ACCOUNT FOR ABOUT 1.6% OF GDP. ACCOMPANYING THE FISCAL RESTRAINT HAS BEEN A PROGRAM OF WHAT THE MEXICAN CALLS "DESINCORPORACION" -- WHICH I WOULD LIKE TO TRANSLATE AS DISEMBODIMENT, BUT WHICH I BELIEVE IS MORE REASONABLY RENDERED AS DIVESTITURE. MEXICANS CONCEIVED AND CARRIED OUT THIS PROGRAM, TO DATE, ON THEIR OWN INITIATIVE; THERE HAS BEEN LITTLE MULTI OR BI-LATERAL DONOR URGING, ASSISTANCE OR INVOLVEMENT IN THE EFFORT.

4. PROGRAM HAS ALREADY HAD DRAMATIC RESULTS. AS OF DECEMBER 1, 1988, THE NUMBER OF PEs HAS BEEN REDUCED (FROM 1155 IN 1982) TO

ROUGHLY 400; I.E., A NUMERICAL REDUCTION OF 65%. OF THE 755 AGENCIES ELIMINATED:

ABOUT 250 HAVE BEEN PUT UP FOR SALE, AND OF THESE, ABOUT 150 SOLD

ABOUT 395 HAVE BEEN PROPOSED FOR LIQUIDATION, AND 260 HAVE BEEN LIQ.

80 PROPOSED FOR MERGER, AND SOME 70 MERGED WITH OTHER UNITS

30 PROPOSED FOR TRANSFER TO STATE GOVTS., PROCESS COMPLETE IN 25

IN TERMS OF NUMBERS OF PEs MEXICAN PRIVATIZATION ONE OF WORLD'S LARGEST.

5. ADMITTEDLY, MOST OF THE FIRMS CLOSED, MERGED OR SOLD HAVE BEEN SMALL AND MEDIUM SIZED FIRMS. THIS IS REVEALED BY NOTING THAT THE ASSETS OF THE 755 ENTITIES TOUCHED BY THE DIVESTITURE/REFORM PROGRAM ACCOUNT FOR ONLY 10% OF THE ASSETS OF THE SECTOR IN 1982. THAT IS, THE REMAINING 35% OF FIRMS IN THE SECTOR ACCOUNT FOR 90% OF THE ASSETS. EVEN MORE REVEALING INFORMATION IS AVAILABLE IF ONE LOOKS AT PE PORTFOLIOS OF THE SECTOR MINISTRIES. SEMIP HAD 398 PEs IN 1982. 155 SOLD, 114 LIQUIDATED AND 37 MERGED/TRANSF. AS OF FALL, 88. 92 PEs HAVE BEEN KEPT. THESE 92 REPRESENT:

23 % OF THE NO. (398)

59 % OF THE LABOR

71 % OF TOTAL SALES

75 % OF TOTAL LIABILITIES

81 % OF THE ASSETS, AND

84 % OF GOVT. TRANSFERS TO THE MINISTRY'S PEs.

6. NONETHELESS, FIVE OF THE PEs SOLD WERE IN THE LIST OF THE 100 LARGEST COs. IN MEXICO, AND SEVERAL OF THE MOST RECENT, INCLUDING AEROMEXICO (AIRLINES) AND TWO COPPER MINES, ARE AMONG THE VERY

LARGEST FIRMS IN THE COUNTRY. AND THERE ARE SEVERAL LARGE COMPANIES IN THE CAPITAL GOODS AND MINING SECTORS INCLUDED IN THE LATEST GROUP OF 50 ENTERPRISES PLACED ON THE SALES BLOCK IN MID-OCTOBER. IT IS ENVISAGED THAT THE PROCESS WILL CONTINUE AND SOME OF THE LARGER AND MORE ECONOMICALLY IMPORTANT PEs WILL BE PUT UP FOR SALE IN THE ADMINISTRATION OF MR. SALINAS DE GORTARI (88-94). IMPORTANT AND LARGELY UNSUNG EFFORT.

7. <u>WHY HAVE SALES TAKEN PLACE?</u> FOR THE SAME SET OF REASONS AS IN OTHER DEVELOPING COUNTRIES: THE FISCAL CRISIS, THE DRAIN ON THE BUDGET, THE CONTINUING LOSSES OF PEs, THEIR LACK OF INVESTMENT, THEIR GENERAL POOR PERFORMANCE AND HIGH COSTS. (AS OPPOSED TO INDUSTRIALIZED COUNTRIES WHERE RAISING REVENUES, LIMITING UNION INFLUENCE, ENHANCING EFFICIENCY AND CREATING OR CONSOLIDATING POPULAR CAPITALISM SEEMED TO HEAD THE LIST OF EXPLANATIONS.) GENERAL EXPLANATION: LACK OF RESOURCES TO CONTINUE THE PAST PRACTICE OF SUBSIDIZING LOSSES; RECOGNITION OF NECESSITY TO CONCENTRATE SCARCE FINANCIAL AND HUMAN -- MANAGERIAL -- RESOURCES ON A LIMITED NUMBER OF PRIORITY FIRMS.

8. <u>WHAT HAS BEEN SOLD?</u> [INFORMATION LARGELY DRAWN FROM RECENT TRIPS TO MEXICO, FURNISHED BY SHCP, SEMIP AND ESPECIALLY A STUDY, "LA PRIVATIZACION EN MEXICO - 1982-1988: EFFECTOS DE LA VENTA DE PARAESTATALES," BY JUAN RICARDO PEREZ ESCAMILLA COSTAS, PROF. OF ECONOMICS AT ITAM, STUDY COMMISSIONED BY SHCP.] MOST OF THE FIRMS SOLD, AS NOTED, SMALL AND MEDIUM SIZED COMPANIES IN THE INDUSTRIAL AND MANUFACTURING FIELDS. ABOUT HALF WERE FORMERLY PRIVATE COMPANIES WHICH HAD BEEN NATIONALIZED, TO PROTECT THE JOBS OF WORKERS, WHEN

THEY WERE ON THE VERGE OF BANKRUPTCY AND CLOSURE. IN ALMOST EVERY CASE THE FIRMS SOLD WERE OPERATING IN COMPETITIVE MARKETS, OR WERE COMPETING AGAINST IMPORTS. ABOUT 30 % OF THE PRIVATIZED FIRMS ALREADY HAD PRIVATE MINORITY PARTNERS. THE ARGUMENT OF THE STATE IS THAT A REVIEW SHOWED EITHER THAT THE GOVT. HAD NO STRATEGIC OR PRIORITY INTEREST IN THE FIRM IN THE FIRST PLACE, AND SHOULD NEVER HAVE BEEN IN THE BUSINESS; OR THAT THE STRATEGIC OBJECTIVE HAD BEEN ACCOMPLISHED, AND THERE WAS NO LONGER ANY NEED FOR THE STATE TO MAINTAIN OWNERSHIP OF THE FIRM.

9. WHO BOUGHT THE PEs? THE OVERWHELMING MAJORITY OF PURCHASERS HAS BEEN MEXICANS. A VERY SMALL NUMBER OF FIRMS HAS BEEN BOUGHT BY FOREIGNERS, ALWAYS ACTING IN COLLABORATION WITH MEXICAN MINORITY PARTNERS. FOREIGNERS HAVE PARTICIPATED IN A TOTAL OF 16 PURCHASES TO DATE. IN MOST CASES SALES HAVE BEEN MADE TO MEXICAN ENTREPRENEURS WORKING IN THE GENERAL TECHNICAL FIELD OF THE FIRM BEING SOLD; I.E., HALF OF THE SALES HAVE RESULTED IN INCREASED VERTICAL INTEGRATION IN THE SECTORS. SPECIAL CONCESSIONS AND ARRANGEMENTS HAVE BEEN MADE AVAILABLE TO UNION MEMBERS, MANAGEMENT OR TECHNICAL ASSOCIATIONS AND/OR FARMERS COOPS ASSOCIATED WITH THE VENTURE. THUS, A MAJOR PARTICIPANT IN THE PURCHASE OF AEROMEXICO WAS THE AIRLINE'S PILOT'S ASSOCIATION. SOME AGRO-INDUSTRIES HAVE BEEN SOLD TO FARMERS GROUPS. GOVT. WELCOMES THESE BUYERS AND GIVES THEM A SPECIAL DEAL.

10. HOW HAVE THE SALES BEEN CONDUCTED? SALES PROCESS HAS BEEN QUIET, PRAGMATIC, DISCREET AND NOT TERRIBLY TRANSPARENT. DONE BY AUCTION, NOT BY SELLING STOCK IN AN EQUITIES MARKET, MAINLY BECAUSE OF THIN-NESS OF LOCAL CAPITAL MARKETS. PROCEDURE GIVES ALL KEY

CENTRAL AGENCIES A PART OF THE JOB, A PART OF THE GLORY AND THE RESPONSIBILITY.

1ST- SPP ASKS CABEZA DE SECTOR FOR CANDIDATES FOR DIVESTITURE

2ND- SPP SENDS SECTOR MIN. PROVIDED SUGGESTIONS TO COMMISSION GASTO/

3RD- COMM. G/F DECIDES APPROVES, OR NOT, SPP RECOMMENDATION, SENDS TO PRESIDENT FOR RATIFICATION, THEN BACK TO C. G/F.

4TH- C. G/F AUTHORIZES SHCP TO CONDUCT SALE

5TH- SHCP (IN REALITY, A 2-3 MAN OPERATION IN HACIENDA) CHOOSES ONE OF 5-6 BANKS (ALL 67% STATE OWNED) TO CARRY OUT SALE

6TH- CHOSEN BANK:

A- AUDITS FIRM AND MAKES A SALE PROSPECTUS

B- DECIDES ON SALE STRATEGY

i- CLOSED BY AUCTION

ii- OPEN BY AD IN NEWSPAPER

7TH- BANK RECEIVES BIDS, PLACES BUYER IN CONTACT WITH SELLER, GENERALLY ASSISTS IN THE DEAL AS MERCHANT OR INVEST. BANKER

8TH- BANK RECOMMENDS ON DISPOSITION TO SHCP, WHICH FINALLY

9TH- APPROVES OR CAN ASK FOR RE-SUBMISSION OR REVISION IF MIN. PRIC HAS BEEN DONE ON MANY OCCASIONS AND ON NEARLY ALL LARGE DEALS.

11. SALES HAVE RAISED TO DATE BETWEEN $500-600 MILLION US, BEFORE SALE OF THE LARGE COOPER MINES, ONE OF WHICH HAS A SALES PRICE OF $1 BILLION US. SOME 60% OF THESE MONIES HAS GONE TO PAY OFF DEBTS OF SOLD FIRMS, SO THAT NEW OWNERS TAKE OVER (MAINLY) CLEAN BALANCE SHEETS.

12. SINE QUA NON: INTENSE AND ENDURING SUPPORT OF HIGHEST LEVEL POLITICAL LEADERSHIP FOR THE PROGRAM.

13. WHAT EFFECTS HAVE THE SALES HAD ON FINANCES AND EFFICIENCY? INFORMATION RECEIVED FROM INTERVIEWS AND EXAMINATION OF 45 PRIVATIZED FIRMS; ONLY SMALL % OF COMPLETE FINANCIAL STATEMENTS RECEIVED, BUT BASED ON INTERVIEWS WITH EXECUTIVES, UNION OFFICIALS, BANKERS TO THE FIRMS, AND COMPETITORS, RESEARCHERS FEEL HIGH DEGREE OF RELIABILITY IN THEIR CONCLUSIONS, WHICH ARE: IN PETROCHEMICAL SUB-SECTOR, INVESTMENTS GENERALLY UP -- A GOOD SIGN, SINCE INVESTMENT HAD STAGNATED UNDER PUBLIC SECTOR FINANCIAL CONSTRAINTS -- FINANCIAL LEVERAGE DOWN, VERTICAL INTEGRATION HAS BROUGHT NEW TECHNICAL VIEWS AND SOME NEW CONTRACTS CONCLUDED. PERHAPS AS MANY AS 30 % OF MANAGERS FIRED IN MANY FIRMS, AND HIGHER SALARIES NOW BEING PAID TO THOSE WHO REMAIN OR WHO REPLACED THOSE WHO LEFT.

IN THE AUTOPARTS SUB-SECTOR, EXPORTS UP, CAPACITY UTILIZATION UP SUBSTANTIALLY, FINANCING ON MARKET CONDITIONS CONCLUDED, NUMBER OF MANAGERS REDUCED SUBSTANTIALLY AND AGAIN, COMPENSATION UP, IN SOME FIRMS LABOR ADDED, IN SOME DECREASED, FOR NO NET CHANGE IN EMPLOYMENT IN SUB-SECTOR -- BUT NOTE THAT CONDITIONS OF WORK HAVE CHANGED WITH MANY WORKERS NO LONGER "TENURED" WITH FULL FRINGE BENEFITS; NOW MANY IN SEASONAL OR TEMPORARY CATEGORY WITH RIGHT TO SMALLER PACKAGE OF BENEFITS. THUS, NUMBER EMPLOYED REMAINS SAME BUT SUBSTANTIAL CHANGE IN THE TOTAL WAGE BILL.

THIS TRUE IN OTHER SUB-SECTORS AS WELL. PRICES UP, INVESTMENTS UP, ESP. FOR COMPUTERS WHICH ARE NOTORIOUSLY DIFFICULT TO PURCHASE IN PEs. TOTAL LAYOFFS OF WORKERS < 5%.

14. SO FAR, NO DEMONSTRABLE EFFICIENCY GAINS IN INVESTIGATED FIRMS AS MEASURED BY RETURN ON ASSETS OR COSTS TO SALES RATIOS. NO DRAMATIC SHORT TERM EFFICIENCY IMPROVEMENTS, SOME FINANCIAL IMPROVEMENTS, AND THE INVESTMENTS AND COST REDUCTION MEASURES SHOULD (SOON) PAYOFF IN EFFICIENCY GAINS. PEREZ ARGUES THAT MUCH OF THE INVESTMENT MADE IN PEs BEING SOLD WOULD HAVE BEEN INVESTED ANYWAY; NOT MUCH NET ADDITIONALITY. STILL, PROGRAM HAS BEEN A SUCCESS FOR GOVT., ALLOWS IT TO CONCENTRATE SCARCE RESOURCES ON FIRMS REMAINING AS PEs. NOW IMPOSSIBLE TO ESTABLISH A NEW PE IN MEXICO. HAS CAUSED REMAINING PEs TO REALIZE THAT THEY COULD FACE BEING SOLD, CREATES A PRESSURE ON THEM TO REFORM. THINKS IT IS GOOD FOR FIRMS TO RECOGNIZE CONSTRAINTS. EXIT NOW WELL ESTABLISHED; THERE WILL BE NO SECONDARY BAIL-OUTS; AS GOVT. ALLOWED GIANT COMPANIES SUCH AS AEROMEX AND FUNDADORA DE MONTERREY TO GO BANKRUPT THEY CERTAINLY WON´T RESCUE THESE SMALL COMMERCIAL FIRMS. NONE HAS YET FAILED, BUT PEREZ IS NOT WORRIED THAT THEY WILL BE RESCUED WHEN AND IF THEY DO.

15. WHAT COMES NEXT? FUTURE SALES MUCH MORE DIFFICULT AND OF DIFFERENT NATURE THAN THOSE CONCLUDED. THE EASY, BECAUSE SMALL AND COMPETITIVE AND ONLY PARTIALLY CONTROVERSIAL (THOUGH THERE HAS BEEN PLENTY OF POLITICAL OPPOSITION TO WHAT HAS ALREADY BEEN CARRIED OUT). NEXT STEPS COULD NOT BE PEMEX OR CFE, THESE IN CONSTITUTION, TOO LARGE, TOO COMPLEX. CONASUPO ALSO UNTOUCHABLE. WHAT CAN BE CONSIDERED? RR, TELMEX, SIDERMEX, FERTIMEX, AZUCAR. THE DISCREET, NON-TRANSPARENT METHOD CONDUCTED PRIVATELY BY 2 MEN IN HACIENDA NOT POSSIBLE FOR LARGER FIRMS REQUIRING MOBILIZATION OF MORE LOCAL AND ESP. FOREIGN CAPITAL. MORE FORMAL PROCESS REQUIRED, AS POL. DIFFICULTIES -- UNION OPPOSITION, DIVIDED CONGRESS, REGULATORY ISSUES

FOR FIRMS IN NON-COMPETITIVE MARKETS -- MORE COMPLEX. PROCESS SHOULD BE CONTINUED, BUT NEEDS A SHIFT IN EMPHASIS AND FORMALIZATION OF APPROACH -- WHICH PRESENT GOVT. IS NOT KEEN ON; WOULD LIKE TO CONTINUE THE ALMOST AD HOC BUT UNDENIABLY SUCCESSFUL METHOD ALREADY USED.

MEXICO

The Sector in 1982

As of 1982 there were 1155 PEs in the sector, contributing 14% of GDP, 30% to gross fixed capital formation, and 4.4% of employment. Government transfers came to more than 3% of GDP.

Legal Preparation

Mexico's divestiture program began in 1983, just after the government of M. de la Madrid took office. Two important legal reforms formed the "enabling" environment for the divestiture program: the 1983 reform of the Mexican Constitution regarding strategic and priority PEs (which allowed the Government to initiate the divestiture program by the simple administrative act of reclassifying a PE from the "priority" catagory to the "non-priority" catagory); and the new Federal Law on Parastatals in 1986. The new law involved a complete overhaul of the institutional and administrative framework of the PE sector.

Institutional Arrangements

No special unit was created to oversee the divestiture program and the process has been ad hoc: there was no classification exercise, no detailed discussion of objectives, and no officially published timetable of actions to be taken. PEs to be divested were essentially chosen at random.

Prior to 1985, divestiture was carried out by each sector Minister. Once the sale was completed they sent a report to the Ministry of Budget and Planning, who formally removed the PE from the PE annex. This process stimulated much confusion and apparently a great deal of criticism from the political opposition and the press. As a result, the Inter-Ministerial Committee for Finance and Expenditure created a new process in 1985.

The selection of firms works as follows: sectoral ministries send proposals of PEs to be divested to the Inter-Ministry Committee for Finance and Expenditure. If the proposal is accepted it is sent on to the Ministry of Budget and Planning, which then passes it on to the President. If the President accepts the proposal it is passed back to the Ministry of Budget and Planning which then instructs the Ministry of Finance to select a commercial bank (one bank handles each sale) to oversee the divestiture. The firms selected are administratively assigned to the Ministy of Finance, 3 staff members of which supervise the sale until delivery.

The sales process works as follows: the commercial bank draws-up a prospectus and identifies potential buyers and receives and classifies bids. The commercial bank then sends its recommendations of the best offers to the Ministry of Finance, which negotiates a final price and makes a final recommendation to the Inter-Ministerial Committee (which usually approves it). The firm is then transferred to the buyer. Overall, the process has been quiet, pragmatic and not very transparent.

Valuation

Valuation methods included: NPV of profits, NPV of cash flows, book value, and in some cases the arthmetic average of prices obtained from a mix of methods. Factors such as the financial and labor situation were considered in valuing the firms. In most cases at least two methods were used for each firm.

Results

As of December 1988: 250 PEs have been put up for sale and of these 188 sold; 395 have been proposed for liquidation and of these 293 have been liquidated, for a total of 755 approved for divestiture and 491 actually divested. These included, among others: sugar mills (27), auto parts, tobacco, textiles, non-basic petrochmical and mining industries (Mexicana de Cobre copper mine), hotels (15 of them and 95% of the sector), soft drinks, steel (unsuccessful 3 times - following up on case) and paper manufacturers. (Sugar, paper and auto parts enterprises generally suffered from financial and/or technical difficulties.)

About half of the firms sold were previously private companies which had been nationalized, and about 30% had private partners when they were privatized. Proceeds are approximately US$ 1 billion, 60% of which went to clean up the balance sheets. The 755 PEs involved in the program to date represent only 10% of 1982 sector assets, revealing the fact that most of the firms sold were small or medium-size (competitive) firms and most of the liquidated firms existed only on paper; however, 5 of the firms sold were among the 100 largest in Mexico (including Aeromexico, Mexicana (1989) and 2 copper mines).

As an example of the impact of the divestitures to date: SEMIP had 398 PEs in 1982. Of these, 155 were sold, 114 liquidated and 37 merged/transferred as of Fall 1988. The remaining 92 PEs represent: 59% of the labor; 71% of total sales; 75% of total liabilities; 81% of the assets; and 84% of Government transfers to SEMIP's PEs.

Prices

About 4 bids were received for each firm. The highest bid was accepted in almost all cases, except when an offer was made by a union or a group of workers from the same firm, in which cases exceptions were made. There have been no reported market, tax or duty concessions or guarantees. The majority of the sales in which the Government provided financing were in the sugar industry, which is subject to numerous controls. On average, prices received were 27% higher than the minimum bid.

Buyers

The vast majority of purchasers were Mexicans; foreigners were only involved in 16 purchases, and in only 2 cases (auto parts) were foreigners the sole buyers. (One strange case: Renault of France was paid by Government to accept Vehiculos Automores Mexicanos (VAM) and its debt -- following which Renault liquidated VAM, the net result of which was presumably a profit.) Unions participated in about 20% of the purchases, primarily in the textile sector. Most sales have been to Mexicans entrepreneurs working in the technical field of the divested firm; i.e., half of the sales resulted in increased vertical integration in the sectors. Special concessions (in terms of price) have been made to unions and cooperatives in many cases; these are buyers which the Government apparently welcomes.

Employment Impact

Overall, public sector employment has been reduced by 660,000, and stood at 1 million in 1989. Lay-offs from a survey of 62 divested firms were estimated at around 10% -- which, if generally applicable, would translate into 66,000 in total. (Another paper reports 5% lay-offs.) (Example from the auto industry: prior to divestiture (1983), the PE portion of employment in the auto production industry was 30%. By 1988 this was down to 7.4% -- mostly due to the sale of RAM to Renault in 1983 and the sale of DINA(?) in 1987. We know the employees at RAM lost their jobs as Renault later liquidated the enterprise.) The bankruptcy of AeroMexico resulted in at least 10,000 employees out of work. The same survey found that managers were removed in 22% of divested firms.

A by-product of divestiture has been its use as a tool for changing Mexican unions' labor regime without requiring a sweeping reform of the labor legislation. Labor contracts are becoming more flexible as Government divests and threats of job losses soften union demands (see TelMex under Future Plans below). In the case of AeroMexico and Cananea copper mine (to be divested), bankruptcy was the critical first step in trimming the work force and cleaning up the companies for public auction.

Fiscal Impact

The public sector wage bill dropped 40% in 4 years. Government transfers to the PE sector at the end of 1988 represented 1.6% of GDP - a reduction of 50% from 1982. Transfers saved were estimated at almost US$4 billion.

The Salinas Administration

Salinas came in 1989; 30 PEs divested his first year in office (no details), including Mexicana Airlines.

Planned for the Future

1. TelMex: Minister of Finance was named Chairman of the TelMex board, thus centralizing the divestiture in his Ministry. TelMex has been restructured; negotiations with the 48,000 member union brought salary and benefits increases in return for improved performance and flexibility in job descriptions. Management is considering a union call for an ESOP.
2. Cananea copper mine (the world's 10th largest) has been allowed to go bankrupt and will be sold; 3000 soldiers were sent to prevent labor unrest after the bankruptcy was declared.
3. Several sugar processing plants
4. An insurance company

5. Real deMonte silver mine
6. Possibly the SIDERMEX steel plant

MEXICO: State Elections Updated On:Monday, November 26, 1990

November 22, 1990

EVENT: Results of elections in the states of Mexico and Hidalgo were officially announced on November 19.

SIGNIFICANCE: The ruling PRI's overwhelming victory raises doubts about the government's commitment to democratisation.

ANALYSIS: Of the elections, which were for state legislatures and municipalities, the more significant were those which took place in the state of Mexico. The conduct of the election in this state -- not only the most populous in the country but also one of the states where the Institutional Revolutionary Party (PRI) was heavily defeated by the pro-Cardenas coalition in the 1988 presidential polls -- was widely regarded as a crucial test of both the government's commitment to democracy and the present strength of Cardenas' Revolutionary Democratic Party (PRD).

The importance that the Salinas government attaches to the state of Mexico has been clear ever since it came to power:

-- It moved swiftly to sack, in a controversial way, the discredited governor of the state, replacing him with a capable administrator.

-- To regain the support of the shanty towns that surround Mexico City, it has targeted its spending under the Programa de Solidaridad ("Solidarity programme") to those areas that had shown the greatest support for Cardenas in 1988.

In the run-up to the state elections, government resources were also widely employed to help the PRI, including the announcement of a new programme providing one kilogram of free tortilla to the worst-off. Press coverage, especially on television was, as usual, strongly biased in favour of the ruling party.

In spite of this effort, and the problems that the PRD had in promoting candidates which had the support of both basic elements of the party (former members of the PRI and the Socialist party), an independent opinion poll taken before the election showed that the PRD was likely to obtain a majority in a substantial number of municipalities. Other polls were less optimistic, but they at least were suggesting a very close race between the PRD and the PRI. Even the PRI, according to an alleged internal document obtained by the magazine Proceso, had envisaged the loss of around 49 municipalities.

The results, however, show a significant rise in the PRI share of the vote -- with the PRI capturing slightly under 57% of the vote compared with 29.79% in 1988 -- and a dramatic decline in the PRD share of the vote. The PRD, which in 1988 won 51.58% of the vote, actually finished third with just 14.47% of the vote; moreover, it finished behind the National Action Party (PAN), which received 16.36% of the vote.

The low PRD figure, when compared to the presidential election of 1988, is partially explained by the fact that in 1988 Cardenas had the support of a group of parties which are now running their own candidates and which enjoy closer relations with the government. (These three parties got slightly under 10% of the votes.) The PRI won 33 of the 57 seats in the state assembly, including all those elected on a first-past-the-post basis, and 116 of the 121 municipalities. Turnout was very low, at about 33%; in the state of Hidalgo it was even lower, at around 10%.

Both the PRD and the PAN claim that the result is the product of a huge electoral fraud and are calling, in the case of the PRD, for complete nullification of the elections and, in the case of the PAN, for selective nullifications. Allegations of electoral malpractice centre on the manipulation of the voter registration roll and, in particular, the duplication of pro-PRI supporters' names, the erasure of citizens known to favour the opposition, and the inclusion of non-residents. The opposition also claims that on polling day the government changed the location of voting booths to dissuade voters, and that groups of PRI supporters were issued with fake electoral cards to enable them to vote more than once.

Elections in Mexico are usually followed by accusations of fraud. The PAN had demanded that the Interamerican Court of Human Rights monitor the elections, but this demand was refused by the government. The absence of any independent body monitoring the elections makes it difficult to know the real extent of the electoral malpractice that went on. Nevertheless, the sheer size of the PRI victory and the spectacular drop in the PRD vote suggest that this may have occurred on a considerable scale.

Despite their willingness to charge the PRI with election fraud, the opposition is largely confining its protests to the legal avenue. Although a number of protests by rank-and-file members of the PRD have taken place (the most recent occurred last weekend and involved the seizure of six city halls and the blocking of several roads), the leadership of the party appears to be adopting a cautious approach. This, and the fact that legal efforts are unlikely to be successful, make it likely that the result will stand.

The unwillingness of the PRD to mobilise its supporters reflects both the success of the PRI in discrediting the electoral process -- also one of the factors behind the very low turnout in the

MEXICO: State Elections

elections -- and the bitter conflicts that currently divide the major figures in the party. Cardenas himself seems to be saving his political capital for the mid-term elections next year, or even the next presidential elections in 1994. Cardenas appears to be bargaining on a serious deterioration in Mexico's economic fortunes, and that the electorate will then be more willing to insist on respect for the vote.

The PAN, which had previously collaborated with the government in the legislative arena, has announced that it will discontinue this support. Although the more important reforms that needed the PAN's support have already been passed, the PAN's new attitude could isolate the government and reinforce the more anti-PRI members of the PAN. Yet, in spite of the rhetoric, the PAN will probably still be prepared to negotiate again with the PRI to ensure continuation of the better treatment it has received from the government at elections. In the near future, the PAN will try to win two strongholds, the municipality of Merida in the state of Yucatan and the governorship of Guanajuato. Victory in these contests would appease the more militant anti-PRI members of the PAN.

The government's electoral strategy distinguishes between, on the one hand, the PAN and other political, even left-wing, elements which are perceived as less threatening and, on the other, the PRD. Thus, for example, the government was prepared to recognize PAN successes in Baja California, which now has a PAN governor, and Saltillo, the capital of the northern state of Coahuila, and the victory of Evaristo Perez Arreola, running as the candidate of the moderate left-wing party PFCRN, in Ciudad Acuna in the state of Coahuila. (Both the PFCRN and Arreola, personally, are close to the government.) The PRD, however, is treated more sternly, facing more difficult conditions in the electoral arena, which is still heavily controlled by the government.

The government's view is that many PRD supporters are former members of the PRI who cannot be allowed to benefit from breaking the rule of loyalty. But, more importantly, in 1988 Cardenas and the PRD showed that they could attract substantial support, which could endanger the political position of the government and the consistency of its economic programme.

CONCLUSION: Potential for political instability remains, should discrimination against the PRD continue.

Keywords: LA/C, Mexico, politics, election, government, party, legislation, regional, corruption

Stuart

MEXICO: INTERVIEW WITH STECKHAN Updated On:Monday, December 10, 1990

Mexico: A Country on the Move

Mexico, the first country to receive debt-reduction assistance under the Brady Plan, launched an economic restructuring program that has put the nation back on the road to growth. A free trade agreement with the United States and Canada could be completed in a year or two, giving Mexico's economy an additional boost.

In an interview with World Bank News, Rainer Steckhan, who heads the World Bank department that manages the lending program in Mexico and Central America, discusses Mexico's prospects for the next few years and some of the problems which must be tackled.

WBN: How did the Brady Plan help Mexico reduce its debt burden, and how important was this move?

Mr. Steckhan: Last year's agreement between the commercial banks and Mexico, with solid support from the World Bank, provided debt relief and some new money.

The most important effect of the Brady package was that it helped to substantially strengthen confidence in the Mexican economy and gave international approval to a courageous and consistent adjustment program.

The results are evident in lower domestic interest rates and longer maturities for government borrowings. Two years ago the government could only borrow for one month at a time; today it is selling paper with maturities of six to 12 months. Flight capital is returning, direct foreign investment has increased substantially and access to institutional investors is growing.

The country has made a dramatic turnaround from being one of the most closed economies to one of the most open. Much of the economy has been deregulated, the financial sector liberalized and commercial banks are being privatized. The country is on the move; in time, it should be able to attract funds from overseas banks for investment projects.

WBN: How important to economic recovery is the pact signed between the government and labor unions to hold wages and prices in line through 1991?

Mr. Steckhan: We have learned that adjustment programs without broad popular support will not work. The Mexican government's pact with vital sectors of the economy, such as business, agriculture and trade unions, provided the means for Mexicans to express their support for the stabilization and adjustment program.

The original rigid price freeze has gradually loosened up with each annual extension of the pact, but the agreement has clearly been instrumental in bringing down annual inflation from 160 percent to between 20 percent to 30 percent.

WBN: What measures are needed to further reduce inflation?

Mr. Steckhan: Mexico has made an extraordinary effort at fiscal and monetary discipline. For instance, public sector borrowing needs are being reduced from almost 17 percent of GDP in 1982 to a planned 1.9 percent in

1991. The government has also eliminated most subsidies and improved the financial management of state enterprises.

The government's efforts are beginning to bear fruit, and it must maintain that discipline.

WBN: According to some observers, living standards in Mexico are lower today than they were in the 1970s. What effect have government cuts in spending had on the poor?

Mr. Steckhan: Poverty is widespread in some rural areas and urban slums in Mexico, and the economic crisis of the 1980's has added to the problem. Real wages have dropped by some 40 percent in the past decade. The government of President Salinas has embarked on a major program of poverty alleviation, and, with incipient growth, more jobs are being created. At the request of the government, the World Bank will support rural development in the four poorest states, basic health care and primary education in these states and in Mexico City, as well as water supply, low-cost housing and other programs to help the poor.

WBN: What effect would the free- trade initiative have on the Mexican economy?

Mr. Steckhan: The proposal is a common initiative between Mexico and its northern neighbors. Increased trade without barriers is certain to benefit these nations. Equally important, free trade will attract more business investment to Mexico to take advantage of low labor costs, the competent work force and export opportunities. Export-oriented industries are more labor-intensive than other industries, and their growth should benefit Mexican workers. The free-trade proposal would also help industries in the United States obtain cheaper supplies and inputs.

WBN: How would a recession in the United States affect the Mexican economy?

Mr. Steckhan: About 70 percent of Mexico's exports are sold in the United States, so a recession in its largest market would put a damper on exports.

However, there are possibilities for export diversification, and I am sure that the Mexican entrepreneur can live up to the challenge.

WBN: As part of the government's economic restructuring program, a number of state-owned industries are being privatized. What is happening to proceeds from the sale of these industries?

Mr. Steckhan: The government has launched a comprehensive privatization program. To date, more than two-thirds of the 1,155 businesses slated for privatization have been sold or shut down. The program started by selling small enterprises, but recently the two national airlines, the telephone monopoly and a copper mine have been put up for sale.

The proceeds are one-time revenues of the government and will be used for programs that will contribute to the country's economic and social development.

WBN: What is the focus of the Bank's lending program for Mexico for the next few years?

Mr. Steckhan: In fiscal 1990, which ended June 30, the World Bank committed $2.6 billion to Mexico--more than to any other borrower--in support of its adjustment program. This represents a doubling of lending and quadrupling of disbursements over the last five years.

We will continue to have a substantial lending program in Mexico with increased emphasis on social sectors and environmental protection, both of which are top priorities of the government of Carlos Salinas de Gortari. We will also be lending for energy, infrastructure, low-cost housing and agriculture.

Document of
The World Bank

FOR OFFICIAL USE ONLY

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

Volume II of II

March 5, 1990

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

Table of Contents

ANNEXES

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER I - INTRODUCTION

This Technical Report contains a selection of the main discussion papers and mission working notes prepared by Bank staff and consultants from August, 1988 to February, 1990. The early papers were prepared in connection with the Bank's Industrial Regulation Study of 1988, while the balance relate to preparation, preappraisal and appraisal of the Road Transport and Telecommunications Adjustment Loan.

Following a brief outline of the main sector entities, the report focusses on the Government's telecommunications policy framework and report program. The bulk of the material is then organized under four headings that parallel those used in the appraisal report to discuss sector issues, the Government's reform program, and Bank loan conditionalities: privatization, competition, regulation and divestiture of SCT operations. The report concludes with a list of other documents that are available in the project file. A brief outline of each chapter is given below.

The background notes on the telecommunications sector, presented in Chapter II, summarize the features of the two main players as of November,1989: Secretaria de Telecomunicaciones (SCT), with operational functions as well as policy and regulatory responsibilities, and Telefonos de Mexico S.A. de C.V. (TELMEX), the main operating company. Some important features have since changed. In particular, a section on the newly established Telecomunicaciones de Mexico (TELECOMM) as of January 1990 has been added, that reflects divestiture of SCT's operating functions.

Chapter III contains the main documents prepared by the Bank at various stages of helping the Government formulate a sector policy and reform program. Particularly influential was the report "Policy Options for Telecommunications Industry Structure and Regulation in Mexico", distributed in October, 1988 to selected senior Government and TELMEX officials. This report provided the basis for initial development of a policy dialogue on the telecommunications sector, where the Bank had only been marginally involved in the past. A paper suggesting a minimum package of reforms followed (eventually overtaken by the Government's more aggressive program) and can be found in the project files. The second paper in this chapter, "Discussion Paper on Transitional Arrangements for the restructuring of the Mexican Telecommunications Sector", was prepared by the Bank in September 1989 and handed over to the various agencies by then already involved in particular aspects of sector reform. It highlights aspects other than the privatization of TELMEX (which occupied almost all of the Government's attention) - in particular, pricing, development of competition and regulation, and innovative modalities to attract private resources for infrastructure development - and the need for all these to converge in time with privatization. The third and last paper contains the Bank's assessment of the Government's telecommunications sector policy of September 1989. The policy paper itself (in files) outlines the reformed sector that the Government is seeking to develop, and thus provides an essential reference.

Documents related to the process of TELMEX privatization are in Chapter IV. The documents in this chapter deal with TELMEX's finances and fiscal impact, in the recent past and under the recently approved changes in tariffs and tax regime. As shown in the projections, the current rates would provide for a solid 30 % Rate of Return on Operating Assets, would generate enough funds for meeting the proposed investment plan and simultaneously would increase the Net Transfers to Government in 30 %. Additionally a document sent to files contains the Bank's main comments and suggestions on issues of the new TELMEX franchise, which were discussed at length by two Bank staff and consultants in 1989. Copy of this note was handed over to SCT during the appraisal mission of January, 1990.

Chapter V contains the Bank's summary comments on initial draft regulations for telecommunications networks and services prepared by SCT in late 1989 (copy in project file). Once fully developed, these regulations and the new TELMEX franchise will constitute the main legal instruments for implementation of the Government's policy in general, and for the development of competition in particular. An annex covers the recent deregulation of subscriber terminal equipment.

Two critically important areas pertaining to sector regulation are in Chapter VI. Four notes deal with TELMEX tariffs. Of particular interest is the paper prepared by Bank staff and consultants on the various options considered by the Government regarding the regulation of TELMEX tariffs once the company is privately owned. An important issue in this context is how to reconcile various pricing objectives (in particular, efficiency, profitability, and generation of large surpluses for accelerated expansion and modernization) with a minimum of regulatory intervention. The chapter also includes a package of technical assistance prepared by the Bank during appraisal, to help develop SCT's regulatory capability. This package mainly covers the areas of licensing of services and networks, pricing, and overviewing compliance with TELMEX's franchise, as well as SCT's management and control of the radio spectrum - a scarce natural resource under increasing demand as competition increases and the number of service providers increases.

Chapter VII briefly relates recent events in the divestiture of SCT's operating functions to the newly established TELECOMM, and changes underway in the relationship between these services and TELMEX. The latter particularly refers to revised tariffs for TELMEX use of SCT microwave and satellite transmission capacity.

SCT has been in contact with Canada to obtain equipment and assistance for radio-spectrum control, but budgetary restrictions have delayed this project. In general, not only for this isolated aspect, SCT would require to strengthen its human and technical resources in order to implement an adequate regulatory capability. A plan for developing this capability should consider, in addition to legal and administrative functions, the strengthening of the following "technical" regulatory areas:

- standards and rules for interconnection of different systems;
- development and updating of the fundamental technical network plans (switching, numbering, transmission, synchronization, signalling, etc.);
- equipment type approval;
- control of service quality;
- radio-spectrum management;
- project control.

DDELGADO
Mexico City, November 14, 1989

ESTRUCTURA ORGANICA DEL GOBIERNO FEDERAL

CONSTITUCION POLITICA DE LOS ESTADOS UNIDOS MEXICANOS

PODER JUDICIAL

SUPREMA CORTE DE JUSTICIA
TRIBUNALES COLEGIADOS DE CIRCUITO
TRIBUNALES UNITARIOS DE CIRCUITO
JUZGADOS DE DISTRITO
JURADO POPULAR

PODER EJECUTIVO

PRESIDENTE DE LOS ESTADOS UNIDOS MEXICANOS
PRESIDENCIA DE LA REPUBLICA

PODER LEGISLATIVO

H. CONGRESO DE LA UNION
CAMARA DE DIPUTADOS
CAMARA DE SENADORES

SECRETARIA DE GOBERNACION	SECRETARIA DE RELACIONES EXTERIORES	SECRETARIA DE LA DEFENSA NACIONAL	SECRETARIA DE MARINA	SECRETARIA DE HACIENDA Y CREDITO PUBLICO	SECRETARIA DE PROGRAMACION Y PRESUPUESTO	SECRETARIA DE LA CONTRALORIA DE LA FEDERACION	SECRETARIA DE TURISMO	SECRETARIA DE PESCA	SECRETARIA DE LA REFORMA AGRARIA
SECRETARIA DE COMUNICACIONES Y TRANSPORTES	SECRETARIA DE DESARROLLO URBANO Y ECOLOGIA	SECRETARIA DE EDUCACION PUBLICA	SECRETARIA DE SALUD	SECRETARIA DEL TRABAJO Y PREVISION SOCIAL	SECRETARIA DE AGRICULTURA Y RECURSOS HIDRAULICOS	SECRETARIA DE ENERGIA, MINAS E INDUSTRIA PARAESTATAL	SECRETARIA DE COMERCIO Y FOMENTO INDUSTRIAL	DEPARTAMENTO DEL DISTRITO FEDERAL	PROCURADURIA GENERAL DE LA REPUBLICA

DEPARTAMENTO DE LA INDUSTRIA MILITAR

TRIBUNAL FISCAL DE LA FEDERACION

- COORDINACIONES
- COMISIONES INTERSECRETARIALES
- SECRETARIADO TECNICO

SECTOR PARAESTATAL

ORGANISMOS DESCENTRALIZADOS

- EMPRESAS DE PARTICIPACION ESTATAL
- SOCIEDADES NACIONALES DE CREDITO
- FIDEICOMISOS PUBLICOS

TRIBUNALES LABORALES

- TRIBUNAL FEDERAL DE CONCILIACION Y ARBITRAJE
- JUNTA FEDERAL DE CONCILIACION Y ARBITRAJE
- JUNTA LOCAL DE CONCILIACION Y ARBITRAJE

- PROCURADURIA GENERAL DE JUSTICIA DEL D.F.
- TRIBUNAL DE LO CONTENCIOSO ADMINISTRATIVO

PRINCIPALES DEPENDENCIAS COORDINADAS DEL SECTOR

SECTOR COMUNICACIONES Y TRANSPORTES

SUBSECTOR AEREO

- AEROPUERTOS Y SERVICIOS AUXILIARES
- TRANSPORTE AEREO FEDERAL
- TURBORREACTORES

SUBSECTOR CARRETERO

- CAMINOS Y PUENTES FEDERALES DE INGRESOS Y SERVICIOS CONEXOS
- FIDEICOMISO 195 CONACAL

SUBSECTOR COMUNICACIONES

- SERVICIO POSTAL MEXICANO
- TELEFONOS DE MEXICO
- TELEGRAFOS NACIONALES

SUBSECTOR FERROVIARIO

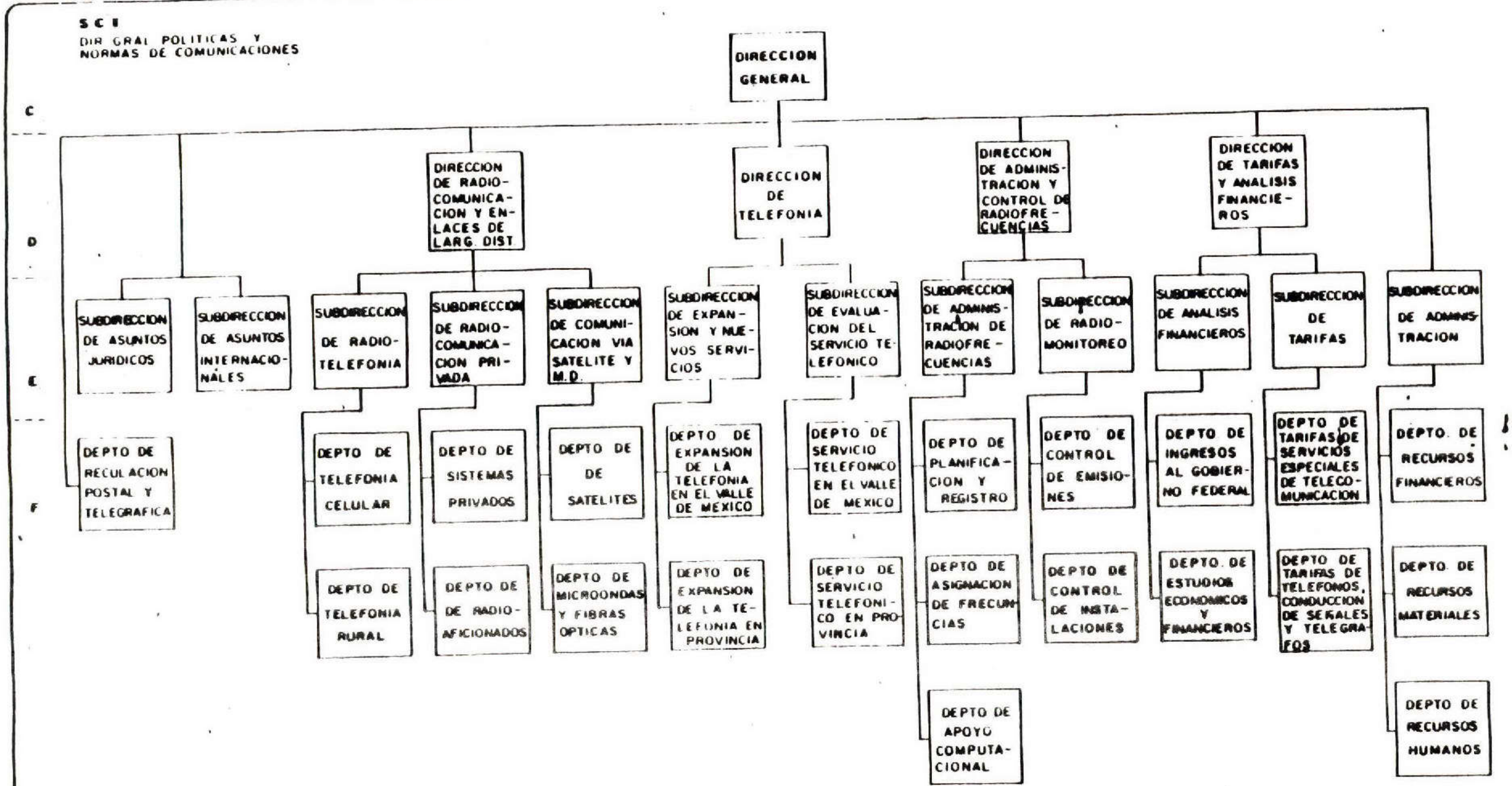
- FERROCARRILES NACIONALES DE MEXICO
- CONSTRUCTORA NACIONAL DE CARROS DE FERROCARRIL

SUBSECTOR MARITIMO

- ASTILLEROS UNIDOS
- FIDEICOMISO DE FORMACION Y CAPACITACION PARA EL PERSONAL DE LA MARINA MERCANTE NACIONAL
- FONDO NACIONAL PARA LOS DESARROLLOS PORTUARIOS

ESTRUCTURA ORGANICA DE LA SECRETARIA DE COMUNICACIONES Y TRANSPORTES

- **SECRETARIO**
  - **SUBSECRETARIA DE INFRAESTRUCTURA**
    - DIRECCION GENERAL DE CARRETERAS FEDERALES
    - DIRECCION GENERAL DE PROYECTOS, SERVICIOS TECNICOS Y CONCESIONES
    - DIRECCION GENERAL DE CONSTRUCCION Y CONSERVACION DE OBRA PUBLICA
    - INSTITUTO MEXICANO DEL TRANSPORTE
  - **SUBSECRETARIA DE OPERACION**
    - DIRECCION GENERAL DE AERONAUTICA CIVIL
    - DIRECCION GENERAL DE TRANSPORTE TERRESTRE
    - DIRECCION GENERAL DE PUERTOS Y MARINA MERCANTE
    - DIRECCION GENERAL DE TARIFAS
    - DIRECCION GENERAL DE MEDICINA PREVENTIVA EN EL TRANSPORTE
    - DIRECCION GENERAL DE POLICIA FEDERAL DE CAMINOS Y PUERTOS
  - DIRECCION GENERAL DE ASUNTOS JURIDICOS
  - DIRECCION GENERAL DE PLANEACION
  - UNIDAD DE COMUNICACION SOCIAL
  - UNIDAD DE INSPECTORES DE OBRA Y OPERACION
  - CENTROS S C T
  - PUERTOS MEXICANOS
  - **SUBSECRETARIA DE COMUNICACIONES Y DESARROLLO TECNOLOGICO**
    - DIRECCION GENERAL DE POLITICAS Y NORMAS DE TELECOMUNICACIONES
    - DIRECCION GENERAL DE FOMENTO DE LAS TELECOMUNICACIONES E INFORMATICA
    - DIRECCION GENERAL DE NORMAS DE RADIO Y TELEVISION
    - SERVICIO DE TELERRESERVACIONES
    - TELECOMUNICACIONES DE MEXICO
    - SERVICIOS A LA NAVEGACION EN EL ESPACIO AEREO MEXICANO
    - INSTITUTO MEXICANO DE COMUNICACIONES
  - **OFICIALIA MAYOR**
    - DIRECCION GENERAL DE RECURSOS FINANCIEROS
    - DIRECCION GENERAL DE RECURSOS HUMANOS
    - DIRECCION GENERAL DE RECURSOS MATERIALES



SECRETARIA DE COMUNICACIONES Y TRANSPORTES: NUEVA ORGANIZACION PROPUESTA

November 1989

Mexico
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER II - SECTOR BACKGROUND

a) SCT Regulatory Functions

SCT is presently responsible for:

- Formulating and directing policies and programs for development of the telecommunications sector.
- Organization and administration of telegraph service.
- Administration of Federal telecommunications services and their coordination with similar licensed public and private services, including interconnection with foreign networks.
- Awarding concessions and permits to establish and operate communications services and systems.
- Establishing and enforcing technical and operation standards.
- Establishing service tariffs (in coordination with Secretaría de Hacienda y Crédito Publico).
- Promoting the creation of cóoperative societies for the provision of telecommunications services.
- Establishing requirements for telecommunications personnel.
- Fostering training, research and technological development in the sector.

Several units under the Subsecretario de Comunicaciones y Desarrollo Tecnológico, mainly the General Direction of Communications Norms and Control, deal with above functions. This latter office works through the Direction of Operation Control, the Direction of Telecommunications Systems and the Under-Direction of Control of the Radioelectric Spectrum. A new structure would be implemented in 2-3 weeks (See Attachment), oriented to the new circumstances in the sector.

Improvement in several areas is possible and necessary. Procedures for granting licenses for the use of radio frequencies and the installation of telecommunications equipment are mostly manual, in spite of the large volume of applications (about 20 daily, for new license or modifications to the existing ones). Monitoring stations (12) must be modernize or replaced by mobile units. Telmex prepares the basic technical plans for the national network, to be approved by SCT, but SCT should take full responsibility for this function. About 60 Technical Standards have been issued (and published in Diario Oficial); and the introduction of new technology in the network will require a permanent and systematic standardization activity. Quality of service is supervised by 26 Delegaciones throughout the country, whose personnel should be trained and provided with adequate instruments and procedures. Approval and monitoring of development plans and investment programs require timely and coordinated efforts of all the units involved in the process.

Mexico
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER II - SECTOR BACKGROUND

b) T E L E C O M M

Organization and Human Resources

TELECOMM is the new entity resulting from merging Telégrafos Nacionales (Telenales) and the operative branch of Secretaría de Comunicaciones y Transportes (SCT) ascribed to Dirección General de Telecomunicaciones (DGT).

Telenales was created as an "Organismo Descentralizado" (decentralized entity) in August 20, 1986. Its name and scope were changed on November 16, 1989 to incorporate in it services and responsibilities presently under DGT. This reorganization is aimed to facilitate modernization and redimensioning of telegraph service and to establish a telecommunications carrier without creating a new entity, therefore propitiating savings and looking to a self-financing organism. In addition to providing the services described below, Telecom would have the following functions: (i) to advise State governments and Federal agencies on their telecommunications systems; (ii) to propose tariffs applicable to its services; (iii) to participate in international conferences on telecommunications; (iv) to promote telecommunications services through a temporary minority share in commercial societies; (v) to manage the National Schools of Telegraph and Telecommunications.

Telecomm's administration would comprise four Directions:

a) Comunicacion por Satélite (Satellite Communications)
b) Red Federal de Microondas y Fibra Optica (Federal Microwave and Fiber Optic Network)
c) Servicios Telemáticos y Especiales (Telematic and Special Services)
d) Telégrafos Nacionales (National Telegraph)

Present planning schemes are inadequate both in Telenales and DGT. The new entity should face the necessary expansion and modernization of the network by establishing a strong planning unit and obtaining technical assistance to review its strategic plan. This technical assistance is also needed to improve efficiency, to implement effective marketing systems, and to ameliorate service quality (operation and maintenance), billing and collection.

Added to the operational problems and network deficiencies that DGT has to cope with, low salary levels have resulted in a loss of specialized staff. About 1,000 employees have left office in 1983-89, remaining now a total of 4,700 staff. Telenales, with 14,700 employees, is also afflicted by low salaries and a very low productivity. It is envisioned that the new entity, Telecomm, adopting the character of "Organismo Descentralizado" that Telenales had, and under the new policies of modernization and expansion, would be able to retain its best personnel and improve substantially its productivity. As a consequence of voluntary retirement and pension programs currently undertaken, Telenales staff would have been reduced by 1,300 at the end of 1989 and to a total of 8,700 by 1990. Telecomm will have to develop accelerated training programs.

Networks and Services

Telecomm will provide and operate a "Basic Strategic Infrastructure" for long distance telecommunications, consisting of a terrestrial network of microwave and cable systems, and a satellite network. These networks will carry voice, data and video signals generated by large users, in addition to the essential communications for rural areas and Government service.

Services that will be provided by Telecomm as a result of the fusion of networks, functions, and responsibilities of Telenales and DGT are:

a) voice, data and video transmission for large users, as a carrier;
b) telex;
c) data transmission and switching;
d) telegraph services;
e) money remittances;
f) public facsimile;
g) other value added services: electronic mail, access to data banks, tele-processing;
h) high frequency radiocommunications, mainly for maritime and aerial navigation support;
i) telephone service for special events and in priority zones, when no other entity is able to provide it or when determined by the Government;
j) promotion of rural telephone service;
k) private Government services.

Telegraph

Traditionally (the first circuit was installed in 1851), it is the most important or the only available communication means for the rural environment. The Constitution (1917) reserves the provision of this service to the State. The national network has 9 automatic switching centers, with 78% of the links being open wire lines spread over 38,000 km, with an average age of 40 years and subject to frequent pilferage. Out of a total of 2,500 sites served, 46% operate through Morse links. In Mexico City, some subscribers have the possibility to read their telegrams by telephone ("Phonotelegrams"). Since 1984, an automatic access is offered to users with large-volume telegraph traffic, but serious deficiencies affect the automatic system in cities like Guadalajara, Monterrey, Hermosillo and Distrito Federal. Even though 950 localities are attended by local neighbors as agents, operation and maintenance expenses are too high. This, added to the lack of reliability of the system and the introduction of other services (telephone, facsimile), is expected to produce a rapid declination of service, which presently requires a subsidy of more than 26%, from DGT operated telex service. A very important use of the telegraph network is for money remittance, which is restricted to incoming transfers from other countries. In 1988, the international telegraph service was incorporated to Telenales and will be kept by Telecomm; international telegrams are transmitted only through point-to-point links.

Telex

This network comprises 62 exchanges linking 102 cities, and has a total capacity of 24,000 subscribers. It is stagnated due to the lack of dedicated lines (that should be provided by Telmex) and the pressure of more modern services.

Public Facsimile

In 1987, public terminals for national traffic were installed in 22 cities. In 1988, this service was extended to the international network. Starting in 1988, a "Girofax" service is offered from the United States to Mexico for money transfer.

Telepac (Data transmission by packet switching)

This service presently covers 23 cities.

Teleprocessing

Infonet service is provided for access to data banks.

Microwave Terrestrial Network

The national microwave network, built over 16,400 km and owned by the State and Telmex, along with the Morelos satellite system, make up the so called basic infrastructure of the Mexican telecommunications network. Initially, Telecom's microwave system will carry 100% of TV signals and 30% of domestic long distance traffic, including data transmission, telex, etc. This system, with more than 20 years of operation, will require rehabilitation, expansion and modernization (only one link is being digitalized and will be cut into operation in January 1990).

Satellite Network

Morelos satellite system has two satellites in orbit and 254 earth stations. Services through this system are exclusively provided by the Government. Connection to international satellite networks will be Telecomm's responsibility. The first Morelos satellite capacity is fully utilized and use of the second satellite is actively being promoted.

Service Demand

Some demand projections exist for the various services (See Attachment 1), but additional analyses and marketing studies would be needed to assess the unexpressed demand and the potential role of Telecom in each of those services. A covenant has been recently discussed with Telmex and is in the final approval process, oriented to secure for Telecomm a share in the provision of telephone circuits in the long distance network. This will require the immediate modernization of the network. It seems that the possibility of Telecomm being considered as a new operator of long distance traffic has been discussed, but the current decision clearly leaves the entity only as a provider of transmission circuits for other companies. In fact, Telmex is the main user of the Federal microwave network and it is expected that Telecomm will provide between 192,000 and 270,000 circuits in 1994, which represents an annual growth of 6.4%-12.7% with respect to the total of 132,000 used by Telmex in 1988. In addition to Telmex demand, it is estimated that Telecomm will increase the number of circuits for private networks from 610 in 1989 to 2,311 in 1994 (30.5% p.a.).

In 1988, five 36 MHz-transponders were used for TV transmission. In 1993-4, it is expected to provide 12 transponders for TV and 10 for telephone service. Private networks (voice and data) would demand about 5,100 satellite circuits in 1994, but this figure would be much lower (900 circuits) if those private companies will establish their own infrastructure. For the international transmission of voice traffic, it is estimated a 6.3% annual growth in the number of satellite circuits supplied to Telmex (683 circuits in 1994). Traffic between Mexico and the United States, which accounts for more than 80% of the total international traffic, will be shared by the Morelos system (50%), Intelsat satellites (12%) and US satellites (38%). A route to Central America and the Caribbean will be established with 100 circuits in 1991 and will grow to 500 circuits in 1994.

Telex service would experiment a 10% annual reduction in the period 1990-94, as a consequence of the preference for more valuable services. Infonet would grow from 2,200 terminals in 1988 to 4,000 terminals at the end of the period. Telepac would be expanded from 850 to 4,700 ports in the same period and could be the object of a new disassociated entity. Electronic Mail will start in 1990 with 1,300 boxes and would grow to 10,000 boxes in 1994. Data transmission and value added services are open to the private initiative since 1982; however, they have not been developed and the quality of existing services is not satisfactory.

Domestic telegrams will decrease by an estimated 9.3% p.a. in 1989-94, while international telegrams will increase 6.6% p.a. Combined national and international money remittances will grow at 4.3% annually to a total of 15 million in 1994. In 1987, gross telex revenue was transferred to telegraph service; in 1988, only the net profit (revenue less operating expenses) was transferred.

In the field of rural telephony, Telecomm would act only as a promoting agent, in coordination with Telmex, the States and other entities.

The Government is preparing licencing arrangements for the Airline Reservations System (Sertel), presently attached to SCT, which could be better operated by a private company.

Investment Program. Expansion and Modernization

Investment program cost in the period 1989-94 is presented in Attachment 2, as estimated in July 1989. Major investments and works are summarized below. Further analysis by the Government would be necessary to establish this program's feasibility, considering the new environment in the telecommunications sector and, perhaps, less ambitious goals under the privatization scheme. Telecom, although a decentralized entity, does not have financial independence and is subject to fiscal borrowing ceilings; thus it has been considered that a portion of its investment program could be replaced by financial lease of the equipment needed. It can be observed that investment budget for year 1990 has been reduced from US$ 281 million as estimated in July 1989 to about US$ 48 million. Meetings with Acting Directors of Telenales and DGT pointed to divergent views on the new entity's role, and the Presidential Decree establishing Telecom would require complementary ruling on the exact nature of services to be provided, the networks to be expanded or maintained, and competition from other telecommunications entities.

Digitalization of the microwave network will continue on the main links and multiplex equipment will be introduced in several links in order to have additional capacity for renting private circuits. The network requires rehabilitation of power supply and air conditioning systems.

Most of the earth stations for satellite communications are equipped for TV reception only, but they will be adapted for transmission of telephone and TV signals. A network linking nodal stations in major cities will be established to concentrate private data lines from remote stations.

Intelsat earth station at Hermosillo will be expanded to improve communications in the Pacific Region. At the same time, Tulacingo and Iztapalapa stations will be equipped to introduce digital voice and data transmission. For medium speed data to the United States and within the country, an earth station will also be installed.

It has been proposed to improve telex service by replacing multiplex equipment, up-dating the exchange equipment and providing redundancy to the system. Public automatic telegraph service will be introduced using the existing telegraph switching exchanges. In addition, open wire lines will be replaced by radio telephone circuits and satellite links. Administration changes are also considered for this service; for example, post and telegraph service would be integrated in about 1,100 rural localities, and in major cities all telecommunications services would be offered within the same office. The possibility of reading telegrams by telephone would be extended to 70 cities. Automatic access would be promoted among major users of telegraph service. A project to modernize money transfers through the use of specialized software has been considered to compensate for the low applicable charges (Telenales fees are much lower than commercial bank fees) and to improve service.

DDELGADO
Mexico, November 1989

Attachment 1

MEXICO
TELECOMM: CAPACITY AND SERVICE DEMAND FORECAST

Capacity and Services	Actual 1988	1989	1990	1991	1992	1993	1994	Growth % 1989-94
		---------- Forecast					----------	
Voice, Data and Video Transmission								
-Equivalent Teleph. Circuits ('000)	31.8	46.9	55.3	65.7	78.1	93.5	110.9	18.8
International Telephone Service								
-Satellite Circuits: Morelos	474						683	
Intelsat								
U.S.A.								
-Central America and Caribbean Terrestrial Circuits	---	---	---	100			500	
Telepac								
-Cities		23					100	
-Ports	850						4700	
Infonet (Terminales)	2200						4000	
Electronic Mail (Boxes)	---	1300					10000	
Telegraph								
-Domestic Telegrams ('000)	11600	11660	12040	12450	12900	13370	13880	3.5
-International Telegrams ('000)	265	220	242	266	293	322	354	10.0
-Money Orders ('000)	11913	12465	13076	13709	14381	15085	15829	4.9
National	11300	11750	12340	12950	13600	14280	15000	5.0
International	613	715	736	759	781	805	829	3.0
-Telegrams by Phone ('000)	337	355	664	995	1354	1747	2183	43.8
-Automatic Access ('000)	236	314	357	400	442	485	528	11.0
Facsimile								
-National ('000)	24	31	39	49	61	76	95	25.1
-International ('000)	18	21	26	33	41	52	64	25.0
-Money Orders ('000)	74	105	115	127	140	154	169	10.0

Sources: -Telenales: "Programa de Mediano Plazo 1989-1994"
-SCT: "Programa 1989-1994", July 1989

November, 1989

Attachment 2

MEXICO
TELECOMM/: INVESTMENT PROGRAM 1989-94 (US$ Million)

Components	1989	1990	1991	1992	1993	1994	Total	%
MW Net. Digitization	2.6	29.2	26.3	10.6	6.4	2.8	77.9	8.6
Fiber Optic Cables	3.3	57.3	51.9	37.4	29.1	22.1	201.1	22.2
Multiplex Equipment	3.9	49.3	44.7	23.3	16.1	9.8	147.1	16.3
Satellite System	7.2	70.9	37.4	71.9	43.6	44.2	275.2	30.4
Telex	2.9	9.5	3.0	2.5	2.0	1.0	20.9	2.3
Telepac	4.0	21.0	6.5	7.2	3.8	3.3	45.8	5.1
Teleprocessing	1.1	3.5	1.5	2.0	1.2	1.5	10.8	1.2
Telegraph and Fax	8.5	8.5	0.3	0.3	0.4	8.5	26.5	2.9
Telegraph Money Ord.	3.1	3.1	0.2	0.2	0.1	3.1	9.8	1.1
Other Services	8.0	25.0	17.0	8.0	8.0	8.0	74.0	8.2
Power and Air Condit.	4.8	3.6	2.4	1.8	1.2	1.2	15.0	1.7
Total:	49.4	280.9	191.2	165.2	111.9	105.5	904.1	100.0

Note: Revised Investment Program for 1990 is only Pesos 137,192
Million (Equivalent to about US$ 48 Million)

Source: "Programa 1989-1994, Telecomunicaciones Nacionales". SCT, July 1989.

November, 1989

Mexico
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER II - SECTOR BACKGROUND

c) T E L M E X

Organization

Telmex was created in 1948 as a result of merging "Teléfonos Ericsson" of Sweden and "Compañia Telefónica Mexicana", an ITT subsidiary. In 1958, Telmex became a wholly Mexican owned company, and in 1972 the Federal Mexican Government acquired 51% of the corporation's shares. A process to privatize Telmex's ownership is now underway, following a general sector reform program. To expedite this process, a new Director General has been designated, and the Secretary of Finance and Public Credit is the new Chairman of the Board. Telmex is registered in the Mexican Stock Exchange and in U.S.A through American Depositary Receipts of NASDAQ Network.

A recent reorganization (June, 1988), undertaken with assistance of Strategic Planning Consultants (SPC), of Washington, DC, decentralized network operations into three regional Operating Directions (North, South, and Distrito Federal + Estado de Mexico), a Long-Distance Direction and a Telephone Development Direction. Other three Directions are responsible for Planning and Development, Human Resources and Labor Relations, and Finance and Administration.

A key element in Telmex development is the group of its 20 subsidiaries involved in activities related to telephone service: outside plant construction, telephone directory production and marketing, mobile communications, telephone plant operation, telephone equipment manufacturing, maintenance and engineering services, etc. The first subsidiary, CTBR, was created in 1924. Now, Telmex controls this group through a holding company, SERCOTEL. All the companies are wholly owned, except Mitel de Mexico which is a joint venture with Mitel Corporation for the manufacturing of PBXs and semiconductors. The group represents 17% of Telmex's assets and 27% of its staff, and generates 22% of its revenues. An indication of the relative size of these companies is given by the following figures on staff:

	1977	1988	Annual Growth
Subsidiaries	6,982	18,369	9.2%
Telmex	23,405	49,995	7.1%
Total	30,387	68,364	6.9%
Subsid./Total	23.0%	26.9%	1.4%

Development Programs

Telmex's development strategy is based on an accelerated growth, improvement of service quality, and modernization and diversification.

During the 1984-88 period (See Attachment 1), the number of telephone lines in service had a annual growth of 5.8%. Development plan 1989-94 (Attachment 2) specifies a 12.3% annual growth, but final goals will depend on several factors that are being analyzed regarding the privatization process (tariffs, taxes, competition). From the viewpoint of technical and human resources, Telmex is able to achieve this growth and other goals being considered for network modernization. On the other hand, service demand as indicated by present telephone density (5.1 lines in service/100 population -See Attachment 2) and 1.5 million applications in waiting list give to Telmex an ample growth margin. Attachment 2 is a set of indicators in the development plan that is presently discussed with the Government. In 1994, 80% of the telephone lines would be digital, representing 57% of the installed plant; about 500,000 existing lines would be replaced by the new technology. By this year, 15,300 localities would be covered by telephone service. LD system, with an annual growth of 6.2% in its transmission capacity, would handle 1,926 million calls, which is twice the present volume. Total investment during the six years is estimated at US$ 11,784.2 million (Attachment 4). This amount is equivalent to about 2.5% of total investment in Mexico according to the National Development Plan. General distribution of the investment is:

Local Telephone Service:	57.9 %
Long Distance Service:	27.2
Civil Works and Power:	10.3
Plant Replacement or Reconstruct.:	4.6

Modernization plans include operations (marketing, services via operators, maintenance), administration (decentralization), human resources, and new technology in the network (digital exchanges, digital transmission, integrated service digital network). It was decided in 1980 that, starting in 1982, all new local and LD telephone exchanges would be digital, and that from 1991 on expansion of existing exchanges would also be with digital equipment. New technology and additional network capacity will allow the introduction of new services or the expansion of the existing ones: touch-tone phones, call waiting, abbreviated dialling, 800 service, party lines, data transmission by packet switching, cellular telephony, rural telephony by Multiple Access Radio systems, LD public telephones. In 1986 were installed in Mexico City the first fiber optic cables and there are today 24 systems over 193 km; trunk systems will be installed by 1991. A digital overlay network would readily improve voice, data and image transmission for large users.

Improvement of service quality is a major concern both for Government and Telmex. A agreement between Telmex and its labor union for special efforts during 45 days in improving quality started on June 1, 1989 and showed the way to establish a permanent program for service stabilization. Some of the aspects deserving permanent monitoring and renovated maintenance efforts are: user claims, access to operator services, quality of local and LD communications, attention to large users, public telephones. Quality objectives are summarized in Attachment 5.

Beginning in 1976, Telmex and its subsidiaries follow a methodical Planning Cycle with annual revisions and programs usually prepared for the next five years (six years have been considered in the last plan). The first year is programed to the level of specific projects and a detailed budget. Planning for the first three years in the 1989-94 period, referred to as "Decision 1991" (Attachment 4, page 2/2), will introduce automatic telephone service in 95 cities and will replace 56 rural exchanges with new equipment; installations in the LD network will be advanced two years (covering 1993 needs), to supply twice the 1988 capacity; all new high-capacity transmission links will be digital; on the route Mexico-Celaya will be installed 261 km of fiber optic cable; six new LD telephone exchanges will be added to the network. The Overlay Network is a modern infrastructure for voice, data and image transmission and packet switching (in 13 cities) that will be in service in early 1990 linking Mexico, Guadalajara and Monterrey; it will offer capacity for transmission at 64 Kb/s and 2 Mb/s, multiplexors for interconnection with analog equipment, access to the public telephone network, virtual networks (temporary digital links for private use), and transition to an Integrated Service Digital Network (ISDN). Four master earth stations installed in Mexico City, Monterrey, Ciudad Juarez, and Merida will complement this Overlay Network. Cellular telephone service will start in 1990 with 1,950 subscribers in Mexico City and Tijuana and will cover other cities and a total of 70,350 subscribers in 1991. During the same period, 9,600 "intelligent" public telephones will be installed. By 1991, Telmex will have a share in the submarine cable TAT-9 linking America and Europe. Strategy for rural service includes the installation of electronic switchboards, replacement and expansion of transmission equipment, and introduction of new services. Service to large users will demand investment on interconnection and monitoring equipment. Finally, the investment program for 1989-91 includes the creation of a new Research Center that will focus on network development and technological transfer.

Telmex, as a company with predominant Government participation, complies with procurement procedures stated mainly in the Procurement Law of 1988 ("Ley de Adquisiciones, Arrendamiento y Prestacion de Servicios Relacionados con Bienes Muebles"). Some of the complex administrative framework for equipment acquisition is lessened by the availability of local manufacturing, including "strategic suppliers" for switching equipment and transmission systems with whom supply contracts are revised periodically according to the development program. Attachment 6 is a matrix of the principal local suppliers and products. Privatization of Telmex will likely improve procurement efficiency.

DDELGADO
Mexico City, November 1989

Attachment 1

MEXICO
TELMEX: PERFORMANCE INDICATORS 1984-88

Indicators	1984	1985	1986	1987	1988	Annual Growth %
Localities with Telephone Service	5242	5418	5631	6004	6420	5.2
Automatic Service	1707	1727	1811	2802	2910	14.3
Manual Service	3535	3691	3810	3089	3262	-2.0
With Multiaccess Systems	---	---	10	113	248	398.0
Telephone Lines in Service ('000)	3398.7	3589.7	3826.2	3984.9	4261.7	5.8
Automatic ('000)	3345.2	3533.7	3772.1	3934.1	4216.0	6.0
Automatic %	98.4	98.4	98.6	98.7	98.9	0.1
Manual ('000)	53.456	56.008	54.143	50.8	45.681	-3.9
Access to Automatic LD (%)	87.8	88.4	n.a.	91.2	n.a.	
Automatic LD Teleph. Exchanges	77	93	104	116	128	13.5
Analog	74	76	76	76	77	1.0
Digital	3	17	28	40	51	103.1
Digital %	3.9	18.3	26.9	34.5	39.8	78.8
Terminals ('000)	156.2	188.2	228.1	271.2	322.0	19.8
LD Circuits in Service ('000)	80.5	87.4	94.9	116.4	131.5	13.1
Circuit-km (Million)	28.4	30.1	31.5	37.4	42.1	10.3
Analog radio channels	1123	1232	1400	1553	1706	11.0
Digital Radio Channels	3	12	39	52	64	114.9
Fiber Optic Systems (140 Mb/s)	---	---	20	22	24	9.5
Cable Circuits	---	---	11520	11520	11520	0.0
Domestic Satellite Circuits	---	---	72	336	660	202.8
International Telephone Circuits	3579	3597	3913	4992	5423	10.9
Intelsat Pacific O. Satellite (%)	0.6	0.6	0.6	0.5	0.6	0.0
Intelsat Atlant. O. Satellite (%)	9.5	10.7	10.3	8.4	8.4	-3.1
Submarine Cable (%)	0.2	0.2	0.2	0.2	0.2	-10.1
MW with Central America (%)	3.2	3.7	3.3	2.7	2.7	-4.1
MW with USA (%)	86.5	84.7	85.6	88.3	88.2	0.5
% of Total LD Circuits	4.4	4.1	4.1	4.3	4.1	-1.7
Effective Call at First Trial (%)						
Domestic Traffic	83.0	89.3	83.8	85.8	89.1	1.8
International Traffic	88.3	90.2	87.5	86.0	90.1	0.5
Total Staff	34667	38410	40940	43037	49995	
Staff/1,000 Teleph. Lines in Svc.	10.2	10.7	10.7	10.8	11.7	
Operation and Maintenance Staff						
Telephone Operators (LD)	10549	11214	11611	11869	12549	4.4
Transmission Systems	963	1139	1247	1354	1568	13.0
LD Telephone Exchanges	321	477	503	1617	1785	53.6

Source: Telmex
November, 1989

Attachment 2

MEXICO
TELMEX: MAIN GROWTH TARGETS 1989-94 (*)

Targets	1989	1990	1991	1992	1993	1994	Annual Growth %
New Telephone Lines in Service ('000)	456.4	716.5	625.0	699.7	783.7	878.3	14.0
Total Telephone Lines in Service ('000)	4,718.1	5,434.6	6,059.6	6,759.3	7,543.0	8,421.3	12.3
New Telephones in Service ('000)	879.5	1,441.3	1,257.1	1,407.4	1,576.5	1,766.7	15.0
Total Telephones in Service ('000)	9,356.2	10,797.4	12,054.6	13,462.0	15,038.5	16,805.1	12.4
Lines in Service/100 Population	5.4	6.1	6.6	7.3	7.9	8.7	9.7
Total LD Circuits ('000)	142.0	152.0	162.0	172.0	182.0	192.0	6.2
Digital Microwave Network (km)	4,263	6,734	8,500	8,500	8,500	8,500	14.8
Fiber Optic Network (km)	138	138	716	1,451	2,186	2,960	84.6
Satellite Circuits	2,500	4,400	5,100	5,800	6,400	7,000	22.9
C-Band Transponders	7	11	13	14	14	15	16.5
Earth Stations	9	11	11	14	14	14	9.2
Total LD Calls (Million)	966.7	1,138.1	1,322.4	1,494.8	1,693.9	1,926.4	14.8
Total Localities with Service	7,518	9,518	11,518	13,518	14,518	15,300	15.3
Investment (Current US$ Million)	1,200.7	1,608.3	1,749.9	2,103.2	2,394.4	2,727.7	17.8

Source: Telmex
November, 1989

Attachment 3

MEXICO
TELEPHONE DENSITY (No. of lines in service/100 population) - Year 1988

State	Population	Lines in Service	Telephone Density %
Aguascalientes	619,873	34,403	5.6
Baja California	3,683,600	119,717	3.3
Baja California Sur	286,150	26,612	9.3
Campeche	515,800	15,474	3.0
Coahuila	2,143,918	131,851	6.2
Colima	332,884	24,467	7.4
Chiapas	2,433,620	45,022	1.9
Chihuahua	2,370,040	159,978	6.8
Distrito Federal	12,509,038	1,313,449	10.5
Durango	1,398,878	46,163	3.3
Guanajuato	3,973,314	139,066	3.5
Guerrero	2,605,781	71,659	2.8
Hidalgo	1,829,387	44,820	2.5
Jalisco	3,985,935	308,910	7.8
Mexico	9,657,107	313,856	3.3
Michoacan	3,453,377	105,328	3.1
Morelos	1,382,392	70,502	5.1
Nayarit	801,022	35,245	4.4
Nuevo Leon	3,148,584	269,204	8.6
Oaxaca	2,544,967	39,447	1.6
Puebla	3,935,571	137,745	3.5
Queretaro	866,648	32,066	3.7
Quintana Roo	210,166	17,654	8.4
San Luis Potosi	2,007,815	65,254	3.3
Sinaloa	2,292,250	100,859	4.4
Sonora	1,836,218	117,518	6.4
Tabasco	1,218,203	35,937	3.0
Tamaulipas	2,395,483	143,729	6.0
Tlaxcala	712,341	14,603	2.1
Veracruz	5,999,815	194,994	3.3
Yucatan	1,408,459	61,268	4.4
Zacatecas	1,381,833	24,873	1.8
Total:	83,940,469	4,261,673	5.1

Source: Telmex
November, 1989

Attachment 4
Page 1/2

MEXICO
TELMEX: INVESTMENT PROGRAM
1989-94 Period (*)

Components	Current US$ Million	Constant US$ Million	Constant US$ (%)
LOCAL TELEPHONE SERVICE			
Switching	2,866.5	2,389.3	24.3
PCM and Fiber Optic Systems	668.2	553.6	5.6
Outside Plant	1,828.6	1,522.3	15.5
Subscriber Terminals	683.6	580.6	5.9
Ancillary Equipment	774.7	649.4	6.6
Subtotal:	6,821.6	5,695.2	57.9
LONG DISTANCE			
Switching	161.7	140.9	1.4
Transmission	943.4	777.2	7.9
Ancillary Equipment	332.9	274.1	2.8
Subtotal:	1,438.0	1,192.2	12.1
SPECIAL PROJECTS			
Overlay Network	584.4	503.8	5.1
LD Public Telephones	196.6	168.2	1.7
Equip. for Large Users	69.7	59.0	0.6
Rural Network	899.0	741.9	7.5
Ancillary Equipment	24.0	20.5	0.2
Subtotal:	1,773.7	1,493.4	15.2
CIVIL WORKS AND POWER			
Land	121.8	100.9	1.0
Buildings	649.4	537.1	5.5
Power Plant	444.9	370.7	3.8
Subtotal:	1,216.1	1,008.7	10.3
Exchange Replacement and Outs. Plant Reconstruction	534.7	447.7	4.6
Total:	11,784.1	9,837.2	100.0

(*) Three alternatives for plant growth have been considered. This program corresponds to the medium alternative, with about 12% annual increase in the number of telephone lines. Includes overhead.

Source: "Estrategia para la Evolucion de Telmex". SCT-Telmex. June, 1989

November, 1989

Attachment 4
Page 2/2

MEXICO
TELMEX: INVESTMENT PROGRAM
"Decision 1991": 1989-91 (*)

Components	Pesos (Million) (1988)	Equivalent US$ Million	%
Switching	654,001.3	288.6	21.1
Crossbar	93,770.9	41.4	3.0
Digital	560,230.5	247.2	18.1
Transmission	1,024,407.2	452.0	33.0
PCM	234,882.0	103.6	7.6
Multiplex	436,742.8	192.7	14.1
Radio	352,782.4	155.7	11.4
Outside Plant	653,465.1	288.3	21.1
Civil Works	165,292.8	72.9	5.3
Repeater Stations	9,748.5	4.3	0.3
Land	25,261.3	11.1	0.8
Buildings	130,283.1	57.5	4.2
Power Plant and Air Cond.	152,322.9	67.2	4.9
Subscriber Terminals	243,596.3	107.5	7.9
Ancillary Equipment	207,629.6	91.6	6.7
Total:	3,100,715.3	1,368.2	100.0

(*) Does not include overhead

Source: "Decision 1991 y Plan Sexenal 1989-1994". Telmex, Sep/89
November, 1989

Attachment 5

MEXICO
TELMEX: SERVICE QUALITY GOALS 1989-94 (End of Year)

Indicators	Apr.19,89	1989	1990	1991	1992	1993	1994
Total No. Lines in Service ('000)	4,261.7	4,718.1	5,434.6	6,059.6	6,759.3	7,543.0	8,421.3
FAULTS AND COMPLAINTS							
Answer within 10 seg (%)	56.0	75	75	75	75	75	75
Answered Complaints (% of Calls)	70.6	92	93	95	95	97	97
Complaints Reported/100 Lines per Day	0.88	0.64	0.64	0.64	0.64	0.64	0.64
Faults Cleared within 24 Hours (%)	36.5	50	50	50	50	50	50
Faults Cleared within 3 Days (%)	77.8	92	96	99	99	99	99
Public Telephones out of Service (%)	24.9	10	5	5	3	3	3
ACCESS TO OPERATORS							
LD Domestic traffic:							
Answer witihin 10 seg (%)	64.7	77	80	80	85	85	85
Effective Calls (% of Calls Dialed)	73.7	92	93	95	95	97	97
International Traffic:							
Answer within 10 seg (%)	50.0	77	80	80	85	85	85
Effective Calls (% of Calls dialed)	60.1	92	93	95	95	97	97
AUTOMATIC TRAFFIC							
Dial Tone within 4 seg (% of Calls)	97.6	99	99	99	99	99	99
Effective Calls at First Trial:							
Local (%)	90.0	97	97	97	97	97	97
LD Domestic Traffic (%)	87.0	88	88	88	88	88	88
USA and Canada (%)	89.3	90	90	90	90	90	90

Source: "Estrategia para la Evolucion de Telmex", SCT-Telmex, Junio 30, 1989.
Note: This set of quality indicators is being revised between SCT and Telmex in relationship with the Licensing Agreement.

November, 1989

Attachment 6

MEXICO
TELMEX: LOCAL SUPPLIERS AND PRODUCTS

Supplier	Telephone Exchanges	Telephones	Cables	Analog Multiplex	Digital Multiplex	Radio Systems	Dig.Access Control
TIM (Ericsson)	*	*		*	*		
INDETEL (Alcatel)	*	*		*	*	*	
CONDUTEL			*				
LATINCASA (Ericsson)			*				
CONDUCTORES MONTERREY			*				
CONELEC			*				
NEC				*		*	
TELETTRA						*	
TSP (Philips)				*	*		
SIEMENS		*				*	
ATT							*

Source: "Telmex - Development and Perspectives". September, 1989

November, 1989

TELEFONOS DE MEXICO (TELMEX)

Labor relations

TELMEX had reached a situation where the contracts with the union provided for a very detailed job description, and the employees had adopted the principle that anything not explicitly stated in their contract was not their responsibility. There were some extreme cases such as messengers where the contract stated they were obliged to carry envelopes, hence they refused to take anything not contained in envelopes or to bring back any message.

To solve this situation the Mexican Government begun a campaign that culminated on 14 April 1989 with the signature of a "Convenio de Concertacion para la Modernizacion de TELMEX". It was signed by the Union, the Secretaries of Communications, Work and Programs and Budget, and as quality witness the President of the Republic.

The main changes were: (a) elimination of the additional 57 departmental contracts, which created room for unending minor disputes, (b) new more general job descriptions, where the employee is responsible in general for a task, and any activity reasonably necessary for the accomplishment of those tasks is considered as included in the contract, (c) from 400 different jobs with 500 salary levels, the new contract stipulates only 40 salary levels, (d) the article that any modernization project (digitalization, automatization etc) had to be presented to the union for its approval, was replaced by the need to inform the union for training and information to the employees.

The old contract, with its 57 departmental sub-contracts made it impossible to transfer employees inside the entity. The new contract allows TELMEX to create a new position in replacement of some retired employee, but that not allow for a decrease in the total number of places. Some media reports about the possible firing of 6,000 employees (5,000 telephone operators) were dismissed by TELMEX, because that kind of action would not be accepted under the current contract. But, they recognized that some 3,000 operators have to be transferred or offered to retire. This new contract will be transferred at the moment of privatizing TELMEX.

Currently there are 43,000 employees union members, and 7,300 high level non-unionized employees. The average salary for union members is Mx $ 1,500,000 per month including fringe benefits (they represent 50 % of the total); for high level employees the average base salary is Mx. 2,000,000 per month, or Mx $ 4,000,000 total. The most important fringe benefits are: (a) Saving Fund, where the company retains some percentage of base salary, and pays it back with interest at year end, and (b) vacation bonus, where every vacation day effectively taken earns a 140 % surcharge.

Simulation Models.(SIMES)

TELMEX has developed more than 1,000 models (SIMES) simulating different alternatives, but a base case scenario (no privatization of TELMEX, no rate increase, keeping low growth rate (6 %)) was missing. TELMEX made its comparisons with a base case (SIMES 985) where the growth rate was high (12 %), rates were increased, TELMEX was not privatized, Government continued investing 25 % of investment plan, and the telephone tax was not converted into tariff; and actually used it to demonstrate the impossibility of this situation. The mission requested to develop a base case representing the continuation of the previous situation: growth rate of 6 %, no privatization, government continues to reinvest, and IEPS not converted into tariff. TELMEX developed this case as SIMES 245, which summary results are in Attachment 1.

The uncertainties in relation to the future, actual function of TELECOM, and competitive environment have created a situation where TELMEX simulates models without knowing the validity of the assumptions. Some of the latest models are:

(a) SIMES 965 which includes the conversion of the telephone tax into tariff.

In both scenarios (985 and 965) the assumed rate increase was:

local service 40 % (Priority Payment increases to Mx \$ 700,000 and installation charges decreases 50 %, from Mx \$ 700,000 to Mx \$ 350,000)

long-distance national 40 %

long-distance international reduction of 6 % per year during 6 years

(b) SIMES 176 which assumes local increases equal to inflation plus 27 % in 1990, plus 10 % in 1991 and plus 10 % in 1992. All other assumptions are as in SIMES 965.

(c) SIMES 240 which partially represents the latest known rate increase proposal:

local: per call rate going up to Mx \$ 300 per 3 minute, minor increase in rental. This model does not include the rate increase assumptions for years 1991 and 1992 in order to reach in January 1993 the target of 80 % of the international rates. These increases would put the average local rate around 65 - 70 % of the international average.

national long-distance: assumes increases of 50 % per peak traffic, 25 % per daily off-peak and 0 % for nightly off-peak rates. As an average national long-distance rates would reach a level 105 % of international level. This would be in excess of the 80 % target for 1992, and is justified as a compensation for the local rate being short of the target.

international: assumes the elimination of the IEPS and an additional reduction, which would give a 39 % discount to the public in relation to current rates.

The main results of SIMES 240 are included as Attachment 2.

Valuation of TELMEX.

Attachment 3 gives some calculations on TELMEX's valuation made inside that entity. The following compares different approaches in order to establish a range of possible values:

(a) Net Book Value. Total Assets less Debt as of December 31, 1988 amounted to Mx. $ 7,608,291 million or US $ 3,335 million.

(b) Stock value: current value per share is Mx. $ 1,920, and there are 3,958 million of shares (as of December 1988), giving Mx $ 7,599,360 million or US $ 3,300 million. This stock value does not reflect the value of the 18 subsidiaries. Today there are 4,045 million shares, and the rate is 2,600 Mx $ per dollar: 1,920 * 4,045 / 2600 = US $ 2,987 million.

(c) Net Present Value of Future Earnings: taking the values of model SIMES 240 the Net Present Value of future distributed dividends plus Net Assets value as of 1994 (at 10 % interest rate) gives US $ 6,500 million for the whole entity. This rather small value reflects the assumption as contained in the model of distributing only 12 % of net profit as dividend.

Net Transfer to Government.

Attachments 4 gives the net transfers to the government for cases 240 and 245. The large decrease in telephone tax (IEPS) from Mx $ 7,640 billion to Mx $ 1,018 billion is compensated by the increase in VAT and income tax, and in addition the reinvestment from government is eliminated, giving a great total net transfer of Mx $ 11,441.8 billion for the case 240 (new tariff, convertion of IEPS into tariff, privatization of TELMEX) , as compared with Mx $ 8,863.7 billion for the base case 245.

Rural Telecommunications.

TELMEX defines as urban an area with 15,000 population or more. In increasing the coverage TELMEX has more or less followed a population decreasing order; currently almost all villages with more than 1,500 population have been covered. The 1989-1994 Plan should add 5,000 to 10,000 more villages, covering up to 500 population.

There are two cases which give origin to special negotiations:

(a) industrial or tourism development: a State Government or developer approaches TELMEX with the request to install facilities not included in the current budget. This situation gives origin to a negotiation which typically ends with some agreement stating that TELMEX will provide local and long-distance switching, and outside plant cables; and the State Government or developer will provide land for exchange, outside plant ducts and some times exchange building. Ownership could be held by State Government or developer, but frequently is transferred free to TELMEX as payment for non-planned implementation.

(b) rural telecommunications: if a State Government requests the inclusion of a locality not considered in TELMEX's priority list a negotiation takes place which may conclude with the State Government partially paying or installing facilities which later are transferred free to TELMEX for operation. Normally TELMEX requires the existence of electric power and year round accessible routes as preconditions for including a locality in its list. During the last years TELMEX was not putting enough effort in rural telephony, and many links were installed by State Governments with D. G. Telecom's help and later transferred to TELMEX, which protested the bad quality of these facilities, some times replacing them by their own new equipment. TELMEX had a IDB financed project (BID-RAM) for multiple access radio rural links.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER III - SECTOR POLICY AND REFORM PROGRAM

a) Issues and Options (Oct. 1988)

DRAFT -- 10/12/88

POLICY OPTIONS FOR TELECOMMUNICATIONS INDUSTRY STRUCTURE AND REGULATION IN MEXICO

Robert R. Bruce
Debevoise & Plimpton
555 13th Street, N.W.
Washington, D.C. 20004

TABLE OF CONTENTS

Page

Page

Page

POLICY OPTIONS FOR RESTRUCTURING TELECOMMUNICATIONS INDUSTRY STRUCTURE AND REGULATION IN MEXICO

I. INTRODUCTION AND OVERALL FRAMEWORK: POLICY ISSUES TO BE ADDRESSED IN RESTRUCTURING THE TELECOMMUNICATIONS SECTOR IN MEXICO

During the initial round of discussions by the World Bank Mission, a number of policy options and issues concerning industry structure and regulatory policies were addressed with a wide range of participants from the public and private sectors with a stake in the future of the Mexican telecommunications. What follows is not intended as a final set of recommendations, but as an preliminary enumeration of issues that might be further explored in ongoing discussions.

Substantial attention in initial discussions was focused on the impact of telecommunications services upon the economic performance of important public and private sector organizations essential to the future development of the Mexican economy. Consequently, many policy issues addressed herein concern how telecommunications services can be made more responsive to the needs of users and can contribute to the future growth of the Mexican economy.

There has been an effort to discuss policy issues not merely in terms of their impact on providers of telecommunications services, per se, but on the economy as a whole. Nevertheless, the economic health and efficiency of the key providers of telecommunications services in Mexico is crucial to the ability of Mexican users of services to obtain the telecommunications services they need. The interests of service providers and users are thus ultimately interdependent and not in conflict with each other from a long-term perspective.

In the short term, what users and service providers may be seeking in the process of sectoral restructuring may seem to be in conflict. It is essential, however, to encourage all participants involved in the telecommunications sector to assess what measures are likely to stimulate long-term growth. For, if more flexible and liberal terms and conditions for the provision of telecommunications services stimulate economic growth and expansion of business activities of telecommunications users, overall demand for telecommunications infrastructure services is likely to grow as well. Likewise, changes in price structures for telecommunications services may have short-term disruptive effects for some users; however, such price reforms may well be the necessary precondition for solid, rapid expansion of the telecommunications sector.

An agenda of policy issues for sectoral restructuring should thus focus on long term, not merely short-term initiatives; but it must also include practical recommendations concerning how long-term adjustments in price structures, in particular, can be achieved. Policymakers must, therefore, not overlook what might be seen as second-best solutions as long as such policy initiatives hold promise for achievement of long-term reform.

An agenda for the future should also focus not only on substantive policy changes, but on mechanisms and procedures for identifying key policy issues, resolving disputes among those with differing interests, and achieving long-term results. Given the interdependence of interests of users and service providers, any new mechanisms for dealing with sectoral reform should afford opportunities for intensified dialogue among users and service providers concerning future arrangements for the Mexican telecommunications sector.

Identified below are a series of issues for further discussion and dialogue. These issues are grouped in several general categories, including issues concerning: (1) the future of Mexican regulatory policy, (2) the organization and future role of the Secretaria de Communicaciones y Transportes (SCT) as a provider of telecommunications services, (3) the organization, pricing policies, and various relationships to the Mexican government of Telefonos de Mexico (TELMEX), (4) options for stimulating new private sector investment in the telecommunications sector, (5) policies for assuring access to a full panoply of information and computer-related services entities in the public and private sectors of the Mexican economy, and (6) the future role of users in shaping Mexican telecommunications policy.

There will inevitably be some overlap in issues addressed under these various general categories. Indeed, many issues outlined in this paper may not in fact represent matters of high priority; other issues that require urgent attention may have been ignored. The objective here is to establish a basis for future dialogue and discussion, not to foreclose other perspectives or options.

In identifying an initial set of issues, there has been substantial reliance on a recent, and necessarily cursory, round of talks held in Mexico City, as well as on the experience of other countries that have been or are still in midst of substantial changes in national telecommunications policy. It is a premise of this discussion paper that there is no single best model for sectoral reform that can be derived from the experience of other countries.[1] Policy makers in different countries face, of course, many common problems; however, the direction of policy change must inevitably be determined by the unique industry arrangements and sector structure, overall market environment, administrative traditions, and social and political values of each country.

Sectoral reform in Mexico cannot be based on a blind application of European, American, or Japanese policies. It should draw on these experiences, of course, but tailor solutions that are appropriate in the Mexican context. Such solutions may, however, have implications for other countries which are seeking, like Mexico, to develop the telecommunications sector as a vehicle for national economic growth.

This paper includes an initial listing of key policy issues. These issues are derived from an analysis of the Mexican telecommunications industry that is attached to this report as Appendix A; and thus, the issues set forth herein are not presented in the context

---

1. For a discussion of differing national approaches to telecommunications policy reform, see Robert R. Bruce, Jeffrey P. Cunard and Mark D. Director, From Telecommunications to Electronic Services (London: Butterworths, 1986); Robert R. Bruce, Jeffrey P. Cunard and Mark D. Director, The Telecom Mosaic: Assembling the New International Structure, (London: Butterworths, 1988).

of a full description of current industry structure arrangements regulatory policies.

II. BRIEF OVERVIEW OF MAJOR PROBLEMS AND CHALLENGES FACING MEXICAN POLICYMAKERS

Set forth below in summary fashion are some of the major problems and challenges that are likely to face Mexican policymakers in any effort to restructure regulatory and industry arrangements in the telecommunications sector. Sections III-VII provide a more detailed description of some policy issues that may warrant attention by policymakers in the days and months ahead.

1. Reforming Price Structures in the Telecommunications Sector:

A wide spectrum of Mexican policymakers seem to agree that the current price structure for telecommunications services is badly in need of reform. In fact, many observers believe that price reform is the single most important priority of any effort to restructure the telecommunications sector. Consequently, many of policy initiatives discussed in further detail in Sections III-VII are directed at the problem of achieving telecommunications price reform.

The reform of telecommunications prices in Mexico involves issues of great complexity and importance.

Pricing policies have a significant bearing on whether TELMEX and SCT will be able to generate the financial resources necessary for the future development of the Mexican telecommunications infrastructure. Moreover, current pricing arrangements are not well-suited for the increasingly complex and competitive telecommunications environment that is emerging world-wide and is inevitably transforming the Mexican telecommunications sector as well.

Such pricing arrangements are very likely to distort a growing number of crucial decisions that must be made by government policymakers, service providers and users concerning investments in, and the utilization of, different types of telecommunications facilities and services. It is widely accepted, for example, that Mexican prices for international and intercity public switched services are set at levels well above their costs and in excess of prices levels prevailing in major industrialized countries including, in particular, the United States. By contrast, local exchange prices are viewed as recovering only a very small proportion of their costs -- generally a lower percentage of their costs than is the case in other countries. The prices for private line services available from SCT may be set closer to their costs, many believe, and certainly represent a more desirable alternative for large business users than the use of public switched network services or other services currently offered by TELMEX.

The consequences of current pricing policies are, of course, difficult to document with precision. However, many believe that local exchange services are not yielding sufficient revenues to support future network expansion. High price levels for intercity and international services are seen as repressing demand for such services; and they are also viewed as severely handicapping large business users who depend on telecommunications services to survive and expand in an ever-more competitive global economy.

Moreover, many observers are convinced that price disparities between functionally similar services -- between private line and public switched services -- skew choices by users with respect to such services and distort the flow of investment funds into the telecommunications sector. Few are confident as well that "internal subsidies" embedded in existing price structures are an efficient or desirable means of isolating and targeting funds for achieving equity-related or other social objectives with respect to the Mexican telecommunications infrastructure.

Certainly, no one who has dealt with the complex process of price reform now underway in many if not most industrialized countries believes that efficient, cost-based pricing arrangements can be achieved with scientific precision. Issues of cost accounting and cost allocation bedevil and frustrate policymakers everywhere. In the United States especially, policymakers have grown very skeptical about the efficacy of the regulatory process and have relied heavily on competitive entry policies to assure cost-based pricing in the telecommunications sector. Elsewhere, but often even in the United States, when policymakers are unable or unwilling to rely on open entry policies to achieve cost-based pricing, they have had to come to grips with the imperfect art of regulatory oversight of telecommunications pricing.

Thus, the challenge facing Mexican policymakers is to move rapidly toward more cost-based prices -- or at least prices more in align with international price levels -- through a mix of traditional price regulation and market structures increasingly based on open entry. At the same time policymakers must acknowledge and cope with the limitations of both regulatory and open entry policies as instruments for achieving price reform.

In the Mexican context as elsewhere, complete reliance on open entry policies is neither immediately achievable, nor even, more importantly, a desired or politically acceptable policy outcome. However, given the absence of any well-developed Mexican tradition of price regulation as well as the inherent limitations of the regulatory process, price reform cannot be expected to evolve inexorably from regulatory initiatives alone.

The policy initiatives outlined in subsequent sections of this paper take full account of the importance of achieving price reform; but they are also based on the perspective that neither new competitive initiatives nor more efficient regulation hold out promise for any simplistic solutions to the urgent need for far-reaching price reform in the Mexican telecommunications sector.

2. Reforming Tax Policy in the Telecommunications Sector:

As integral part of the process of achieving telecommunications price reform, the current scheme of value added and other special taxes applicable to the telecommunications services of TELMEX must also be thoroughly reassessed.

These taxes on particular services offered by TELMEX often equal or exceed the prices that TELMEX charges subscribers for such services. Though these special taxes were originally intended as a means of earmarking funds for reinvestment in the telecommunications sector, the government has increasingly relied on special tax revenues from telecommunications services to meet its general revenue needs. Such taxes do not apply to private line or satellite networking services offered by SCT; and thus they figure importantly in the choice that large users make between the private line services of SCT and the public switched network services of TELMEX.

Any discussion of future tax policy for the telecommunications sector must take account of a number of different objectives that the Mexican government has been pursuing through the existing scheme of special telecommunications taxes. It has variously been seeking to: (1) finance the operational and long-term investment requirements of TELMEX and SCT, (2) finance uneconomic investments necessary to offer services in remote areas throughout Mexico, and (3) generate revenues to support the state budget.

A crucial question is whether current tax policies are effective in achieving any of these various objectives. Many observers believe, for example, that reductions of prices for intercity and international services along with elimination of value-added taxes on telecommunications services would stimulate demand for such services and significantly increase TELMEX's revenues and profitability. In this view, lost revenues from special taxes would be offset by increased income taxes paid by TELMEX. The same net transfer payments might well be made by TELMEX to the government; but TELMEX and telecommunications users would reap the benefits of more efficient pricing arrangements.

3. Restructuring TELMEX's Relationship with the State:

Issues of tax and price reform are also intertwined with the need to restructure TELMEX's relationship with the state.

Whether or not TELMEX is privatized, policymakers believe that it is crucially important to allow TELMEX to operate on a more independent and business-like basis. TELMEX would continue to have public obligations; but such obligations would be imposed on a more arms length and transparent basis through explicit government regulations and tax policies applicable to other business organizations.

Such an arm's length relationship between TELMEX and the government is important for a number of reasons.

First, Telmex should have more leeway to funnel resources into investments in the telecommunications infrastructure; and it should be able to orient its energies more toward its customers rather than the complex and often shifting priorities of government policymakers.

Second, a more arm's length relationship between TELMEX and the government is necessary because of the demands of an emerging competitive telecommunications market in Mexico. TELMEX is now facing increasing competition from new service providers from the private sector and even from SCT. The new competitive environment must be fair for new entrants and must not be biased because of the government's ownership stake in TELMEX and SCT. But, TELMEX must also have the flexibility to respond to its competitors and must not be burdened by public obligations that are not viable in a more competitive market.

4. Separating the Regulatory and Entrepreneurial Roles of the State:

There is thus a widely perceived need to establish an effective and independent regulatory mechanism to oversee TELMEX's and SCT's relationship with the state and to establish the "rules of the game" for an increasing number of new suppliers of telecommunications services.

More and more, new service providers will be offering services and equipment in competition with SCT and TELMEX. Thus, many policymakers agree that an independent referee must establish new competition policies. SCT now has a dual role as regulator and service provider and thus is widely viewed as not the appropriate entity, at least as it is now structured, to function as an independent regulatory overseer of future Mexican telecommunications arrangements.

In addition, as Mexican telecommunications policies begin to affect a larger number of interested parties -- new service providers and users alike -- it is essential, many observers believe, to make the process of establishing the rules of the new competitive environment more open and transparent. Those affected by regulation want prior notice of any new regulations and an opportunity to influence the outcome of the regulatory process.

5. Devising New Competition Policies:

Mexican policymakers are well aware that technological and economic pressures are giving rise to more liberal telecommunications policies around the world. They recognize that Mexico cannot isolate itself from these developments and remain competitive in the global economy.

Policymakers in Mexico must wrestle with a number of difficult issues involving the competitive relationship of TELMEX and SCT, and in particular their respective roles as providers of data services. Because of the growing demand by users for information related and data processing services, it is no longer realistic to restrict TELMEX from offering data access and transmission services over its network infrastructure.

The role of new entrants in offering services in competition with TELMEX and SCT must also be defined. Policymakers must as well address how much leeway users of telecommunications services should have to meet their own communications needs and those of other entities with which they regularly transact business.

Many large users now have considerable latitude to meet their own needs by installing private communications networks. However, policymakers will need to focus on how to assure that equivalent options are available to small and medium sized firms as well.

In a very fundamental way, Mexican policymakers must now redefine the roles of established service providers, new service providers, and users in financing and operating a wide range of telecommunications services. Many of the policy issues delineated in subsequent sections of this paper focus in detail on how new competitive rules of the game should be defined and on what the roles of established service providers, new entrants, and users in the provision of future telecommunications services should be.

6. Modernizing the Entrepreneurial Structure of TELMEX and SCT:

Confronted with intensified competition in the telecommunications sector, TELMEX and SCT must be able to function like efficiently managed business enterprises even if they remain state-owned and controlled.

SCT offers telecommunications services to the public through a variety of entrepreneurial and institutional arrangements. A thorough management review of SCT's business activities may be necessary to assure that SCT's future infrastructure investments are well-targeted and efficiently managed.

TELMEX is already in the midst of a far-reaching reorganization. Among its major challenges are to deal effectively with its labor-management relationships and to establish new management arrangements that allow it to be more responsive to the needs of its customers.

In isolation, the process of institutional modernization of SCT and TELMEX would be an extraordinarily demanding and complex task. However, this process is rendered even more difficult because of the need concurrently to reassess the relationship of SCT and TELMEX to the state, to reform the telecommunications price structure, and to redefine the competitive rules of the game between SCT and TELMEX and between these two entities and other potential service providers and users.

7. Assuring that Telecommunications Policy Promotes the Needs of Users and the Growth of the Mexican Economy:

Many Mexican users of telecommunications services believe that policymakers have long been too preoccupied with a set of issues involving the inter-relationship of the two major Mexican telecommunications service providers -- SCT and TELMEX. They believe that telecommunications policy should be set in a broader context and should seek first and foremost to promote the competitiveness of business users dependent on telecommunications services and to stimulate the growth of the economy as a whole.

For example, many users believe that it is essential to increase their access to critical information-related and data processing services. They view, as a matter of secondary concern, whether the availability of such new services might adversely affect SCT's current business activities. Likewise, users would like to see fewer restrictions on the use of leased lines provided by SCT. They do not believe that the possibility that such liberal policies might adversely affect TELMEX should be the determinative factor in setting national telecommunications policy.

8. Assuring Additional Investment Capital and New Centers of Entrepreneurial Initiative:

As noted at the outset, one of the key challenges facing Mexican policymakers is to assure that the price structure for telecommunications services generates adequate financing for future infrastructure investments by TELMEX and SCT. However, price reform is very likely to be a slow and arduous process; and the internally generated cash flows of TELMEX and SCT may not prove to be adequate to meet projected investment requirements. Even if the projected levels of investment funds prove to be attainable, some observers question whether TELMEX and SCT can manage efficiently and effectively the substantially increased levels of investment in new plant and facilities that is planned.

Policymakers may thus have a critical stake in identifying new mechanisms for tapping private sector investment capital. They may also have an interest in exploring new management structures or institutional arrangements for installing telecommunications plant and facilities. One option may be to allow large users and other state-owned entities or corporations greater leeway to invest in and install telecommunications infrastructure that could be utilized by SCT and TELMEX to offer services to the public. Several specific options for attracting such new investment funds are set forth in subsequent sections of this paper.

9. Protecting Important Social Objectives for the Mexican Telecommunications Infrastructure:

Policymakers generally recognize the importance of reforming pricing policies, improving the competitiveness of TELMEX and SCT, devising new competition policies, and increasing the responsiveness of telecommunications providers to the needs of large business users. Such policies are, however, very likely to link more closely the prices and the costs of telecommunications services. They will certainly create pressure to increase the prices of services provided to residential and local exchange users and to users located in rural areas.

As a result of many of the policy initiatives outlined below, services that have traditionally been seen as subsidizing uneconomic services will be exposed to competition. And competition is likely to reduce policymakers' ability to depend on subsidies for uneconomic services that may have been embedded in traditional pricing structures.

Policies that are intended to increase the efficiency and competitiveness in the telecommunications sector will, therefore, bring into sharp focus the need for new policies to assure social equity with respect to the telecommunications infrastructure. Subsidies for rural telecommunications development will have to become more transparent and visible; indeed, many countries have already begun to devise such new and more open subsidy mechanisms to finance services in high cost rural areas.

Future Mexican pricing policies for local exchange services might, for example, include imaginative "two-tier" features. Such two-tier pricing arrangements might allow upward price adjustments for new digital local exchange services for business users and high-income residential subscribers but result in more gradual price adjustments for subscribers of existing local exchange services.

In the long-run, a transition toward more efficient and cost-based pricing arrangements may be more likely to promote the "universal" development of the telecommunications infrastructure than current pricing policies. New pricing arrangements should stimulate demand for, and revenues from, telecommunications services important to the business community; and ultimately the availability of efficiently priced telecommunications services should stimulate growth in the Mexican economy.

Policies stimulating growth of the telecommunications infrastructure and of the economy as a whole -- which should in turn stimulate demand for further investment in the telecommunications infrastructure -- may well be, in the final analysis, the best guarantee of the universal availability of the Mexican telecommunications infrastructure. Faced with limited investment resources in the short term, policymakers may need to target funds and to maximize any "multiplier effects" of such investments in the telecommunications sector and the economy as a whole.

Ultimately, new policies to assure social equity with respect to the telecommunications infrastructure are needed because past policies based on reliance on internal subsidies have not worked effectively. The size of embedded subsidies has always been difficult to measure; and there is little or no reason to believe that such subsidies have been well-targeted at crucial social needs and priorities. Finally, it has always been relatively easy for government policymakers to divert funds earmarked for "uneconomic" infrastructure development toward other public needs.

As noted above, any hope of continuing to rely on past policies for assuring universal service is already being eroded by competitive pressures on existing price structures. Thus, delay in implementing pricing and other reforms -- on the ground that such policies would undermine traditional commitments to "universal service" and social equity -- is likely only to weaken TELMEX and SCT as well as the competitive position of Mexican users of telecommunications services. Such a result would certainly set back, many believe, any real prospect of ever assuring the universal availability of the Mexican telecommunications infrastructure.

Thus, policies that attach high priority to the rapid restructuring and modernization of the Mexican telecommunications sector may ultimately be the best hope for, and the first important step toward, new initiatives to assure equitable availability of telecommunications services in the Mexico. Though many of the initiatives outlined below focus primarily on increasing efficiency and competitiveness, they should not be viewed as in fundamental conflict with achievement of important social policy objectives. Devising imaginative new policies to promote rural telecommunications can and should go hand in hand with any major new initiative to reform and restructure the Mexican telecommunications sector.

The following sections of this paper describe in more detail some of the major policy issues that have been generally outlined above.

III. ISSUES RELATING TO FUTURE MEXICAN REGULATORY POLICY

1. Separating Regulatory and Operational Activities of SCT

Currently, SCT is not only a major provider of telecommunications services to Mexican users, but is also the primary agency with responsibility for telecommunications regulation. Though operational and regulatory functions are separated into different divisions of the

SCT, ultimately the same senior-level officials have responsibility for the economic viability of SCT's business activities and for establishing the terms and conditions with respect to which other entities might compete with SCT. Consequently, senior officials are confronted with inherent and unavoidable conflicts of interest; and there may be some risk that SCT might protect SCT's own business activities at the expense of overall sectoral development.

There are no doubt be a number of options for increasing the separation of SCT's two conflicting roles. One option may be to spin SCT's business activities out into one or more parastatal-like activities, increase the entrepreneurial autonomy of these entities, but leave the Secretary with oversight of such entities. Another option might be to shift oversight responsibility for SCT's operational activities to a government body with responsibility for overseeing the Mexican government's investments in the telecommunications sector. Finally, of course, SCT's business activities could be privatized or could be structured to facilitate investment by private sector investors or by state-owned holding companies. All of these various options need to be assessed in greater detail.

Policy issues raised by increasing the separation of the regulatory and operational responsibilities of SCT are, of course, integrally related to the question of how the business activities of SCT are to be organized and managed. See III.1 and III.4 below.

2. <u>Integrating Various Regulatory Activities Now Dispersed Among Various Agencies</u>

Various regulatory functions affecting the activities of TELMEX, in particular, are now widely dispersed within the Mexican government. The SCT and the Secretaria de Hacienda y Credito Publico (SHCP) both have an important role in setting rates levels and tariff structures for TELMEX. In many countries, such tariff oversight and rate setting functions are concentrated in a single agency.

One policy option would be to concentrate regulatory policy in a single, separate regulatory body. It may be difficult, however, to transfer to a new regulatory entity functions that are in fact integrally related to SHCP's mandate as overseer of government fiscal policy. SHCP's role could be focused on the aggregate effects of tariff policy on government revenues; and SCT would have primary responsibility for such matters as (1) setting rate levels and structures, (2) adopting and implementing cost accounting systems, (3) assuring the compliance of rate levels and structures with prescribed cost allocation procedures, (4) assessing the impact of rates on users and competitors to SCT and TELMEX, and (5) resolving disputes and controversies over rate-related matters.

3. <u>Establishing a Regulatory Process Not a Regulatory Institution Per Se</u>

It may well be less important to establish a new formal regulatory institution than to initiate new procedures to deal with critical and long-lingering regulatory concerns. For example, policy makers should focus on how to deal in the short-term with pressing issues relating to the price structures of TELMEX services. Practical steps should be taken to establish new accounting procedures, cost allocation standards, and new price structures as a matter of first priority. These tasks should not be delayed until a new regulatory mechanism is established.

Restructuring TELMEX's prices obviously involves many high level political and policy considerations. Senior level officials at SCT, SHCP, TELMEX, and the Secretaria de Programacion y Presupuesto (SPP) must all agree on a new pricing scheme. However, new price structures must be addressed at a technocratic level as well. Political and technocratic processes must evolve in tandem.

Telecommunications regulatory policy in Mexico, as elsewhere, must necessarily reflect a number of different areas of policy concern: overall economic policy, budgetary and fiscal policy, competition policy, international trade policy, among others. It is essential to establish an effective coordinating process among key government ministries that brings these different perspectives to bear on officials who have specific responsibility for Mexican telecommunications policy.

4. Establishing a Transparent Mechanism for Meshing Divergent Policy Perspectives

Regulatory policy should openly acknowledge and highlight controversies arising from varying policy perspectives within the government, from divergent interests among telecommunications service providers and from differing viewpoints between service providers and users.

Currently, many such policy conflicts may be internalized within one or more government agencies or hidden from the view of all interested parties. There may be much benefit in openly surfacing policy differences and allowing wider participation in key policy choices, particularly by telecommunications users.

Opening the policymaking process means reliance on some set of procedures that make important policy choices more visible. Such measures would include public or broader circulation of policy papers, prior notice of key policy issues, and opportunities for discussion and comment by all interested parties.

Whether and how such more open procedures are utilized may depend substantially on the particular issues being addressed. Issues of rate structure for TELMEX do not merely affect government revenues; they affect users as well.

Any regulations affecting the terms and conditions of use of telecommunications service, i.e., public switched services or private line services, should probably be open for public comment before any such regulations are adopted as government policy.

5. Establishing Procedures for Addressing the Price Structure for TELMEX and SCT Services

As will be noted in further detail below, the current price structure of TELMEX's services is seriously distorted. As in many countries around the world, local exchange services recover only a small percentage of their costs; long distance and particularly international services are set at levels well in excess of their costs.

(Prices for international services may recover two or three times their cost.)

The necessary direction of tariff realignment is not in dispute; however, rate structure reform should be premised upon the establishment of better accounting systems, better cost allocation criteria, and more effective means of assessing the revenue-cost relationships of various services on an ongoing basis.

Pricing of TELMEX's services is also distorted by the fact that value added and other special telephone taxes represent such a substantial portion of the total price paid by telephone users. Prices should be based on the real cost of service not an artificial construct of the price of telephone services plus taxes.

SCT's pricing policies may also warrant close scrutiny. It is not clear whether prices for use of the Morelos satellite system are substantially cost-based. Below cost pricing of SCT's services would tend to skew the choices of users between services offered by SCT and any services that are now, or might in the future, be offered by TELMEX.

For example, with respect to interexchange services, it is apparent that private line circuits available from SCT are priced closer to their real cost than are public switched services offered by TELMEX. Such price differentials that are deeply embedded in the existing price structure affect the choice of users with respect to service options. As is discussed in greater detail below, in the short-term it may be useful, and even necessary, to exploit and "institutionalize" embedded price discriminations, as a transitional step in a process of reforming the existing price structure for the telecommunications services.

6. Refining Policies with Respect to the Provision of Underlying Infrastructure Facilities and the Provision of Services to End Users

As a central element of telecommunications policy reforms now underway in many countries, a distinction has been established between the provision of the physical infrastructure for offering telecommunications services, *i.e.*, the provision of coaxial or fiber optic cables or satellite services, and the provision of services to end users. Varying degrees of competition with respect to the provision of infrastructure, on the one hand, and the provision of services, on the other hand, are allowed in different countries.

Such a policy distinction is part of current arrangements in Mexico. SCT, for example, operates both as a facilities provider to TELMEX and as an offeror of services; *i.e.*, private line and satellite services to end users. However, future Mexican policy options might be refined and sharpened by assessing in a more structured way (1) which entities will be authorized to engage in the provision of underlying facilities and in the provision of services to end users and (2) under what terms and conditions they will be allowed to do so.

For example, new entities might be authorized to market or resell services utilizing existing facilities offered by TELMEX or SCT. Moreover, while fully acknowledging the importance of economies of scale and the need for efficiency in the provision of infrastructure, it may still be desirable to allow a greater range of participants to make investments in facilities infrastructure. Such investments could be authorized without impairing, for example, any exclusive role of TELMEX as a provider of public switched long distance services or of SCT as a provider of leased private line services. Some options for increasing private sector investment in the provision of facilities infrastructure are discussed in Section V below.

A number of issues concerning arrangements for the provision of services -- as opposed to the provision of facilities -- are discussed below.

7. Liberalizing the Terms and Conditions of Use of Private Line Services

Currently, the Mexican regulatory scheme places substantial importance on a distinction between public services and private line services.[2] SCT offers private line voice and data services to users as well as some public switched data services; TELMEX offers only public switched voice services and is apparently restricted from offering private line services.

Under current guidelines of the SCT, users are allowed to connect their own subsidiaries to a leased private line. However, SCT sometimes expresses concern about connecting legally separate entities that are under common legal control. On an ad hoc basis, private line customers may also be able to connect to their private line networks affiliated entities that are not commonly owned, such as dealers or distributors.

---

2. Such a distinction is commonplace in telecommunications regulation around the world. The so-called D Series Recommendations of the Consultative Committee on International Telegraph and Telephone ("CCITT") of the International Telecommunications Union ("ITU") attempt to establish a line of demarcation between private line services and public switched telecommunications services.

SCT might be well advised to develop a more liberal and transparent set of principles for the provision of private line services. It is unlikely to be easy or feasible to adopt a sharp distinction between private line services and services to "third parties". Instead, SCT should probably continue to apply a liberal interpretation to guidelines with respect to use of leased circuits. It should generally view with favor requests to interconnect private line networks to additional users and to TELMEX's public switched network services where such additional interconnection arrangements promote a business activity of the customer of the leased line service other than pure resale of such private line service.

Thus, SCT might well consider adopting a policy of allowing private line users free access to local exchange services offered by TELMEX at both ends of a leased circuit where such services would not be utilized by the customer to make a public offering of public switched voice service directly competitive with TELMEX's services. Such interconnection practices would, of course, permit private line circuits to be utilized as a functional equivalent of TELMEX's public switched telephone services.

Though such a liberal interconnection policy would result in some circumvention by a limited number of users of TELMEX's existing public switched tariff structures, such a result might not necessarily be detrimental in the long run. It might, in fact, be a step in the direction of an urgently needed reform of the current telephone price structure. Since private line services are not subject to the value added or special telephone taxes applicable to long distance services and are priced on a more cost-related basis, a liberal interconnection policy would allow business users to benefit from more efficiently priced long distance services while an overall realignment of TELMEX's price structure is undertaken.

In order to deal with any possible adverse revenue consequences for TELMEX, a number of steps might be considered. First, any new and liberalized policy of interconnecting private lines to the switched network might be conditioned upon the implementation of access tariffs fixed at a higher rate than ordinary local exchange tariffs. Second, the benefits of offering such "enhanced" private network services might be extended to TELMEX which is currently restricted with respect to the specialized private line and data services that it can offer its customers.

TELMEX might initially be allowed to market Morelos satellite services to its customers. In this role, TELMEX would act simply as a sales agent for SCT. As is discussed more fully below, it may be desirable to allow TELMEX to market to its larger business customers any new fiber optic or terrestrial microwave services it installs. Customers should in principle have a choice of utilizing either satellite-based or terrestrial services in establishing private networks.

8. <u>Liberalizing the Terms and Conditions of Access to the Morelos Satellite System in Order to Allow Small and Medium Sized Firms to Have Access to Private Network Services</u>

Large Mexican firms are now actively and effectively utilizing the Morelos satellite to establish private network services. In order to assure their competitiveness, small and mid-sized firms should be allowed to have comparable access to such communications services and to share satellite channels and earth stations.

Such sharing arrangements might be arranged through a nonprofit or cooperative organization that might provide assurances against pure resale of communications services by a third party for a profit and against overly aggressive exploitation of disparities between existing private line and public switched tariff structures. The cooperative or nonprofit entity would assure the sharing of satellite circuits by groups of companies with common business or other close affiliations. When sharing of voice and data services is permitted by nonprofit intermediaries formed by users, entities unaffiliated with such users should be allowed to manage the facilities and make available technical and organizational resources that may not necessarily be readily available to users.

Such sharing arrangements would undoubtedly create pressure for accelerated reform of TELMEX's price structure. Such a policy should certainly not be viewed as a substitute for comprehensive price reform but as an interim measure to afford earlier and more equitable access by business users to the benefits of a more efficient and cost-based price structure.

9. Liberalizing the Provision of Information-Based Services and Value-Added Services but Should Not Restrict Service-Based Competition to Data Services

Many industrialized countries have recently liberalized the provision of information services and so-called value-added or enhanced services. Mexican policymakers should consider taking similar steps as a matter of high priority; however, they should not necessarily restrict the scope of service-based competition to non-voice services.

As a first step, as discussed further in III.2 below, SCT should not restrict or limit in any way the provision of reservations or information services competitive with similar services it offers. There is little justification for a monopoly with respect to reservations services offered to third parties; indeed, the ready availability of such services may be essential to stimulating the travel and tourism sectors of the Mexican economy.

In addition, no restrictive licensing policies should be applicable to pure remote access data processing services. Such service providers should have the option of utilizing public packet switching services or leasing private line circuits to offer services to the public.

Many countries are now struggling with how to define the scope of value added services. It may not be desirable, however, to adopt a restrictive definition of such services and to insist, as have some European countries, that such services include any minimum percentage of data processing services.

As suggested in II.7 and II.8, it may be desirable to permit limited resale of both data and voice services by nonprofit or cooperative intermediaries and by users of leased private line circuits.

Such policies for liberalizing the provision of private network and value added services exceed in scope reforms now being implemented in Europe. However, European style reforms should not necessarily be the benchmark for changes in Mexican telecommunications policy. In Mexico there may well be an urgent need to initiate, even on a "piece-meal" basis, reforms that will accelerate the reform of the existing price structure and quickly improve the access of Mexican firms to efficiently priced telecommunications services, and hence their overall competitiveness.

10. <u>Considering Other Measures to Initiate "Piece-Meal" Price Reform for a New Generation of Digital Local Exchange Services</u>

The steps toward liberalization of private line services are intended both to make available new services and to initiate "piece-meal" changes in prices of interexchange services applicable to certain groups of users.

It may also be possible to implement reforms of local exchange pricing on a similar basis, as is discussed as well in IV.2 and V.3 below. For example, as new digital exchanges are installed in various parts of

TELMEX's local network, it may be desirable and useful to establish a new category of service and new rate structures for such services as well. For example, it might be possible to restructure prices for digital exchange services and provide for recovery of nontraffic sensitive investment in local loops through a so-called subscriber line charge. Since digital exchanges may be first installed in metropolitan areas and areas with a high concentration of business and higher income residential users, higher local exchange charges may have progressive income distribution effects. New pricing arrangements would be intended to facilitate further expansion and growth of the network to serve less affluent users.

Options for channeling additional private sector investment into digital exchange services that are an "overlay" on the existing exchange network are set forth in V.3.

11. Rationalizing the Roles of SCT and TELMEX As Separate Providers of Voice and Data Services

Under current regulatory arrangements, TELMEX is restricted to offering local exchange and inter-exchange public switched services. SCT provides private lines for voice and data services as well as various switched data services including public packet switching services.

As outlined above, and subject to possible further reforms in the way in which SCT might offer services as described in III.1, SCT's private line services would increasingly offer services that are in some respects functionally equivalent to TELMEX's public switched services. Any adverse impact of such new service offerings by SCT on TELMEX could be mitigated, as suggested above, by establishing access charges for use of TELMEX's local exchange network.

Offsetting this shift in the current boundary between the services available from SCT and TELMEX should be a clarification of TELMEX's role in offering data related services. The local exchange network is now vital to obtaining local access to many information-based services. Local exchange and long distance services are already substantially utilized for facsimile services. However, current regulatory practice does not explicitly acknowledge TELMEX's role in offering local data access for facsimile and PC to PC communications services.

TELMEX should be able to assist its customers in utilizing its local exchange network for data access services. Many users also have needs for local private line services that do not seem to be adequately fulfilled by SCT. TELMEX should be authorized to assist in meeting these important customer needs.

Moreover, if there is liberalization of the terms and conditions under which private leased circuits can be utilized and if the provision of value added services is authorized, Mexican policymakers must decide what TELMEX's role in offering such services should be. If entities other than SCT are authorized to offer such services, then there is much to be said for allowing TELMEX to do so as well. In that event, TELMEX might be allowed to offer such services subject to various regulatory safeguards to assure fair competition. For example, it might offer "private network" or "managed network services" through a separate subsidiary. This subsidiary would have its own accounts, offer services on a cost-related basis, and obtain access to local exchange and interexchange transmission services on an arms length basis. Such safeguards would assure that revenues generated by, or needed for, local exchange services could not be diverted for use in offering new competitive services.

IV. STRUCTURE OF THE SECRETARIA DE COMMUNICACIONES Y TRANSPORTES (SCT)

The preceding section outlines a number of shifts in regulatory policies and procedures that might affect the future operation and structure of SCT. There are a number of policy issues specifically affecting SCT that may warrant further discussion and dialogue. These issues are set forth briefly below.

1. Reviewing the Management Structure of, and Arrangements for, the Various Operational Activities of SCT

At the present time, there are a number of different management structures and arrangements for the services offered by SCT. As a result of recent reforms, postal, telex, and telereservations activities are provided through separate business units that report directly to the Secretary of SCT. By contrast, the Morelos satellite system and leased circuit services offered by SCT are under the control of a directorate within the SCT.

One option may be to place the now burgeoning business activities of the group in charge of the Morelos satellite in a separate corporate entity owned by the state. The AUSSAT, the government-owned corporation that operates the Australian national satellite system, and Telesat Canada are two examples of separate business organizations that offer satellite-based services in competition with providers of terrestrial services.

Among the issues to be addressed by Mexican policymakers is whether the leasing of terrestrial circuits by SCT should be included in the same business group. Another issue concerns how any new business entity might handle its role as a wholesaler to third parties and as provider of end to end services to users. As suggested in II.7 and II.8 above, entities might well be authorized to provide specialized private networks, for example, where satellite services are shared by groups of users. If TELMEX is allowed to offer satellite circuits to its customers, then SCT's Morelos services would in effect be marketed on a wholesale basis through TELMEX.

In the event SCT's services are offered both on a wholesale and retail basis, tariffs for various elements of satellite-based private networks will have to be restructured and unbundled. As noted elsewhere, efforts will have to be made to assure that prices for Morelos services are cost-based if TELMEX is ever allowed to compete with SCT's Morelos services by offering specialized private line networks utilizing its existing microwave or its planned fiber optic network.

2. Appraising Future Business Prospects for Some of SCT's Services and Developing Transition Plans

Some of SCT's current services such as telegraph and telex services may face an increasingly hostile market environment. Facsimile, PC-to-PC services, and various electronic mail offerings that can be offered with increasing ease over the switched telephone network are likely to slow considerably the future growth of some of SCT's public switched data services.

Close scrutiny of each of these lines of business may be essential to assure that necessary cost efficiencies are achieved and future investments with respect to these services are well-targeted.

Mexican policymakers should explicitly recognize that telex, telegraph, and other public switched data services are not necessarily on the ascendancy around the world and that transition plans may be required to deal with these business operations.

As noted in II.9, the current restrictive climate with respect to the offering of reservations services to third parties may not well serve the needs of the Mexican travel and tourist industries for a diverse array of information-based and reservations services. These lines of business within SCT are likely to need to be braced to accept a more competitive environment.

3. <u>Converting SCT into a Body with only Regulatory and Policy Related Roles</u>

As outlined in Section II.1. above, a number of options exist with respect to separating SCT's operational and regulatory roles. However, it may be worthwhile to focus SCT entirely on policy related and regulatory roles.

Devising future regulatory policies and structural arrangements in the telecommunications sector and overseeing the implementation of necessary changes is an immense and important task. It may well warrant the undivided attention of SCT. SCT should have the central role in establishing new arrangements for the sector and should, in particular, focus attention not merely on the performance of service providers but on the effects of new policies on telecommunications users and the economy as a whole.

As noted elsewhere, the Mexican government has a variety of policy interests with respect to the telecommunications sector ranging from, inter alia,

(1) assuring adequate support for the state budget from tax revenues paid by service providers and users;

(2) effectively overseeing the government's investments in the telecommunications sector and managing ventures controlled by the state;

(3) establishing terms and conditions for the provision of telecommunications and information services, some of which may be supplied on a

competitive basis by Mexican and foreign service providers;

(4) establishing a price structure for telecommunications services that is cost-based and allows the future development of the telecommunications infrastructure;

(5) promoting the growth of the Mexican economy and assuring equitable access to telecommunications services throughout the country;

(6) assuring that the Mexican telecommunications sector can adapt to, and hold its own in, a new international trading environment; and

(7) taking full account of labor and employment related consequences of telecommunications policy decisions.

Not all these objectives are fully compatible. Thus, to assure that policymakers carefully evaluate hard policy choices often involving conflicting objectives, it may be very useful to coalesce responsibilities for major differing clusters of policy concerns into separate and distinct centers of policymaking responsibility.

For example, the third and fourth objectives, i.e., overseeing rate structures and establishing the terms and conditions for the provision of facilities and services, are probably the core of the traditional regulatory process and should be one major pole of policymaking responsibility.

Issues affecting the national economy and social equity have often become entangled in the regulatory process since telecommunications price structures have often been utilized to achieve broader social objectives through reliance on embedded cross-subsidies, i.e., support of local services through long distance services or support of high-cost rural services by urban ratepayers. However, the question of assuring adequate financial support for uneconomic but socially desirable investments in telecommunications infrastructure should probably be dealt with through visible subsidies for economically unviable services. As such, support for telecommunications infrastructures development should be dealt with as a separate pole of policy responsibility.

A third pole of policymaking responsibility might involve assuring the efficient management of the state's investments in the telecommunications sector -- its equity interest in TELMEX as well as its interests in the operating businesses of SCT. The government's interest in having well-run, profitable telecommunications enterprises might well be contrary to its interest in maximizing transfer payments from those businesses to the government. Thus, the management of state enterprises represents another separate pole of policy responsibility. Management responsibility for TELMEX and other state-owned telecommunications enterprises might thus be vested in a strong, independent boards of directors; and responsibility to vote the shares in state-owned enterprises might be placed in the hands of a state-controlled holding company or investment trust with a specific mandate to manage effectively public enterprises. Such a holding company might seek to deal on an arms-length basis with other government entities concerned with the telecommunications sector.

Policies with respect to labor and employment matters in TELMEX and the sector as a whole obviously are politically sensitive but also vitally affect the efficiency and overall performance of state-owned enterprises. To the extent feasible, government policy should encourage traditional arms-length, good faith labor-management relationships between TELMEX and its unions.

Any restructuring of SCT's role should probably take full account of these different interests and policy perspectives and assure that these different responsibilities are adequately separated from each other. An effective mechanism should be established under the umbrella of SCT to resolve conflicts among different clusters of interests within the Mexican government. Such a mechanism should allow participation by all interests, including private sector interests, in important policy decisions affecting future industry structure and regulatory policies in the telecommunications sector.

V. STRUCTURE AND FUTURE ACTIVITIES OF TELMEX

TELMEX faces a great challenge. It must provide the future core infrastructure for Mexican telecommunications; but it must generate over $8 billion over the next five years to finance infrastructure development, must modernize its corporate structure, and bring into effect new price structures in the sector.

This preliminary review of future telecommunications policy issues in Mexico can only address superficially the hard policy choices and business strategies that TELMEX should be pursuing in the months and years ahead. It offers only a general framework of concerns upon which attention might be focused.

1. <u>Privatizing TELMEX versus Assuring More Autonomy for TELMEX to Operate Like a Business</u>

Substantial attention of policymakers has been focused on whether TELMEX should be privatized.

Since private investors already hold a minority (49%) interest in TELMEX, the crucial policy issues are likely to center around (1) whether the government should turn over a controlling interest to the private sector, (2) which interests in the private sector might acquire an additional stake in TELMEX, (3) what types of regulatory or other conditions might be imposed on TELMEX in the event the government turns over a controlling interest in the company, and (4) how the work force of TELMEX might react to any government moves toward privatization.

Though issues of the ownership and capital structure of TELMEX are no doubt of great long term importance, it is also evident that other issues such as TELMEX's relationship with the Mexican government, its pricing policies, and its ability to generate the capital needed to expand its network are of very pressing importance. Indeed, such issues would have to be in all likelihood clarified before any sale of the government's interest in TELMEX could be successfully undertaken.

In the short run, it may well be more important to assure that TELMEX can operate, as a state owned company, in a more business like way than to embark headlong on what might turn into a very controversial effort to change TELMEX's capital structure. Even without transforming TELMEX from a publicly controlled to a privately controlled entity, there may be other avenues for tapping additional private sector capital necessary to finance the construction of the future Mexican telecommunications infrastructure. See V.1 and V.3 below.

2. Reforming and Rebalancing of TELMEX's Price Structure is of Crucial Importance

As noted elsewhere, the prices of TELMEX's local exchange and long distance services, in particular its international services, are not cost-based. Local exchange services appear to recover approximately a third of the costs incurred in offering such services. By contrast, international services are billed at a premium amounting to two or three times their costs.

This price structure is not an effective means of recovering the cost of past investments and generating revenues for future infrastructure investments. It also produces distorting effects on the utilization of existing infrastructure by encouraging in all likelihood large users to migrate to private line services that are priced closer to their cost. Such pricing practices also favor very large users that can take advantage of private networks at the expense of small to mid-sized firms with no choice but to use public switched network services.

The existing price structure of TELMEX's services is not sustainable over the long term. Cross subsidies of local services by international and long distance services are likely to erode quickly under external pressure from an ever more competitive international environment. Competition among U.S. carriers offering international long distance services to Mexico will drive the prices of such services toward their costs. While such competition will reduce the prices charged by U.S. carriers and not necessarily the prices charged by TELMEX, users will increasingly engage in reverse charging to circumvent high international tariffs charged by TELMEX.

Price reductions for telecommunications services in the U.S. and Canada are also likely to exercise a gravitational pull on the pricing of telecommunications services in Mexico. In recent years, Canadian telecommunications regulators have worried that Canadian users would route services across Canada via U.S. facilities in order to take advantage of lower U.S. rates. As a result, there is now underway in Canada a significant rebalancing of rates -- reductions in long distance rates and increases in local rates. Similar trends can, in fact, be observed in all major industrialized countries as a result of a newly competitive international environment.

The prospects for bypass of Mexican facilities and price structure may not be as critical a concern in Mexico as they are in Canada. Nevertheless, the maintenance of a rate structure for telecommunications services not well aligned with international pricing trends is likely to place Mexican industries dependent on telecommunications and information services at a significant competitive disadvantage in an ever more competitive international economy.

Though there may be a consensus among Mexican policymakers about the need for price structure reform, the problems of implementing the necessary reforms are immense. The disruptive effects of precipitous changes in local exchange pricing could be significant. Local telephone users are not likely to be enthusiastic about price hikes; and the government may be very concerned about revenue losses to the state treasury that might result from reductions in long distance and international tariffs.

Notwithstanding all the obstacles, price reform is a matter of the highest priority for TELMEX and for the entire telecommunications sector. It is an issue that must be addressed both in political as well as technocratic terms. See II.5 above.

A transition plan for phasing in new pricing arrangements needs to be worked out. In the meantime, policymakers should look for means of implementing ad hoc changes in pricing arrangements as outlined in II.7, II.8 and II.9 below.

The pace of price reform also will have an important bearing on TELMEX's ability to generate, through internal cash flow, the funds needed for its future construction plans. If reforms cannot be promptly implemented, targets for infrastructure development might have to be postponed or new means of generating necessary investment funds might have to be identified.

3. Reevaluating Current Consumer Taxes on Telephone Services

Currently telephone services are subject to very high value added and special telephone taxes. These tax revenues were initially intended to be substantially utilized in the construction of new telecommunications infrastructure. Recently, however, the return flow of tax revenues to TELMEX has diminished, and TELMEX is not able to project with any certainty the availability of investment capital for its long-term infrastructure construction plans.

Many observers believe that value added and other special taxes on telephone services should be phased out and that revenue transfers by TELMEX to the government should be effectuated by taxes on TELMEX's income. A combination of price reductions for long distance and international services and a phase-out of telephone taxes would stimulate, it is suggested, increased utilization of TELMEX's network, increased revenues, and hence increased net payments by TELMEX to the government.

4. <u>Making Additional Investment in Infrastructure to Cope with Likely Increased Utilization of the Infrastructure Resulting from Price Reductions for Interexchange Services</u>

Many observers express concern that significant price reductions for long distance or international services could stimulate substantial additional demand and choke existing facilities. Thus, price reform and new infrastructure investment must go hand in hand in this view. Policymakers face a chicken and egg problem since the financing for new infrastructure is substantially dependent on price structure reform.

Policymakers should assess specific options for addressing concerns about the effect of excessive stimulation of demand that might result from cross-the-board price reductions without new infrastructure investment. One approach may be to introduce price reductions through some of the liberalization policies outlined in II.7, II.8, and II.9 above. These steps would produce selective and immediate price reductions for certain users that might be implemented as part of a process of comprehensive price reform. The impact on user demand of these steps may be more limited and easier to predict than the demand stimulation effects of immediate, cross-the-board pricing changes.

5. Dealing with the Effects of Pricing and Tax Reforms on Net Payments by TELMEX to the Government

Changes in price structure and tax policy no doubt create uncertainty about their effect on the flow of net payments by TELMEX to the government.

It would be very useful, therefore, to determine future revenue targets that TELMEX might be expected to meet. On the basis of these targets, policymakers might be able to structure a combination of pricing and tax arrangements, or external guarantees during a transition period, that could reliably produce an agreed-upon net payment to the government by TELMEX.

TELMEX should promptly be put in a position where it can rely, to the greatest extent possible, on firm expectations about its financial obligations to the government and about expected future capital investments by the government in TELMEX.

Reforms in pricing and tax policy are of such importance that substantial attention should be focused on how to minimize the financial risk to the government in implementing such crucial reforms. Perhaps some scheme to guarantee a minimum net payment from TELMEX to the government during a transition period might be devised.

6. Dealing with Crucial Personnel and Staffing Issues

To remain effective and competitive in meeting the needs of large business users, TELMEX must be able to recruit and retain highly skilled staff in several critical areas.

Such personnel, particularly in the fields of marketing and software engineering, often have employment options in the private sector at higher pay levels than may be feasible currently at TELMEX. Even if TELMEX is not privatized, it must be able to compensate key staff at levels competitive with the private sector.

Moreover, to the extent TELMEX offers services that are also available from the private sector, it must be staffed and organized to compete head to head with private sector suppliers. Ultimately, with respect to those activities of TELMEX that are subject to competition, TELMEX's costs and efficiency must be aligned with companies in the private sector.

Many observers are concerned that TELMEX's staffing levels are growing at a faster rate than the number of lines installed. Moreover, it is evident that there is considerable resistance by TELMEX's unions to staff redeployments that may be required by the installation of new generations of technology. Such new equipment may reduce staffing requirements and require new skill levels.

A new dialogue may be required between labor and management with respect to how to increase staffing levels only on a basis commensurate with real expansion in the network infrastructure and in the scale of TELMEX's business activities. Since substantial increases in TELMEX's infrastructure and overall business is the intended result of TELMEX's ambitious investment program, it may be possible to establish mutually acceptable expectations about TELMEX's future staffing needs between labor and management. It may certainly be useful to stimulate a dialogue on the interdependence of the efficient performance of TELMEX, the expansion of economic activity of firms dependent on TELMEX's services, and the consequential expansion of demand for infrastructure services offered by TELMEX.

7. Restructuring TELMEX's Internal Organization

TELMEX has been implementing a number of changes in its internal organization to make it more responsive to its customers and to market pressures in general. It has also utilized separate subsidiaries as a means of offering certain new services that might be available on a competitive basis from private sector suppliers.

According to some observers, TELMEX has not yet fully developed its internal accounting systems and ability to identify with precision the revenues and costs of its various lines of business. TELMEX seems to have taken important strides toward a profit center management scheme. An intensification of TELMEX's efforts in this direction seems very likely to facilitate the role of government officials who must oversee TELMEX's current and pricing arrangements and devise new price structures.

It may also be useful to assess to what extent TELMEX might actively utilize subsidiaries or specialized operating units within TELMEX -- even for certain core or basic services. Such a restructuring effort might contribute toward better cost and revenue management and greater efficiency and productivity in the provision of services offered by such a subsidiary or specialized operating unit. Smaller and separate organizational units might also permit improved labor management relationships and better service for users. In addition, as outlined in V.3, such structures might become vehicles for new private sector investment in TELMEX.

Reliance on subsidiaries or separate business units may not, of course, always be appropriate. Such a business strategy, however, may provide an avenue for "piece-meal" or bottom up institutional revitalization. Such reforms may be able to proceed more rapidly than would be possible in the case of across the board, top down changes in corporate management practices.

8. TELMEX's Role As a Provider of New Services

As outlined in II.11 above, TELMEX's role in providing new data services and specialized services for large users should be promptly clarified.

However, its role in offering all types of new specialized information and anciliary services should be carefully assessed. One issue to be addressed concerns the extent to which TELMEX should focus on the provision of core or basic infrastructure services and allow other entities, particularly private sector entities, to offer new services independently of TELMEX or in joint ventures with TELMEX.

Any new regulatory mechanism should offer an efficient and expeditious process for addressing such important policy questions.

As outlined in V.3 below, TELMEX might usefully explore a range of joint ventures or joint investment arrangements with customers or other potential sources of investment capital for new infrastructure.

VI. NEW MECHANISMS FOR GENERATING PRIVATE SECTOR INVESTMENT IN TELECOMMUNICATIONS INFRASTRUCTURE

Among key policies intended to yield access to new sources of investment in telecommunications infrastructure are the privatization of TELMEX and the generation of increased cash flow by TELMEX through restructuring of its pricing arrangements.

It may also be useful to assess other arrangements for tapping investment resources available from telecommunications users who depend on telecommunications infrastructure in their daily business operations.

A number of different approaches may warrant consideration.

1. Encouraging Cooperative Sharing and Joint Investment Arrangements Among Small to Mid-sized Users of the Morelos Satellite System

In order to expand the range of companies able to utilize the Morelos satellite system for private networking, it might be feasible to encourage joint investments among users in satellite earth stations as well as in local access facilities necessary to connect their premises to earth stations.

Allowing such arrangements would reduce the investment burdens imposed on SCT.

2. Encouraging Investment by Groups of Users in Facilities to Access Interexchange Facilities Offered by TELMEX

In the same way that a user or groups of users might be encouraged to invest in facilities needed to access the Morelos system, such entities might also be allowed to invest in local switching and networking infrastructures needed for access to TELMEX's toll switching facilities. Users now have certain flexibility to offer telecommunications equipment on their own premises. However, government regulatory policy might encourage TELMEX to permit investment in shared tenant systems or local switching concentrators in large office buildings, residential developments, or industrial parks.

Such systems could be managed by a third party or by TELMEX; and installation arrangements could be undertaken subject to review and supervision by TELMEX. However, such arrangements would allow users to take more direct responsibility for the installation of lines to access TELMEX's local exchange or toll switching facilities.

In a similar way, SCT should allow users more flexibility to plan, engineer, and install local microwave or cable channels needed to connect different premises of the same company or the premises of entities with an independent business relationship.

Such initiatives would diversify the resources available to install infrastructure; but they would also be consistent with the ongoing responsibility of SCT or TELMEX as the ultimate service providers. See II.6 above. The premise of the proposed arrangement is that private sector entities would be involved only in the installation of facilities infrastructure and not in the actual provision of services.

3. <u>Joint Ventures between the Private Sector and TELMEX for Installation of New Digital Switching Infrastructure</u>

Another even more far reaching option might be to establish a framework for joint ventures controlled by

TELMEX to offer an overlay of digital switching services on top of existing local exchange services. Such ventures might be utilized, for example, to install new digital local exchange services in the financial district of Mexico City.

Such ventures would provide access to private sector capital; but they would not involve fundamental modification of the current capital structure of TELMEX. This proposal would involve a form of "bottom up privatization" with TELMEX remaining as a state controlled holding company.

This structural arrangement for joint ventures might have a number of advantages worth further exploration. It would permit clear differentiation of existing and new digital local exchange services. Such joint ventures could establish new tariff structures for digital local exchange services based on cost-based pricing principles. See Section II.5 above. Rate levels and structures would differ from those applicable to existing local exchange services. Both the new generation of switching equipment and the new subsidiary structure would provide the rationale for applicability of new rate structures and management practices to new digital services.

The capital structure of new subsidiaries or joint ventures might provide for a variety of options for private investors. For example, private investors might hold nonvoting stock; or options might be provided for repurchase of private sector shares by TELMEX after a specified period of years. Such a repurchase option would allow the new subsidiaries to be folded back into the TELMEX organizational structure. Thus, the new entities might be viewed primarily as a means of facilitating a transition process with respect to the existing organization and pricing structures of TELMEX.

4. Facilitating the Pooling of Infrastructure Facilities Among Other Operating Large Scale Private Networks

A number of government entities or corporations including PEMEX, Ferronales (the National Railway Company), and the Comision Federal de Electricidad (CFE) have under consideration plans for the installation of high capacity communications links.

The National Railway Company is apparently considering the installation of a fiber optic link along its main line between Mexico City and Laredo. At some point PEMEX may install fiber optic links among the major organizational groups in PEMEX that are located in different parts of Mexico.

It may, therefore, be very useful to encourage arrangements for sharing of facilities among TELMEX, SCT, Ferronales, CFE, and these other governmental or quasi-governmental entities.

TELMEX would, of course, continue to have responsibility for offering services to the public; but it could seek to draw on a diverse number of providers of the facilities infrastructure. See II.__.

VII. ASSURING MEXICAN TELECOMMUNICATIONS POLICIES FULLY RESPONSIVE TO THE FUSION OF THE TELECOMMUNICATIONS AND COMPUTER/INFORMATION SERVICE SECTORS

Some observers of the Mexican telecommunications scene believe that past government policy allowed telecommunications or data communications services to become a bottleneck controlling access to vitally needed data processing or information services.

The very importance of data processing services and information services to the business community may have been seen by some Mexican telecommunications officials as the basis for enhancing the value to the user of the communications "access link" to such services -- and ultimately the economic power and visibility of telecommunications services providers.

Mexican telecommunications policy may need to encourage, as a high priority matter, removal of all restrictions on access to computer and information-based services essential to the modernization of the Mexican economy. Telecommunications services providers should be encouraged to view themselves as offering a key factor of production and as facilitating access to information-based and computer processing resources. They should be discouraged from policies that enhance the power of the telecommunications sector at the expense of the rest of the Mexican economy.

It may not be easy to infuse this different policy perspective into the formulation of telecommunications policy in Mexico. A number of policy initiatives may, however, be useful.

First, there are a number of associations of users of different types of computer systems that are relatively well organized in Mexico. Increasingly, the heads of data processing services in large business organizations are also taking responsibility for the management of telecommunications facilities and systems. Data processing experts and associations of computer users, who seem, in fact, far better organized than users of telecommunications services in Mexico, should be actively encouraged to participate in key decisions about the restructuring of the telecommunications sector in Mexico. The interexchange between computer and software experts and the corps of telecommunications engineers that have traditionally dominated Mexican telecommunications policymaking should stimulate the emergence of more innovative and liberal policy options.

Second, the directorate within the Secretaria de Programmacion y Presupuesto (SPP) that is responsible for Mexican information policy should also be encouraged to become more actively involved in the formulation of national telecommunications policy.

VIII. ENCOURAGING THE ACTIVE INVOLVEMENT OF USERS IN THE FORMULATION OF TELECOMMUNICATIONS REGULATORY AND SECTORAL POLICIES

An underlying theme of many of the policy issues discussed above is that telecommunications policy must be reoriented to promote the overall development of the Mexican economy and not merely the interests of telecommunications service providers. Any restructuring of the Mexican telecommunications sector must be undertaken in this broader policy context.

The telecommunications sector cannot grow and flourish unless the Mexican economy as a whole can be revitalized. Increasingly, ready access to efficiently priced, reliable telecommunications and information services is essential to the competitiveness of both manufacturing and service-oriented firms. The round of discussions held by the World Bank Mission with a diverse range of Mexican users confirmed how essential the future of the telecommunications sector is to the business community in Mexico.

Given their huge stake in the future development and success of the telecommunications sector, users should be encouraged to become more active in the telecommunications policymaking process. Both SCT and TELMEX might well encourage the formation of various users groups that could assure greater responsiveness to the needs of users. Currently, many users are fearful that their participation in such users groups could jeopardize their access to communications services essential to their business activities.

It might be well to encourage a series of round table discussions among users and service providers. These discussions might focus on unfulfilled needs and frustrations of users. They could offer an opportunity for service providers to ventilate their future investment plans and to begin to establish a consensus for necessary long term changes in regulatory policies and industry structures.

IX. CONCLUSION

It should be stressed in conclusion that the foregoing summary of policy issues is merely preliminary in nature. Hopefully, these observations will stimulate comments and criticism as well as views and perspectives that are not yet reflected in this discussion paper. These views are certainly not intended as a definitive set of recommendations for policy reform but are offered to contribute to discussions now underway in Mexico.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER III - SECTOR POLICY AND REFORM PROGRAM

b) Implementation of Sector Reforms (Sept. 1989)

DRAFT SEPTEMBER 20, 1989

DISCUSSION PAPER ON TRANSITIONAL ARRANGEMENTS FOR THE RESTRUCTURING OF THE MEXICAN TELECOMMUNICATIONS SECTOR: Some Initiatives to Encourage Institutional and Entrepreneurial Innovation

I. Introduction

The Mexican telecommunications sector is now in the midst of a far-reaching and complex process of restructuring. Whatever decisions are finally reached by Mexican policymakers concerning future industry structure and competitive arrangements, it is critical to focus attention on the process of implementing new sectoral policies. A recent World Bank mission to Mexico, following up on a Bank effort last fall to assess the options and opportunities for policy reform in the telecommunications sector, discussed with sector authorities, a number of specific initiatives to facilitate the transition process. This memorandum is intended to continue the dialogue and to identify specific areas which might warrant follow-up discussion.[1]

---

1. This paper does not reflect Bank policy or recommendations and is prepared only for the purpose of stimulating discussion.

II. Initiatives to Facilitate the Implementation of Reforms

Outlined below are some possible areas for initiatives that would facilitate implementation of reform in the Mexican telecommunications sector.

Among these would be efforts to (1) identify key regulatory issues that must be addressed in the transition process and devise effective dispute resolution procedures for dealing with such issues; (2) address various organizational and long-range planning issues involved in consolidating various telecommunications-related businesses of SCT in a single entrepreneurially oriented business entity; (3) analyze new institutional mechanisms for attracting additional private sector investment, particularly from telecommunications users, to finance telecommunications infrastructure development; and (4) develop mechanisms to intensify the involvement of large users of telecommunications services in the process of sectoral restructuring.

A. Identifying Key Regulatory Issues and Dispute Resolution Procedures:

During recent discussions in Mexico it was evident that there was a keen interest in addressing some specific regulatory issues such as interconnection arrangements between Telmex and new competitors (e.g., providers of value added or cellular services) or between Telmex and established service providers (especially SCT). There was also interest in identifying and assessing a spectrum of broader regulatory issues of importance to the transition process.

There was particular stress during our discussions on how any new regulatory process might work. It was viewed as essential that any such process be well adapted to Mexican administrative and legal traditions but that it must also deal effectively and efficiently with issues raised by new and more competitive industry arrangements in the Mexican telecommunications sector. There was less interest in creating a formal new regulatory apparatus than on devising practical and informal dispute resolution mechanisms. For example, there was considerable focus on how Telmex could be engaged, with oversight by regulatory officials, in a constructive dialogue with users and new competitors with respect to interconnection and pricing issues.

1. Establishing a Diverse Group to Identify Key Transitional Issues

One specific proposal discussed in some detail involved an effort to gather together a group composed of participants from a number of different ministries (SCT, SPP, SHCP, SECOFI), as well as from the operational groups within SCT (currently DGT or a newly designated entity), Telmex, and the user community. Such a group might begin to identify an inventory of key issues that needed to be resolved as well as the timetable and procedures for dealing with such issues. It was agreed that any meeting of such a group would be most productive if short position papers were prepared and circulated beforehand. Out of an initial discussion of the overall scope of issues to be addressed in the transition process might emerge an agreement on procedures for continuing discussions on specific issues.

2. Dealing with Interconnection Issues in a Specific and General Context: Interconnection for New Cellular Radio Competitors

Obviously one of the more pressing concerns facing policymakers involves the terms, conditions, and pricing arrangements for interconnection between Telmex and newly authorized competitors. Such issues may, in fact, emerge most prominently as a result of the implementation of competition with respect to cellular radio services.

Interconnection arrangements for new cellular competitors can and should be dealt with in the broader context of how Telmex will interconnect with other competitive service providers. However, useful insights about resolving interconnection issues _generally_ may be derived from careful observation and oversight of the process of resolving _specific_ controversies involving interconnection of cellular radio competitors.

Thus, it might be very productive for the policy group referred to above to focus its attention early on to interconnection arrangements for cellular services. Such issues have already been confronted in the U.S. and the U.K., as well as other countries like the Federal Republic of Germany and France, where cellular services are being initiated on a competitive basis. These experiences are likely to be quite instructive for Mexican policymakers.

In turn, it may be useful to structure the dialogue between new cellular entrants and Telmex with respect to what technical, operational, and pricing arrangements are being sought by the new entrants and to what is being offered by Telmex. It may be possible to develop some objective benchmarks for determining the reasonableness of any interconnection requests by competitors.

In the longer term, Telmex may be able to structure, with the collaboration of regulatory officials, some transparent mechanisms for identifying various switching configurations essential for interconnection and their cost. The transparency of such mechanisms -- which may be facilitated by developing within Telmex new cost accounting and cost allocation systems -- should increase the effectiveness with which the key parties to any negotiations over interconnection -- Telmex and any new entrants -- can work out their differences.

3. Devising Dispute Resolution Procedures

Even with a properly structured negotiating process, there is a reasonable possibility that the parties will not be able to reach agreement. In the event an informal process fails, it may be useful to establish the parameters of a more structured dispute resolution process to be utilized when negotiations reach an impasse. For example, the two parties might be requested to set forth their positions in brief written submissions. The regulatory body might be able to gather or develop additional information; but ultimately a decision would be taken that would be set forth in writing and explained in clear but brief terms. Some provision might be made for review at the level of the Secretary of C&T, with a possible right of appeal in specified circumstances to the level of the economic cabinet. There exist a number of interesting precedents for such procedures. In Canada, for example, there are options for appeal of decisions of the Canadian regulatory body, the Canadian Radio-Television and Telecommunications Commission both through judicial and political processes.

One objective of any dispute resolution process is surely to encourage to the maximum possible extent the parties to work out their differences and to leave ministerial level officials with a relatively limited review role. Such an approach to the regulatory process would tend to depoliticize most regulatory controversies. It should also minimize the potential for conflict between SCT's regulatory responsibilities and its role as overseer of the government's ownership interests in the telecommunications sector.

4. Dealing with the Broad Spectrum of Interconnection Issues: Assessing the Relevance of ONA Principles in the Mexican Telecommunications Sector

It is likely to be very useful to anticipate the potential range of interconnection requests that might be forthcoming in light of changing sectoral policies.

For example, users with large private networks offered by means of SCT's Morelos satellites or Telmex's leased circuits may be seeking increased flexibility to connect such networks to the switched network. One area to focus discussions of an informal policy group would certainly be the technical, operational, and pricing arrangements for such interconnection. Such discussions would also have to address Telmex's current tariff structure because of the relationship between interconnected private network services and existing public switched network offerings available from Telmex.

Procedures should be devised to allow the identification of potential interconnection needs on the basis of the generic requirements of different categories of service providers and users. Options should also be provided for more individualized discussions between Telmex and new service providers and users. The existence of these two tracks for dealing with interconnection issues should not promote discrimination with respect to interconnection configurations or pricing. Nor should it be allowed to impair the transparency of the overall process of establishing interconnection arrangements.

Both the FCC and the European Commission have had considerable experience in devising informal procedures for working out arrangements for their respective Open Network Architecture (ONA) and Open Network Provision (ONP) initiatives.[2] Given the geographic proximity of the American market, it may be useful to examine the potential applicability of ONA concepts in Mexico and the need to assure compatibility

---

2. The FCC's Open Network Architecture (ONA) arrangement is an initiative arising out of the FCC's Computer III decision. Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry), 104 F.C.C. 2d 958 (1986), recon., 2 F.C.C. Rcd. 3035 (1987), further recon., 3 F.C.C. Rcd. 1135 (1988). Under this initiative, local exchange carriers and, in particular, the Bell Operating Companies are required to unbundle and offer to enhanced service providers and users certain features and functionalities of their local exchange facilities such as automatic number identification and called party. The EC's Open Network Provision (ONP) effort is often compared with the FCC's ONA plans. However, the ONP activities of the EC so far largely involve establishing a framework for the common provision on a community wide basis of the terms and conditions of access to leased line and certain public switched services. Unlike the FCC's ONA plan, European initiatives have not yet proposed significant unbundling of local exchange capabilities.

between data services dependent on ONA capabilities that might operate between the two countries. Such an inquiry would provide a benchmark for determining what aspects of American or other regulatory arrangements for interconnection might be relevant or appropriate to apply in the Mexican context.

A close examination of the pricing and cost allocation and accounting arrangements applicable to interconnection and access arrangements[3] in the U.S. might also be useful. Such an inquiry might sharpen the

---

3. The FCC has dealt with access arrangements for public switched voice services and for nonvoice enhanced services in the context of different regulatory proceedings. Access arrangements for new competitors to AT&T in the public switched voice market such as MCI and Sprint evolved as competition developed in the long distance market. The FCC has exercised broad oversight over the pricing and features that were made available to new competitors; and ultimately these interconnection arrangements were required to be comply with additional requirements to assure nondiscrimination, unbundling, and separate pricing of unbundled features that were imposed in the Modified Final Judgment ("MFJ") ending the Department of Justice's antitrust suit against AT&T. The requirements for switched voice and other access arrangements are set forth in FCC regulations. By contrast, nonvoice access arrangements have been refined in the FCC's Computer II and Computer III decisions, and in particular its Open Network Architecture initiative discussed in note 2 supra. The FCC is now examining how to better integrate the treatment of voice and nonvoice access arrangements in its regulations.

perspective of Mexican policymakers and users with respect to the relevance if any of such regulatory measures in the Mexican context. It should also assist in identifying mechanisms for introducing related regulatory arrangements in Mexico in appropriate circumstances.

Such a policy assessment could be pursued through the preparation of a background briefing paper. It might also be very useful to organize a roundtable symposium with users, service providers, and regulators from the U.S. and Canada as well as other administrations where competitive policies have been introduced.

5. Dealing with Pricing Controversies and Cost Accounting and Cost Allocation Issues

In addition to dealing specifically with controversies over access pricing, it may also be useful to initiate a review of options for dealing with controversies over predatory or unfair pricing practices generally.

Regulators are likely to be concerned first and foremost with the pricing practices of entities with the power to set prices without regard to market pressures. Such pricing practices are likely to fall into two broad categories. One set of concerns center around minimizing the risk of predatory pricing practices that could have a highly detrimental impact on the emergence of the competition in the sector. There may also be concerns that in the process of restructuring local and interexchange prices users may be unfairly burdened with prices unrelated to the cost of providing a particular telecommunications service.

Introducing efficient and practical mechanisms for oversight of pricing practices in an industry sector where regulation has had a limited role is not at all an easy task.

Prior to the initiation of competition in the U.K., there was no existing regulatory tradition, nor did British Telecom have any accounting systems in place to identify the costs of providing different types of services. It was simply unprepared and unable to justify in any sort of a public process its existing pricing practices. There was, however, a convergence between British Telecom's interest in devising more refined internal cost accounting systems and the need on the part of regulatory officials for better cost-related information.

Thus, in the process of sectoral reform in Mexico, it may be useful to assure good coordination between the development of new internal cost accounting systems and procedures at SCT and Telmex and the emerging needs of Mexican regulators for better accounting systems for regulatory purposes. It makes good sense, therefore, to link together a number of transitional initiatives that are important to regulators and service providers alike.

Such initiatives might involve the development of common regulatory and business-oriented cost accounting and cost allocation systems that are focused on demarcations between major lines of business activity, i.e., the provision of (1) terminal equipment, (2) local exchange services in different major geographic areas, (3) public switched interexchange services, (4) specialized private networking activities, and (5) other competitive services.

Such cost allocation benchmarks are likely to be useful to Telmex and SCT as well as entities that depend on the services of these two entities to offer a variety of other services. Moreover, Telmex may wish to assure that its private networking and SCT's satellite services are offered on an equivalent cost-related basis to assure fair competition.

Some development of line of business oriented accounting systems is likely to be necessary even if it is determined that price cap regulation rather than traditional rate regulation is appropriate with respect to various Telmex services. Price cap regulation cannot work effectively unless the initial tariffs subject to a price cap are reasonably related to their costs. Such regulation may also be more effectively introduced if there are initially a number of different baskets of services subject to price caps rather than a single basket with many services.

In the Mexican context, there must, of course, be from the start a careful review of what types of oversight of pricing practices are likely to be necessary or practical. Such oversight is likely to center around the pricing for key "bottleneck" access services offered by Telmex to other service providers, and around prices to end users. Additionally, there may be great utility in having some mechanism for assuring the transparency of the process of restructuring Telmex's rates. Users may be more willing to accept the consequences of substantial price restructuring if they understand that it is based on some benchmark principles and there is some opportunity for them to participate in the process of restructuring prices.

Once there is agreement on the desirable or necessary scope of price regulation, then the availability and effectiveness of various mechanisms for overseeing pricing -- in particular, the utility of price cap regulation -- must also be analyzed.

As in the case of controversies over interconnection, it may be desirable to deal with price-related controversies through informal dispute resolution mechanisms. The service provider might be expected to make available certain accounting and cost allocation data justifying proposed pricing changes and to respond to inquiries concerning such data from affected users. Based on such information, service providers and users might be able to negotiate about rate levels or terms and conditions of service subject to the oversight of regulatory officials.

6. Additional Issues Requiring Attention: Competitive Safeguards and the Relevance of Economic Analysis and Competition Law

Finally, there may be other issues relevant to assuring fair competition in the Mexican telecommunications sector process that will need to be identified and resolved in the transition process. Among such issues might be requirements relating to the disclosure of network-related technical information by entities such as Telmex. Another issue of importance involves the need for restrictions on the use of customer-related information for marketing or other purposes by Telmex subsidiaries offering competitive services.

In establishing new regulatory arrangements, it may also be desirable to consider how to assure that regulatory options are subject to careful analysis of their likely economic consequences. The relevance of competition law principles to the regulatory process should also be assessed. In Mexico, of course, competition law principles are administered by SECOFI but have not traditionally been accorded substantial prominence in the telecommunications sector.

Competition and regulatory policy in the telecommunications sector have been closely related both in the U.S. regulatory process -- and importantly in Europe where competition policy officials (from Directorate General IV of the European Commission) have had an influential role in devising the EC's initiatives in the telecommunications sector. It may be useful, therefore, to consider the degree to which competition policy should be a factor in influencing emerging regulatory policies in the telecom sector in Mexico.

B. Transitional Initiatives Involving SCT

SCT is actually involved in the provision of several telecommunications services. Some of these business units are likely to be placed under the control of a single decentralized entity. Other such business units including those involved in telereservations services (Sertel) and packet switched services might well be privatized.

This reorganization of SCT's operational activities is likely to give rise to a number of complex transitional issues. For example, if the business group offering private network services through the Moreles satellite system is transferred into the decentralized entity, Telegrafos Nationales ("Telenales"), a number of important business related and regulatory issues are likely to be raised. To assure a fair competitive relationship between SCT's private network services and any group within Telmex offering similar services, it will be essential to implement effective line-of-business accounting and cost allocation systems, as noted above. It might well be easier to put in place such accounting safeguards if satellite-based private network services could be established in a separate business unit owned and controlled by Telenales.

Indeed, if SCT's private network business unit is to face vigorous competition from a very commercially oriented group in Telmex, there may even be a case for setting it up as a subsidiary that is government owned but incorporated under private law. Such a structure might ultimately facilitate additional private sector investment or the establishment of joint ventures with private sector entities. A similar assessment might be made with respect to other separate business groups within SCT.

With respect to the telereservations services and packet switching services, which may well be privatized, it may be useful to assess carefully the options for implementing this process. For example, it will be necessary in offering such services to potential purchasers to determine precisely what regulatory conditions will be applicable to the future provision of such services. Though the sale price of such entities might be enhanced by a protected regulatory position, the development of information-related and value-added services in Mexico might be seriously impaired by applying overly restrictive regulatory conditions with respect to the provision of packet switching or telereservations services. Thus, it is likely to be quite important to assure coordinated consideration by SCT, SHCP, and other ministries concerned broadly with economic policy of the issues raised by any spin-off or privatization of some of SCT's business units.

It might well be very productive, therefore, to explore what additional resources might be needed by SCT -- and by the broader group of concerned ministries -- to deal with these transitional issues. In particular, there may well be an interest within SCT in strengthening the capabilities of the newly established entrepreneurial group within SCT to deal with medium and long-term strategic planning issues.

C. Initiatives to Develop New Private Sector Investment to Finance Infrastructure Development

One of the key elements of emerging reforms of the telecommunications sector in Mexico is to stimulate new private sector investment to develop the telecommunications infrastructure. A diverse array of policy initiatives are being pursued, including the privatization of Telmex, the development of "complementary networks" owned and operated by users, and more flexible arrangements for the use of private networks.

The refinement of new institutional mechanisms to attract increased private sector investment in the sector might well be a key part of any program to provide technical assistance and additional resources to implement sectoral reforms. A number of different mechanisms might be examined.

For example, there appears to be interest in encouraging the development by business or residential groups of network facilities complementary to those of Telmex or SCT, particularly (but not only) where important needs cannot be readily met by these two entities. Such network facilities could either be independently operated by a consortium of users and interconnected to existing networks; or alternatively new infrastructure could be planned and financed in consultation with Telmex and SCT but operated as a Telmex or SCT service. In the latter scenario, an independent entrepreneur would be responsible for planning and raising capital for infrastructure but it would not have any direct operational responsibilities after the infrastructure was installed.

Though some such infrastructure investment projects might be initiated in new business or residential developments that currently do not have service, it might also be envisioned that such planning and financing techniques could be utilized to develop "overlay networks" or to rebuild existing network plant.

Reliance on such separate financing of infrastructure development could potentially have a number of advantages. It would allow large business users of telecommunications services to take greater initiative to effectuate the upgrade of telecommunications services in key geographical regions or industry sectors. Additionally, these new entities might also accelerate the introduction of more efficient management and organizational structures within Telmex. For example, such entities could contract with Telmex to obtain key planning and operational expertise. They could also be structured as joint ventures between Telmex and private sector entities interested in investing in infrastructure development projects. As a result of such initiatives, it might be possible to encourage additional private investment and management reform within Telmex on a "bottom up" basis.

In addition, the plans to privatize Telmex seem very likely to proceed ahead in the weeks and months ahead. Though there will no doubt be pressure to complete this process on a high priority basis, it may still be useful to examine a number of financing options that might well complement any effort to bring new private sector investors into Telmex.

For example, in discussion papers prepared by the World Bank last year, it was suggested that in order to gain greater public support for rapid introduction of price increases for local exchange service it might be possible to characterize any incremental payments by subscribers as capital contributions. In this way, subscribers might be given a small equity stake in Telmex and thus might more enthusiastically support any government initiative to privatize Telmex. There appears to be as well potential interest in increasing opportunties for employee stock ownership perhaps through an Employee Stock Option Plan ("ESOP") financing scheme.

Though both an initiative to increase subscriber and employee stock ownership might require careful planning beyond that involved in a private placement or even a traditional public offering, it might be very desirable to consider the inclusion of such ownership options in establishing any plans for privatization of Telmex. Increased ownership options for subscribers and employees might well increase overall public and employee support for reforms in the telecommunications sector. In addition, if such ownership options are ever likely to be seriously considered, it may be necessary to disclose this possibility to potential new investors in a first phase of any effort to privatize Telmex.

A carefully considered long-range financing plan for Telmex is likely to bolster the confidence of investors and ultimately enhance the value of Telmex in the financial market.

In order to assess these various options for financing infrastructure, it may be useful at the outset to determine which options and scenarios might be most useful or desirable. It might, for example, be worthwhile to assemble a small working group drawn from Telmex and perhaps some investment banking firms in order to assess the possibility of financing Telmex infrastructure by utilizing a separate financing units and leaseback of assets to Telmex.

Overall, a working group to deal with issues relating to financing infrastructure might be established. This group could commission studies of the feasibility of various new financing techniques and evaluate specific new financing proposals presented by the private sector.

D. Initiatives to Encourage Greater Involvement by Users of Telecommunications Services

Though the initiative outlined dealing with the implementation of a new regulatory processs would involve the active participation of telecommunications users, it may also be useful to take some additional steps to increase the awareness, and encourage the participation, of users with respect to the process of reforming the Mexican telecommunications sector. These efforts should be aimed both at executives with specific responsiblity for telecommunications and information processing services as well as chief executive officers with overall management responsibility.

It might be useful, for example, to arrange through an ad hoc consortium of large users of telecommunications services a symposium outlining the major initiatives involved in the reform process as well as the key issues to be addressed in implementing reforms. This symposium might also center around a dialogue between Mexican exeuctives and senior executives from Europe, North America, and Japan, who lead major corporations highly dependent on telecommunications. It would be primarily intended to increase the understanding within the business community in Mexico about the importance of telecommmunications services to industrial performance.

By focusing on difficult issues in implementing telecommunications reforms, the symposium might assist in developing a constituency within the Mexican business community that would take an active role in any new mechanisms that might be devised to implement sectoral reforms.

III. Summary: Next Steps

This memorandum identifies a number of initiatives that might warrant further discussion. In addition, there seems likely to be some consideration on a parellel basis by officials in the Mexican government concerning how an effort might be structured to facilitate the implementation of structural reforms.

It is clear that there are a number of areas for exploration. Such an inquiry might well be initiated by the roundtable process outlined above. An agenda of issues for further exploration should be developed; and then various detailed discussion papers can be prepared and follow-up meetings can be scheduled. The need for outside assistance can, of course, be better guaged after some initial exploratory discussions have taken place.

Finally, it should be noted that the implementation of new regulatory policies and procedures should not be seen as an effort divorced from any initiative to privatize Telmex. Ultimately, potential private sector investors in Telmex will be greatly concerned about future regulatory arrangements. The more transparent such future policies can be made -- recognizing, of course, the need for government policymakers to retain discretion to deal with future developments -- the more saleable and valuable Telmex is likely to be in financial markets. Thus, any regulatory initiatives should be closely coordinated with efforts within the Mexican government to arrange for the privatization of Telmex.

It may thus be useful to arrange in the coming weeks an opportunity for further discussion of the ideas set forth in this memorandum and other ideas that might have emerged as a result of our meetings in Mexico last month. Based on this discussion, a more specific proposal could hopefully be finalized in the month of October.

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER III - SECTOR POLICY AND REFORM PROGRAM

c) Comments to Sept. 1989 Modernization Program (Dec. 1989)

The program for the modernization of the telecommunications sector that was released by the Mexican government in September 1989 is fundamentally a sound and progressive set of initiatives to reform the telecommunications sector.

Outlined below are some observations about the program that highlight issues that may be of particular significance with respect to the Bank's current lending operation in Mexico.

September 1989 Policy Document Superceded by New Developments

First, the document outlining the government's program has been in significant respects superceded by subsequent developments. In particular, the program highlights a major initiative to privatize Teléfonos de México (Telmex) and devise a set of regulatory and competitive conditions for its future activities. Most of these conditions, which concern most significantly arrangements for setting Telmex's future rates and imposing interconnection obligations on Telmex, are now being set forth in further detail in a draft license between Telmex and the Mexican government. This draft license must be completed prior to the implementation of plans to privatize Telmex; indeed, it must be substantially finalized before the government solicits bids from private investors for its controlling interest in Telmex. Thus, the September 1989 policy document has already been superceded in importance. The Telmex license and related policy documents produced during the process of privatizing Telmex will be where the government fills in the details of the future regulatory and competitive framework for Telmex.

In particular, as well, the policy statement does not address definitively the sensitive issue of restrictions on the future foreign ownership of Telmex. There is some thinking within the government that sharing holding would be limited to 49% by foreign investors, with no single investor exceeding a 10% ownership share. The general inclination within the government may, however, be to focus on assuring Mexican control thereby permitting foreign equity interests to exceed a 49% benchmark provided that control is squarely vested in Mexican hands. Issues concerning the future configuration of ownership and control arrangements within Telmex will inevitably be resolved in the process of privatizing Telmex.

Need for More Focus on Transitional Measures

Second, though the September 1989 program certainly notes the need to promulgate new regulatory policies in restructuring the Mexican telecom sector, it does not adequately acknowledge the magnitude of the task of putting in place new competition policies and regulatory initiatives to oversee a newly privatized Telmex.

During the Bank mission to Mexico in November 1989, considerable attention was focused on the critical need for Mexican regulatory officials to develop in detail their plans, among other important regulatory initiatives, to oversee Telmex's rates and the emergence of competition in the telecom sector as well as the procedures through which such initiatives would be formulated and implemented. Specifically, during discussions with regulatory officials at SCT, an initiative to provide technical assistance and resources to develop a strategic plan for SCT's future regulatory activities was explored in detail; it was agreed that this initiative should be pursued as matter of highest priority concern.

Both the September 1989 program as well as independent talks with Mexican officials suggest that there is great wariness in agencies other than SCT about expanding the regulatory role of SCT. Such concerns may well be soundly based to the extent that any future SCT regulatory initiatives confer -- in an unstructured, traditional way -- very broad discretionary powers on the Secretary of the SCT. The dilemna facing Mexican policymakers is that their ambitious and well focused program for restructuring the telecom sector cannot really be effectively put into action without establishing detailed policies and procedures for addressing a number of critical policy issues involved in the transition from the present industry structure to one that is more modern and competitive. However, it is not clear that progressive, well defined regulatory programs will be put in place by the current Secretary of the SCT whose "old school" political and economic views are not well attuned with those of Salinas's "economic cabinet".

It is very doubtful, in fact, that the policy guidelines in the September 1989 program or even detailed provisions of the Telmex license will be "self-executing" and not require refinement by SCT regulatory officials in the future. In particular, both the September 1989 program and the Telmex draft license provide that Telmex rates should be set at international levels and should be structured to avoid cross subsidies between services.

However, setting Telmex's rates in relation to a basket of international prices will require the delineation of a rate setting methodology that is likely to be too complex and detailed for inclusion even in the Telmex license. In fact, international benchmark prices may prove more useful as a "target" for setting the overall level and structure of Telmex's rates than as a practical mechanism for overseeing Telmex's actual rate levels and structure. Indeed, there was an apparent consensus among participants in the November 1989 Bank mission that SCT ought to be exploring the feasibility of utilizing some form of price cap regulation to oversee Telmex's rates on an ongoing basis. Indeed, there is reason to believe as well that the government's proposal can be viewed as a de facto price cap mechanism given the reliance on "national factors" in the proposed formula to relate prices to profits.

Implementation of such a regulatory scheme might well require some effort -- difficult though it might be -- to examine the underlying cost structure for Telmex's various services; however, views within the Bank Mission differ on some points of detail and nuance as to whether price regulation can be implemented without reference of the cost structure of various telecommunications services. Many officials outside SCT do not believe that any such effort to set rates based on costs is likely either to be feasible or productive; more fundamentally, they are fearful that SCT would attempt to implement a highly arbitrary set of controls over rates to maximize its influence over Telmex and in the telecom sector overall.

Mexican regulatory officials do acknowledge that they will have to deal with the not insignificant task of overseeing the implementation of cost accounting procedures within Telmex. In particular, under the terms of the draft license for Telmex, they are likely to have to review cost allocation and accounting schemes that are to be initially proposed by Telmex.

In addition, the Telmex license is likely to require SCT to resolve disputes over interconnection between Telmex and new providers of cellular and value added services. During discussions with Mexican officials, it was suggested, moreover, that SCT might have to play an active role in assuring that Telmex proposed a consistent set of interconnection options for all types of new entrants.

Finally, the policy statement does not discuss the government's views with respect to the participation of users and the public in the regulatory process. The policy statement refers to a coordination forum involving service providers and users; however, a more open-ended process of consultation on important policy issues might be very useful in implementing the government's program for the telecom sector. Mexican officials do not seem very inclined to implement any such arrangements to make the regulatory process more open and transparent.

Competition Policies Need Further Refinement

With respect to future competition policies the September 1989 program sets forth the government's broad commitment to encouraging new competition in the Mexican telecom sector. In general, the policy statement appropriately identifies services where competition might have to restricted rather than those services where competition is to be allowed. Nevertheless, the policy statement remains, in the view of some participants in Bank's November 1989 mission, too unspecific and indefinite with regard to its delineation of the scope of, and the terms and conditions for, competition in the Mexican telecom sector. Such lack of specificity is of particular concern because there may be pressures in the course of privatizing Telmex to water down the government's commitment to competition policy.

Competition policy is particularly unfocused with respect to the government's approach to the resale of leased line services, in particular its commitment to allowing the resale of private user networks and their interconnection with the public switched network. Moreover, the government's approach to licensing so-called complementary networks seems promising and potentially a very effective means of stimulating Telmex to serve new residential and business development areas or to acquiesce to others taking on the responsibility.

Views within the Bank delegation differ with respect to whether the government's competition policies should be further delineated in a supplemental policy statement or in an ad hoc fashion as details of the government's regulatory program are filled in. Specifically, there will be an opportunity to refine the government's competition policies when SCT issues its regulations concerning value added and competitive network services. In the course of that activity, SCT will have to clarify the different licensing obligations that are likely to be applicable to facilities-based as opposed to service-based competitors.

Uncertainty about the Future Role of Telecom

The policy statement also deals with the important subject of the future role of SCT as a service provider. There apparently exist important differences within the government as to whether SCT's operational functions should be allowed to languish on the vine or should be developed into service offerings potentially competitive with those of Telmex. Though the future role of SCT is a subject clearly requiring detailed independent analysis beyond the scope of this note on the government's September 1989 program, much can be said in favor of encouraging SCT's emergence as a potential rival to Telmex in some critical markets provided that Telecom is increasingly pushed in the direction of being a private sector entity.

Given this view that Telmex might perform more efficiently faced with some competition from Telcom, the Bank might well focus the government's attention on the potential benefits of not immediately selling the federal microwave system to Telmex. Rather these facilities might be placed in an institutional structure where they can be utilized by Telecom to compete with Telmex's service offerings on a fully fair competitive basis; any arrangement to assure fair competition, however, must guarentee that tariffs or other charges for the federal microwave system are cost-based.

The government clearly plans to privatize various existing SCT activities such as its reservations services and packet switching activities. However, little attention has been focused on the regulatory status or position of such entities when privatized. Such important concerns should not be allowed to slip through the cracks while attention is focused on more high profile issues such as the privatization of Telmex.

Other Issues Raised by the September 1989 Program

A number of other issues touched on in the September 1989 policy statement might well have been addressed in a more complete and comprehensive manner.

For example, how private entities will be allowed to compete in the provision of public phone booths is not delineated fully. It is not clear whether such entities will require any permits or licenses.

Moreover, the role of Telmex as a provider of cellular services is an important and complex one. Some participants in the Bank mission are of the view that Telmex's role as a cellular supplier in Mexico City should be restricted in order to increase competitive pressure on Telmex. For its part Telmex is concerned about the restrictions on its ability to provide cellular services in areas outside of Mexico City and Tijuana. The Telmex license addresses these issues; such issues must also be faced immediately in the context of the now ongoing process of allocating cellular licenses.

The policy statement does not address the question whether or not cellular licensees will be able to operate their own long distance transmission services. The proposed Telmex license suggests, however, that any competitive long distance service will not be authorized prior to 1994. Thus, it seems likely that the government will restrict cellular licensees to interconnecting with existing or otherwise authorized providers of public network services and that the authorization of new cellular services at the local level does not imply any commitment to increased competition in the provision of interexchange competition to meet the needs of cellular licensees or the public generally.

Concluding Observations

In conclusion, the September 1989 policy statement should be viewed as an important milestone in the government's efforts to restructure Mexican telecommunications policy. However, the program does not identify any dates or procedures for addressing issues outlined in the program. Moreover, as noted above, the program does not adequately acknowledge the essential role of an ongoing regulatory process.

No useful purpose would be served by urging the government to revisit its policy statement; indeed, the government should be given substantial credit for a well-designed and ambitious program of sectoral reform. The message that should be conveyed loud and clear is that the proof of the pudding will be in the refinement and implementation of the broad policy precepts set forth in the September 1989 program. The drafting and final negotiation of the Telmex license, the implementation of mechanisms for overseeing Telmex's rates and other regulatory procedures, the further delineation of competition policies -- all these separate and complex regulatory initiatives will ultimately determine whether the government's restructuring program should be held up as a model for other countries to follow.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER IV - PRIVATIZATION

a) TELMEX: Financial Statements

The attached 1988 - 1994 Financial Projections are based upon Simulation Model # 281. Starting from the January 1990 tariffs, this model assumes annual rate increases in a percentage equal to current year CPI. As a decreasing rate of inflation is assumed, this method provides for less than inflationary adjustments.

The assumed Investment Plan gives a 12 % increase in lines. The staff has been calculated assuming a 8 % annual increase.

The following paragraphs highlight the most important results:

Income Statement

a) The operating revenue increases in the period 1988 - 1994 at an annual rate of 28.6 %. The per line operating revenue increases at a 15.3 % annual rate; from US $ 365 in 1988, to US $ 700 in 1990 as a result of the rate increase, and to US $ 859 in 1994.

b) The Rate of Return on Net Operating Assets is kept at 30 % throughout the period. This explain TELMEX's position in considering the tariff level reached in January 1990 as the target international level, though some Ministries' officials still discuss on how to reach the international target level (assumed to be some 15 to 20 % above current levels).

Basic Parameters

a) Mexico had 4,480,000 working telephone lines for 85.2 million population in 1989, which gives an index of 5.26 per 100 people. The projected situation in 1994 will be 7,908,000 working lines for an estimated population of 93.6 million, giving an index of 8.45 working lines per 100 population.

b) The fill ratio (working lines to installed lines) is a healthy 85.7 % to 88.5 % in the period.

c) Though the staff increases from 49,995 in 1988 to 74,777 in 1994 (6.9 % annual increase), the ratio Staff per 1,000 lines decreases from 11.3 to 9.1, which is a good indicator for a developing country. (This index typically ranges between 20 and 150 in the developing world).

d) The average book value per working line ranges from US $ 900 in 1989 to US $ 1,324 in 1994, which is in the acceptable range.

e) The estimate of Accounts Receivable gives a healthy under 2 months for the period 1990 - 1994.

Sources and Applications of Funds

a) The Net Internal Cash Generation covers 100 % of Investment in the period 1990 - 1994.

b) Borrowing from banks and suppliers is decreasing throughout the period, and it is not required in 1994. This may indicate an excessive profitability.

TELMEX
INCOME STATEMENT

(millions of U.S. $)

year ended 31 Dec. 198-	1988	1989	1990	1991	1992	1993	1994
I - REVENUES							
Installation	91.2	168.8	187.0	229.2	266.0	307.4	358.9
Local - Rental	180.7	218.7	360.7	410.4	473.3	543.1	625.1
- per use	30.2	44.8	547.2	647.3	774.0	917.3	1,087.3
- Public Booths	0.6	1.5	1.6	1.7	1.8	2.0	2.1
- Others	7.0	25.3	35.7	42.2	50.5	59.8	70.9
Trunk calls	450.4	704.2	1,322.2	1,599.0	1,934.1	2,324.9	2,779.0
International calls	281.9	358.5	324.8	370.9	419.1	470.9	527.6
Intern. calls adjustment	430.6	490.1	535.9	621.5	697.1	790.6	888.6
Total Traditional Telephone	1,472.6	2,011.9	3,315.1	3,922.2	4,615.9	5,416.0	6,339.5
800 Service	0.0	3.2	8.5	12.4	14.0	15.4	16.8
Additional Local Services	0.0	0.6	3.2	7.2	11.5	16.4	24.6
Cellular Telephony	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Smart Public Booths	0.0	3.8	18.4	36.4	54.5	72.6	90.2
Data Transmission	6.0	31.5	68.8	98.5	140.5	172.9	175.6
Publicity	25.3	62.5	71.7	84.8	101.5	120.2	142.5
Others	0.0	1.8	1.7	2.4	2.5	2.6	2.9
Total New Services	31.3	103.4	172.3	241.7	324.5	400.1	452.6
Operating Revenue (A)	1,503.9	2,115.3	3,487.4	4,163.9	4,940.4	5,816.1	6,792.1
Non - Oper. revenue							
TOTAL REVENUE (C)	1,503.9	2,115.3	3,487.4	4,163.9	4,940.4	5,816.1	6,792.1
II - EXPENSES							
Operation		758.5	833.8	940.7	1,072.9	1,218.6	1,388.9
Maintenance		318.5	369.1	439.7	527.5	628.2	747.3
Depreciation		347.5	384.2	453.0	546.4	649.7	770.5
Taxes (IPST)		5.6	492.2	517.9	550.2	581.3	615.6
TOTAL OPER. EXPENSES (D)		1,430.1	2,079.3	2,351.3	2,697.0	3,077.8	3,522.3
NET OPER. REV (A - D)		685.2	1,408.1	1,812.6	2,243.4	2,738.3	3,269.8
Interest payments (E)		157.4	244.7	264.0	260.8	293.2	219.9
Monetary Correction		(79.6)	(47.1)	(96.0)	(74.3)	(52.5)	0.0
Income before Tax & PTU		607.4	1,210.5	1,644.6	2,056.9	2,497.6	3,049.9
Income Tax (F)		75.5	118.9	200.4	257.3	307.0	377.2
PTU		57.4	87.7	107.8	139.8	162.2	194.7
NET PROFIT		474.5	1,003.9	1,336.4	1,659.8	2,028.4	2,478.0

TELMEX

INCOME STATEMENT(cont.)

year ended 31 Dec. 19..	1988	1989	1990	1991	1992	1993	1994
III - PERFORMANCE INDICATORS							
Installation	6.19%	8.39%	5.64%	5.84%	5.76%	5.68%	5.66%
Local - Rental	12.27%	10.87%	10.88%	10.46%	10.25%	10.03%	9.86%
- per use	2.05%	2.23%	16.51%	16.50%	16.77%	16.94%	17.15%
- Public Booths	0.04%	0.07%	0.05%	0.04%	0.04%	0.04%	0.03%
- Others	0.48%	1.26%	1.08%	1.08%	1.09%	1.10%	1.12%
Trunk calls	30.59%	35.00%	39.88%	40.77%	41.90%	42.93%	43.84%
International calls	19.14%	17.82%	9.80%	9.46%	9.08%	8.69%	8.32%
Intern. calls adjustment	29.24%	24.36%	16.17%	15.85%	15.10%	14.60%	14.02%
Total Telephone	97.92%	95.11%	95.06%	94.20%	93.43%	93.12%	93.34%
800 Service							
Additional Local Services							
Cellular Telephony							
Smart Public Booths	0.00%	3.09%	4.93%	5.13%	4.31%	3.85%	3.71%
Data Transmission	0.00%	0.58%	1.86%	2.98%	3.54%	4.10%	5.44%
Publicity	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Others	0.00%	3.68%	10.68%	15.06%	16.80%	18.15%	19.93%
Total New Services	2.08%	4.89%	4.94%	5.80%	6.57%	6.88%	6.66%
Gross Actual Oper. Rev.	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Oper. Ratio (D/A) %	0.00%	67.61%	59.62%	56.47%	54.59%	52.92%	51.86%
Number of Main Lines _DELc(G)	4,123	4,480	4,985	5,606	6,305	7,069	7,908
Oper. Rev per DEL (A/G)	364,728	472,176	699,586	742,758	783,550	822,732	858,846
Oper Cost per DEL (D/G)		319,226	417,116	419,426	427,746	435,379	445,387
Cash Oper Cost/DEL (D-dep)/G		241,657	340,044	338,619	341,086	343,473	347,959
Income for ROR (A-D-F)		609.70	1,289.20	1,612.20	1,986.10	2,431.30	2,892.60
Rate Base (Net Plnt in Oper)							
(i) historical		1,993.60	4,382.00	5,366.50	6,605.15	8,010.60	9,617.95
Rate of Return (ROR) %							
(i) historical		30.58%	29.42%	30.04%	30.07%	30.35%	30.08%

TELMEX

BASIC PARAMETERS

year ended 31 Dec. 19..	1988	1989	1990	1991	1992	1993	1994
DEL's							
Added during the year	276.7	436.4	573.7	668.4	729.9	798.3	880.0
Total year end	4,261.7	4,698.1	5,271.8	5,940.2	6,670.1	7,468.4	8,348.4
Year average (N)	4,123.4	4,479.9	4,985.0	5,606.0	6,305.2	7,069.3	7,908.4
TELEPHONE EXCHANGE CAPACITY							
Added during the year		508.1	568.4	732.5	781.9	889.0	960.0
Total year end	4,972.6	5,480.7	6,049.1	6,781.6	7,563.5	8,452.5	9,412.5
Year average (O)		5,226.7	5,764.9	6,415.4	7,172.6	8,008.0	8,932.5
Fill Ratio % (N/O)		85.71%	86.47%	87.38%	87.91%	88.28%	88.54%
STAFF							
Added in year		1,302	3,545	4,331	4,729	5,173	5,702
Total year end	49,995	51,297	54,842	59,173	63,902	69,075	74,777
Average		50,646	53,070	57,008	61,538	66,489	71,926
Average Staff/1,000 DEL		11.3	10.6	10.2	9.8	9.4	9.1
NET PLANT IN OPERATION		3,987.20	4,776.80	5,956.20	7,254.10	8,767.10	10,468.80
DEL (000'S)	4,123	4,480	4,985	5,606	6,305	7,069	7,908
U.S.$ / DEL (book value)	0	890	958	1,062	1,151	1,240	1,324

Accounts Receivable Analysis

Monthly Oper. Revenue	176.28	290.62	346.99	411.70	484.68	566.01
Accounts Receivable in months	2.68	1.79	1.84	1.79	1.76	1.95
(assuming 50 % of AccRcvb + Cash)						

TELMEX
BALANCE SHEET
(millions of U. S. $)

year ended 31 Dec. 19..	1988	1989	1990	1991	1992	1993	1994
I - FIXED ASSETS							
Plant in Operation (J)							
less:cum. Depreciation (K)							
Net Plant in Oper. (L)		3,987.2	4,776.8	5,956.2	7,254.1	8,767.1	10,468.8
Plant under construction (M)		519.1	639.1	796.7	895.1	1,045.6	1,202.4
TOTAL NET FIXED ASSETS		4,506.3	5,415.9	6,752.9	8,149.2	9,812.7	11,671.2
Fin. Investments		405.5	418.0	445.8	472.8	500.2	525.1
TOTAL FIXED ASSETS		4,911.8	5,833.9	7,198.7	8,622.0	10,312.9	12,196.3
II - CURRENT ASSETS							
Cash and Banks & Accounts Receivable		944.7	1,042.7	1,273.6	1,473.2	1,703.7	2,211.5
Inventory		457.1	712.2	906.8	1,231.0	1,605.0	1,926.4
TOTAL CURRENT ASSETS (R)		1,401.8	1,754.9	2,180.4	2,704.2	3,308.7	4,137.9
TOTAL ASSETS		6,313.6	7,588.8	9,379.1	11,326.2	13,621.6	16,334.2
I - EQUITY							
Equity		160.3	147.3	145.7	147.4	150.8	153.3
Monetary Correction		1,642.4	1,729.2	1,927.1	2,190.7	2,543.3	3,040.4
Sale of Shares		441.4	526.9	672.2	853.0	1,069.1	1,308.7
Legal Reserve		36.0	51.1	93.2	152.6	227.9	316.5
Cumulative Net Profit (n-1)		588.1	848.4	1,552.7	2,549.0	3,806.3	5,283.6
Net Profit		440.8	953.4	1,304.4	1,634.5	2,009.4	2,433.6
TOTAL EQUITY (S)		3,309.0	4,256.3	5,695.3	7,527.2	9,806.8	12,536.1
II - LIABILITIES							
Suppliers		466.2	669.7	747.5	658.8	579.3	504.5
Banks		876.8	1,097.1	1,145.4	1,355.7	1,471.8	1,400.4
New Financing		241.4	71.6	234.0	171.0	27.9	0.0
Total Long Term Debt		1,584.4	1,838.4	2,126.9	2,185.5	2,079.0	1,904.9
Accounts payable		124.8	106.7	93.9	85.4	78.2	42.0
Special Reserve (Pension Fund)		284.8	359.5	468.9	605	768.4	950.1
Others		1,010.6	1,027.9	994.1	923.1	889.2	901.1
TOTAL LIABILITIES		3,004.6	3,332.5	3,683.8	3,799.0	3,814.8	3,798.1
TOTAL EQUITY AND LIABILITIES		6,313.6	7,588.8	9,379.1	11,326.2	13,621.6	16,334.2
III - PERFORMANCE INDICATORS							
Current Ratio _timesc(R/U)		0.99	1.17	1.40	1.68	1.91	2.19
Debt Equity Ratio % (T/S+T)		32.38%	30.16%	27.19%	22.50%	17.49%	13.19%

T E L M E X
S O U R C E S   A N D   A P P L I C A T I O N S   O F   F U N D S

(millions of U. S. $)

year ended 31 Dec. 19..	1988	1989	1990	1991	1992	1993	1994
I - SOURCES							
Net Profit (C-D-E-F)		474.5	1,003.9	1,336.4	1,659.8	2,028.4	2,478.0
Depreciation		347.5	384.2	453.0	546.4	649.7	770.5
others							
Interest (E)		157.4	244.7	264.0	260.8	293.2	219.9
Gross Internal Cash Generation (V)		979.4	1,632.8	2,053.4	2,467.0	2,971.3	3,468.4
Debt amortization		110.6	91.6	111.9	117.0	138.0	206.9
Interest (E)		157.4	244.7	264.0	260.8	293.2	219.9
Total Debt Service (W)		268.0	336.3	375.9	377.8	431.2	426.8
Net Internal Cash Generation (X)		711.4	1,296.5	1,677.5	2,089.2	2,540.1	3,041.6
Equity contributions (Y)		253.7	151.8	186.0	215.9	249.4	291.2
New Borrowing		241.4	71.6	234.0	171.0	27.9	1.8
Suppliers		200.3	271.8	160.0	0.0	0.0	0.0
Pension Fund		101.1	114.4	132.7	155.8	181.8	213.1
Others		258.3	144.7	24.6	(34.9)	(8.5)	44.7
TOTAL SOURCES		1,766.2	2,050.8	2,414.8	2,597.0	2,990.7	3,592.4
II - APPLICATIONS							
Increase in Fixed Oper. Assets		975.0	1,231.6	1,478.5	1,636.6	1,894.8	2,208.4
Increase in W. in Progress		126.7	189.2	198.2	131.3	176.1	193.2
Investment (Z)		1,101.7	1,420.8	1,676.7	1,767.9	2,070.9	2,401.6
Inventory & Acct. Payable		375.8	509.3	371.0	497.6	554.1	537.7
Changes in Working Capital		189.8	32.2	165.6	114.4	128.5	419.2
Dividends		19.4	40.8	105.4	142.1	183.9	230.6
Other		79.5	47.7	96.1	75.0	53.3	3.3
TOTAL APPLICATIONS		1,766.2	2,050.8	2,414.8	2,597.0	2,990.7	3,592.4
III - PERFORMANCE INDICATORS							
Debt Service Ratio _times¢ (V/W)		3.65	4.86	5.46	6.53	6.89	8.13
Int. Cash Gen. Ratio % [X/(Z-Y)]		83.89%	102.17%	112.53%	134.61%	139.45%	144.12%

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER IV - PRIVATIZATION

b) TELMEX: Transfers to Government

Attachments 2 and 3 present the Transfers from TELMEX to the Government for the period 1985 - 1994 according to the current assumptions (tariffs, staff and others like in the projected Financial Statements) and in the Base Case Scenario. The Base Case Scenario assumes no privatization of TELMEX, thus the Government continues reinvesting, the increase in the number of lines is the historical annual 6 %, the investment program is modest, and the tariffs are kept at the historical level and under the old adjustment system.

Attachment 1 summarizes the comparison between the two scenarios.

a) Total revenues are 61 % larger under the current assumption as a result of the January 1990 Tariffs adjustment.

b) The elimination of the Old Telephone Tax (IEPS) is almost compensated by increases in VAT, Income Tax and the non-creditable part (35 %) of the New Telephone Tax (IPST).

c) Under the old system the "Reglamento de Prioridades" imposed to new customers the need to buy shares or bonds; this system forced the Government to take new shares in order to keep the 51/49 % distribution. The elimination of this procedure generates an important saving in transfers from the Government, resulting in a Total Net Increase of Transfers from TELMEX to the Government of US $ 1,274 million in the 1990 - 94 period.

Attachment 1

TELMEX

TRANSFERS TO GOVERNMENT

(millions of U.S. $)

	CURRENT PROJECTION Total 1990 - 94	BASE CASE Total 1990 - 94	DIFFERENCE
Total Revenues	25,199.8	15,660.9	9,538.9
Old Telephone Tax (IEPS)	0.0	3,821.0	(3,821.0)
Net VAT	1,100.3	735.8	364.5
Income Tax	1,260.8	477.6	783.2
Other Taxes & New Telephone Tax (IPST)	2,803.0	530.4	2,272.6
Total Taxes	5,164.1	5,564.9	(400.8)
Government Reinvestment	0.0	1,780.5	(1,780.5)
Interest on Gov. Bonds	28.6	332.9	(304.3)
Dividends on Gov. Shares	364.1	165.3	198.8
NET TRANSFERS TO GOV.	5,556.8	4,282.5	1,274.3

Attachment 2

TELMEX
TRANSFERS TO GOVERNMENT

(millions of U.S. $)

year ended 31 Dec. 198-	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total 1990 - 94
Total Revenues	1,027.0	923.7	1,090.1	1,503.9	2,115.2	3,487.4	4,163.9	4,940.5	5,816.0	6,792.0	25,199.8
Old Telephone Tax (IEPS)	216.8	188.8	178.6	341.5	425.9	0.0	0.0	0.0	0.0	0.0	0.0
Net VAT	47.5	31.1	21.9	55.3	52.3	104.9	158.0	220.4	272.0	345.0	1,100.3
Income Tax	35.0	22.4	52.5	63.1	152.8	118.9	200.4	257.3	307.0	377.2	1,260.8
Other Taxes & New Telephone Tax (IPST)	45.5	37.8	108.0	85.8	92.9	496.4	526.9	560.5	592.4	626.8	2,803.0
Total Taxes	344.8	280.1	361.0	545.7	723.9	720.2	885.3	1,038.2	1,171.4	1,349.0	5,164.1
Government Reinvestment	80.9	89.3	173.3	149.6	121.6	0.0	0.0	0.0	0.0	0.0	0.0
Interest on Gov. Bonds	24.9	34.2	37.0	48.7	24.1	11.1	6.5	4.5	3.5	3.0	28.6
Dividends on Gov. Shares	16.0	10.1	6.9	8.0	12.1	23.0	58.9	76.1	93.9	112.2	364.1
NET TRANSFERS TO GOV.	304.8	235.1	231.6	452.8	638.5	754.3	950.7	1,118.8	1,268.8	1,464.2	5,556.8
PTU					57.4	87.7	107.8	139.8	162.2	194.7	692.2

Attachment 3

TELMEX

TRANSFERS TO GOVERNMENT

BASE CASE SCENARIO

(millions of U.S. $)

year ended 31 Dec. 198-	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total 1990 - 94
Total Revenues	1,026.9	923.9	1,090.2	1,504.1	2,113.9	2,466.7	2,750.4	3,102.6	3,479.8	3,861.4	15,660.9
Old Telephone Tax (IEPS)	216.8	188.8	178.6	341.6	501.1	580.0	675.3	760.1	851.6	954.0	3,821.0
Net VAT	47.5	31.1	21.9	55.3	53.8	54.5	105.4	165.1	189.3	221.5	735.8
Income Tax	35.0	22.4	52.5	63.1	172.3	85.9	93.4	101.7	91.7	105.0	477.6
Other Taxes & New Telephone Tax (IPST)	45.5	37.8	108.0	85.8	92.9	95.6	100.5	106.1	111.5	116.8	530.4
Total Taxes	344.8	280.1	361.0	545.8	820.1	816.0	974.6	1,132.9	1,244.1	1,397.2	5,564.9
Government Reinvestment	80.9	89.3	173.3	149.6	121.6	347.9	354.2	315.3	355.3	407.9	1,780.5
Interest on Gov. Bonds	24.9	34.2	37.0	48.7	24.1	29.7	50.2	65.9	81.0	106.0	332.9
Dividends on Gov. Shares	16.0	10.1	6.9	8.0	12.1	21.6	29.9	32.0	38.4	43.5	165.3
NET TRANSFERS TO GOV.	304.7	235.1	231.6	452.9	734.7	519.4	700.5	915.6	1,008.2	1,138.8	4,282.5

- 149 -

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER V - COMPETITION

a) Comments on Proposed Networks and Systems Regulation (Dec. 1989)

During the November 1989 Bank Mission to Mexico, SCT officials reviewed with participants in the Mission a preliminary draft of a regulation that would permit the provision of a number of different services that could be offered on a competitive basis: (1) telematic services; (2) complementary services, (3) voice, data, and videoconference services by satellite, and (4) the provision of overlay networks. This regulation is hereinafter referred to as the "value-added regulation."

The SCT has not finalized the draft and is apparently in the midst of redrafting the regulation; indeed, SCT officials indicated that they would take into account a number of observations that were offered by participants in the Mission, or solicited informally by SCT officials, during recent discussions in Mexico.

The target date for the release of the redrafted value added regulation is not clear.

Though the potential scope of the draft regulation is far-reaching and could significantly increase the level of competition in the Mexican telecom sector, the current value added regulation is very seriously flawed and needs a major redrafting. Outlined below are some of the most critical issues that require attention in the redrafting process.

No effort has been made to undertake a detailed explication or critique of the regulation on a line by line or paragraph by paragraph basis; rather only the most important issues, in our view, are identified.

First, the draft regulation adopts an approach based on defining services that are open to competition rather than identifying activities excluded from competition. In so doing, it creates uncertainty about the legal and regulatory status of resale activities and other competitive services that might be left in "grey areas" between defined services.

Article 2 sets forth the scope of services covered by the regulation as well as definitions of each of the major categories covered, e.g., telematic services, complementary services, services provided by satellite, and overlay network. Telematic services are defined to included a specific list of services such as teletex, electronic mail, videotex, teletext, facsimile, telewriting, videophone, teleprocessing, data communications, access to data processing, and other similar services to be defined by the Secretary of the SCT. (Note: the document does not differentiate between "teletex" and "teletext" services -- both of which are included in the government's list of value added services.)

The definitions of complementary and overlay networks are incomplete even though, together with other articles in the draft regulation, they are determinative of the conditions under which such services can be offered. For example, complementary networks are to be offered in areas where basic services are not available; the definition of overlay networks in Article 2 is less substantive than it is descriptive in nature. According to the definition in Article 2, overlay networks are established "in parallel" to basic networks. It is not clear, however, whether overlay networks (1) involve the use of leased lines and an "overlay" of switching equipment and network concentrators or (2) must involve duplication of transmission facilities as well.

Provided that the government actually differentiates between different types of "overlay" networks -- those involving installation of new plant and facilities and those which only utilize new switching attached to leased lines or the public network -- the government's concept of overlay networks should be workable.

Finally, the regulation -- especially in Articles 21 and 22 -- seems to differentiate between "private networks" and "public networks", i.e., apparently those provided to third parties. The draft Telmex license also refers to, but does not set forth the basis for, this distinction.

The list of telematic services enumerated in Article 2 is unclear on a number of points (the relationship of teletex and teletext; the scope of the definition of data communications services and its relationship to similar services to be provided under other categories such as voice, data, and videocon-ferencing by satellite.)

Some differentiation of services is likely to be required in the draft regulation; at minimum, the regulation ought to adopt a different approach with respect to service-based as opposed to facilities-based competition. It ought in turn to differentiate between overlay networks that "duplicate" existing transmission facilities and those that merely allow new service providers to add switching and nodes to Telmex or SCT-provided transmission facilities. It ought to clarify the distinction between private networks and those open to third parties, i.e., public networks.

The regulation ought to include a general presumption in favor of competition and specifically enumerate exceptions to this policy.

Second, the regulation, as noted above, deals with both service-based and facilities-based competition. Its commitment to opening some facilities-based competition is significant; however, the criteria for granting applications for overlay and complementary networks is not clearly set forth.

Article 4 asserts that complementary services can only be provided on complementary networks where other public network services are not available ("disponible"). The Secretary has discretion to decide when such services are not available; however, does "availability" depend on the fact that (1) there are no existing lines in a community, (2) that lines could be connected but have not been connected, (3) that lines will not be connected for some period of time? Further, what happens if an application for a complementary network is filed and then Telmex decides to provide services?

Can a "complementary" network be constructed when Telmex decides not to augment services, i.e., add digital or other upgraded capabilities? It would seem that such a network might be classified as an "overlay" network since there are apparently existing basic network services. If there are different licensing criteria for complementary and overlay networks, it might become more significant whether a proposed application should be considered as an overlay or complementary network.

For reasons set forth in other discussion papers, it might be very useful for the Secretary to adopt a rather liberal approach to approving applications for complementary networks. Telmex is likely to become more responsive to the needs of users; indeed, it may be more vigorous about extending services into underserved or unserved areas. Telmex must interconnect with such new service providers because the regulation as well as the draft Telmex license guarantee such access. However, the Secretary might condition interconnection on lease-back of facilities to Telmex or on the establishment of other conditions concerning payments for "access" to the public network. Such a liberal approach to licensing complementary networks might allow the construction of new infrastructure to proceed on a more decentralized and efficient basis.

The primary concern that might be raised by the draft regulation is that the Secretary might be too restrictive in granting applications for complementary networks. Time will tell, of course, whether this will be the case. It might be wise, however, to prod SCT into putting more of its cards on the table up front and delineating its strategy and policies with respect to complementary networks. It might be important, moreover, for potential investors in Telmex to understand better when complementary networks might be approved by SCT.

Article 6 sets forth the criteria for granting applications for overlay networks. Overlay networks are to be constructed when basic networks cannot be modernized in the short run ("a corto plazo") to fulfill demands for the provision of new services. Such a definition is, of course, far too restrictive if switching and concentrators for data services are included in the definition of overlay networks. The provision of specialized networks consisting of competitively supplied switching utilizing only leased line or public switched network services should be subject to only minimal regulatory oversight. Such services should not face substantial entry barriers; indeed, they should be able to operate only upon notification to the SCT.

Third, the draft regulation requires excessive information from potential applicants, particularly those not involved in constructing or operating facilities-based networks. Articles 19 and 20 set forth the criteria for obtaining licenses from the Secretary and should be consulted directly for full details of the requirements. In brief, however, Article 20 requires information relating to market potential, needed investments, sources of financing, costs of operation, revenue estimates, details of tariff policies, as well as technical documentation concerning networks and services. Such information is entirely inappropriate to require with respect to various data oriented services included in the category of telematic services.

It should be noted as well that Article 19 sets out certain requirements relating to the national origin of applicants and their compliance with laws on foreign investment. This article appears to be applicable only to entities offering "public" services; its impact on the ability of foreign investors to operate services and facilities necessary for their daily activities should be examined more closely.

SCT officials explained that they intended merely a registration or notification process for some value added services. However, there does not appear to be any differentiation in the regulation itself.

However, Article 21 does appear to require somewhat less information from operators of private networks. Technical descriptions of such networks and copies of agreements showing the relationship among the participants in the network are required. Even this requirement for submitting information to SCT may be unduly burdensome and unnecessary with respect to certain types of private user networks.

Article 22 relating to registration of facsimile networks continues a "make work" regulatory requirement that appears to be primarily beneficial to Mexican communications consultants and a source of potential low-level abuse and harassment of users. Further, regulation of service-based competitors utilizing leased lines to provide services to third parties is largely counterproductive and unnecessary; the government should be encouraged to adopt at most only a notification scheme for oversight of most "service-based" competitors.

Fourth, the distinction between third party networks and private networks is potentially a useful and important one; but, as noted above, it is not delineated in the draft regulation. The provisions relating to private networks may or may not, in the view of the drafters, address the issue of how resale of leased lines will be dealt with. If these articles of the draft regulation are, in fact, the resale-related provisions of the draft regulation, they certainly do not take on the issue head-on.

For example, in other discussion papers we have suggested that users of SCT-provided leased lines and private networks might be accorded more flexibility to sell off excess capacity and interconnect their networks with the public switched network services of Telmex. Such a capability would create de facto public network services competitive with Telmex's long distance offerings. The proposed regulation does not clearly address how such a scenario might be dealt with.

Other international regulatory schemes for value added services, most significantly the Telecommunications Business Law in Japan, distinguish between services made available indiscriminately to the public and other services that are offered on a more selective basis. In U.S. regulation, moreover, services that are not held out indifferently to the public are not common carrier services. It might be useful for the Mexicans to consider developing a distinction between "public networks" and other types of networks serving third parties in their emerging regulatory scheme.

Fifth, the regulation accords the SCT the authority to establish technical standards for the various services within its scope. Though it may be appropriate to assure the inter-operability of complementary networks with the public network, the focus in the draft regulation on standardization, particularly for telematic services, seems misplaced. Users have access to equipment and services that conform with international standards. Those users that are truly concerned about issues of compatibility and interoperability can protect their own interests; regulations mandating standards are unnecessary and unduly restrict users in selecting the services and systems that might be required in their particular business operations. They also give rise to an unnecessary "cottage industry" in certifying and registering systems.

Finally, a few additional comments about the regulation seem appropriate. There are a number of examples of where the regulation is too heavy handed. For example, it requires that all networks licensed by the SCT must be inspected prior to their operation. Such a requirement may certainly be more appropriate for facilities-based systems than for telematic services. Likewise, requirements that a service provider not discriminate among potential users is more appropriately applied to entities with substantial market power than to service providers that lack such power.

Entities that provide basic services are required to offer to third parties telematic services, satellite networks, or overlay networks through separate subsidiaries. Such a requirement might be appropriate for Telmex or SCT. However, it need not be imposed upon entities lacking any market power. The regulation entirely fails to specify what relationship can exist between the basic service provider and its filial. "Arms length" requirements must ultimately specify in detail the terms and conditions of the relationship between the entities subject to such a requirement.

Overall, the regulation needs substantial work. It was our view last November that the SCT staff needed to undertake a thorough redrafting before the regulation was released and put into effect. The Bank should be prepared to offer some comments on the new draft or even to make specific comments on the current draft. Indeed, there may have been some discussion last November about the possibility that such comments or observations on the draft regulation might be provided by the Bank.

A proposed approach for dealing with competitive services might consist of the following elements:

1. The regulation should identify services that are not open to competition; it should not attempt to enumerate services that can be provided

competitively. There should be a presumptive in favor of the competitive provision of services.

2. In addition, the regulation should affirmatively address whether resale of leased lines is subject to the provisions of the new regulatory scheme; it should essentially leave pure resale of leased circuits an unregulated activity except where leased circuits are interconnected at both ends to the switched network and are resold to the public at large.

3. More specifically, the government should be encouraged to adopt a liberal approach to the resale of leased circuits that are provided by SCT to large users and should liberally allow their interconnection to the public switched network subject to the payment of appropriate access charges.

The government may wish to defer until 1994 the provision of cross-the-board long distance competition (see the proposed Telmex license); it should consider permitting large users putting in place specialized long distance networks primarily used for intra-corporate purposes or for the provision of the core business activities of the licensee of the leased circuits.

The development of such specialized networks will provide a market-based set of "benchmark prices" to use in overseeing Telmex's prices; it should accelerate the process of price reform as well.

4. The new regulation should distinguish between licensing new entrants (1) where "facilities" are offered competitively and (2) where new entrants only propose to offer "services" utilizing existing network infrastructure. The provision of switching and concentrators should not be considered facilities-based competition; and it should require only prior notification where public switched network services or leased lines are utilized by new entrants.

5. The onerous application procedures set forth in the proposed regulation should be eliminated and applied only in very limited circumstances. Indeed, the government should adopt liberal licensing criteria even for complementary and overlay networks.

If new entrants can easily enter to meet the needs of underserved areas, there will be less need to oversee Telmex's investment program for remote or unserved areas. Likewise, liberal entry requirements with respect to the market for "overlay" networks should keep Telmex on its toes meeting the needs of its customers for up-to-date services.

The government should carefully assess, therefore, how its licensing policies for complementary and overlay networks might influence any legal obligations imposed on Telmex in the new Telmex license.

6. The government should resist the temptation to impose technical standards on value added service providers. It also need not meddle unduly in setting standards for overlay networks. If new entrants hope to interconnect with the Telmex network, there will be substantial marketplace

pressure to reach voluntary agreements on standards. Technical standard setting is not an area where SCT should be encouraged to retain a high profile regulatory stance.

7. Finally, any new regulatory framework for competitive services should be developed through a process providing for public consultation and input. The proposed draft regulation should be published prior to its release and comments should be sought from interested parties.

The proposed regulatory arrangements for competitive services are a critical part of the process of restructuring the Mexican telecom sector. Thus, there should be some discussion on an urgent basis about how the Bank might wish to follow up with respect to this important draft regulation on competitive services.

Fri 17 November 1989

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VI - REGULATION, TARIFFS AND TAXES

a) Telephone Tariffs and Taxes.

During the last years telephone rates were adjusted annually following the inflationary index, but giving some extra increase to local rates. Current rates are the result of the increase made in December 1988: local and National Long-distance in 50 %, and a small reduction for international rates.

Tariff and taxes are currently under discussion, hence every day and every different person interviewed provided a new version, sometimes additions to the previous picture, sometimes contradictory with previous information. What follows is a summary of all the information received, eliminating versions that appear less probable or in error. The description and comments are presented by tariff component (local rental, local per call or minute, national long-distance, and international).

1. ACCESS CHARGES.

It has two components: a non-refundable installation charge (currently Mx $ 700,000), and "Reglamento de Prioridades", according to which Telmex decides every month whether to charge bonds (obligaciones) or shares, or a mix of both. Currently the amount to be subscribed by the new customer is Mx $ 700,000. Shares and bonds could be sold immediately, the only difference for the public derives from the difference between short term and long term interest rates. In the case of shares the customer will buy them at Mx $ 2,250 (book value as of Sept. 30, 1989) and would sell at the current market rate of Mx $ 1920; bonds are bought at Mx $ 1,000 and sold at Mx $ 750.

Changes in the access charge are not included in the everyday discussion. The definition whether to decrease a rather high value or maintain it as a demand regulator has been left aside for the future.

2. RENTAL.

Attachment 1 presents the current rates: the Metropolitan Area is divide into 4 concentric rings, with rates lowest in downtown and increasing with distance from city center. Other urban areas are divided into 4 types, with rates increasing with size, up to a rate equal to downtown Mexico City. The Metropolitan area covers approximately a 12 km radius circle with almost 20 million people, out of which some 12 million are in the Federal District.

Up to August 1989, the commercial rental included 300 free calls, and 150 free calls for residential subscribers. In August 1989, commercial subscribers were left with zero free calls included in the basic rental. Most exchanges were neither equipped with call meters nor with pulse counters, then in many cases in practice the number of free calls was unlimited, but now Telmex is rapidly implementing a project for adding call meters to all cross-bar exchanges. Today 60 % of the lines have call counters, and only 5 - 10 % have minute meters.

The average basic rental is US $ 2.78 per month, which is far too low for international standards. Price per additional call is Mx $ 21.73 (US 0.85 cent) for residential customers, and Mx $ 32.73 (US $ 1.25 cents) for business customers. The rental rate would be increased only marginally, mainly according to inflation; but the per call (or per minute) rate would increase to Mx $ 300 per call (Mx $ 100 per minute). According to TELMEX statistics 63 % of residential customers make less than 150 calls per month.

The general idea is to raise local tariffs to 80 % of the "international rate" by December 31, 1992. It is still undefined whether to reach this average with very high per call rates and low rentals or other mix. One of the proposals under consideration would increase the per call or per minute rate by ranges, with the rate increasing for ranges with more traffic. This scheme could produce the negative effect of being attractive for the customer to pay additional lines instead of increasing the traffic per line.

New tariff are being discussed but changes in the rental have to wait until April 1990 for implementation. In November 1987 the Government signed the first "Pacto de Solidaridad Economica" aimed to reduce the then very high inflation rate. It was renewed in December 1988 under a new name: "Pacto por la Estabilidad del Crecimiento Economico"; any rate adjustment has to wait for the end of the current Pact. Changes in the per call rate are considered minor and could be implemented before April 1990, though the elimination in August of free calls for commercial customers generated some protests.

3. SPECIAL TELEPHONE TAX.

All telephone rates are increased in the Telephone Tax, officially called "Impuesto Especial a la Produccion y Servicios" (IEPS):

60 % for local residential
72 % for local commercial
32 % for long-distance residential
42 % for long-distance commercial
22 % for long-distance international

The price plus telephone rate is increased by the 15 % VAT. Hence current surcharges for a local commercial customer are almost 100 % (1.72 * 1.15).

The new tariff would convert the current Telephone Tax into a rate increase with no effect on the public, except for international calls where the telephone tax would disappear.

The conversion of the IEPS into tariff would increase the net profit with the consequence of increasing disproportionately the employees's participation (PTU= participacion de trabajadores en las utilidades). As a way to avoid this extra expense and simultaneously force the new private owners to invest the extra profit, the proposed new treatment includes the creation of a new tax, now called telephone tax. This new telephone tax or retention, would apply as a 35 % discount on gross operating revenues before calculation of income tax and PTU. Then, this amount would be treated as depreciation, appearing as a Source in the Sources and Application Statement. If the investment were smaller than this retained amount the difference should be paid as tax; if the investment were equal or larger than this retention, no tax should be payable.

4. NATIONAL LONG-DISTANCE RATES.

National long-distance rates are considered not too far from the target of 80 % of the international basket rate. Two international baskets were considered in the calculations: (a) one including the 10 countries with the highest international trade with Mexico, and (b) one with the 10 countries with the highest telephone traffic with Mexico. Both rankings are almost identical, with USA representing more than 90 % of the weight.

The target for long-distance rates is 80 % of the international basket rate and it would be possible to reach that level almost immediately.

5. INTERNATIONAL SETTLEMENTS.

More than 90 % of international traffic is with US, hence the revenue settlement with AT&T governs the telephone international revenues. The traffic unbalance (including the effect of collect calls) is a relation 2:1.

Up to mid-1989 the revenue settlement agreement with AT&T stated:

(a) net collection rates (charges to the public) should be equal to accounting rates (rates used for the settlement). Due to VAT and telephone tax, gross charges to the public in Mexico were always larger than in US.

b) considering that the community of interest from US with Mexico is 70 % in border states, plus 20 % in Chicago area, and 10 % in New York, and that most calls in Mexico reach the Federal District and central States, it was agreed to compensate the mexican company for the longer routes used (routes are basically terrestrial) giving 75 % of revenues to Mexico and 25 % to USA, for both incoming and outgoing calls.

(c) the basic rate (net of taxes) was US $ 1.30 per minute.

(d) for incoming and outgoing collect calls the US $ 2.00 operator surcharge was paid to Mexico

The new agreement establishes a target to be reached in 10 years: US 0.60 per minute for Mexico, US $ 0.40 per minute for USA. The reduction from the current US $ 0.975 per minute to the US $ 0.60 target will be through annual reductions of US $ 0.035 (3.5 cents).

This new agreement eliminates the need to keep collection rates equal to accounting rates.

The current assumption is a decrease in international telephone rates top approximate them to international levels, having a target to be reached on December 31, 1992 of 110 % of the international basket average.

6. NATIONAL AND QUALITY FACTORS.

The tariffs under discussion assumes that the targets (80 % of international basket for local and national long-distance, and 110 % for international calls) will be reached by December 31, 1992 and that starting January 31, 1993 those rates will be reviewed every year and modified according to two factors: (a) a national factor, which represents a political decision which introducing some cost considerations will provide for the maintenance of cross-subsidies, and (b) a quality factor, which will apply by exchange or exchange groups resulting in a rate decrease in some or one (still under study) quality parameter has been under the acceptable level. Beginning 1992 TELMEX and SCT will begin measuring these parameters by exchange to be applied since January 1993.

7. LEASED CIRCUITS BETWEEN TELMEX <-> TELECOMM.

TELMEX leases some 50 ,000 circuits from D. G. Telecom, which at its turn takes in lease some 5,000 circuits from TELMEX. The charge for this circuits is 15 % of the AT&T rate for similar lengths, when the circuits are delivered at the base band level (in groups of 12 channels, or supergroups of 60 channels). In TELMEX's financial statements this expense is included in Operating Expenses, and is not a substantial amount. In D. G. Telecom's financial statements this is the most important component of revenue.

A recent modification of the agreement, which effect will begin from January 1990 increases the rate to 30 % of the AT&T charge for non-multiplexed circuits, and to 70 % of the AT&T rate for voice level circuits (fully multiplexed circuits). These prices are indexed to the US $, with monthly adjustments following the exchange rate variation. In the case of channels owned by D. G. Telecom. and leased by TELMEX, the rates are not normal rates because prices of services provided directly by the central government are called "derechos" and are fixed by law, hence a change to the law is required in order to modify this Federal Fee, even when in January 1990 D. G. Telecom should have been converted into a decentralized entity. That would be the situation of a Federal Fee established by law for a specific service, but the Central Government not being anymore involved in the actual provision of the service; but the service being provided by a decentralized entity, whose rates are not Federal Fees (Derechos Federales), but normal rates. This amendment still requires a law, because is not the actual provision of the service what matters, but the change of an existing Federal Fee is what requires a law.

The rate table establishes several distance ranges with prices per km decreasing with distance. The old agreement operated with a total cumulative distance interpretation: all circuits were added to give a great total cumulative distance (as if it were only one very lengthy circuit) and then the first 80 or so km were charged at the highest rate, the next 80 km to the second rate, and so on. The new agreement gives a better interpretation of the mechanics: now each circuit is independently charged according to the price per distance rate table.

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VI - REGULATION, TARIFFS AND TAXES

b) Tariffs Adjustment Mechanism (Dec. 1989)

Proposal

1. The Mexican authorities have proposed a tariff adjustment mechanism for Telmex whereby tariffs would be adjusted annually to bring them in line, subject to adjustment factors, with a basket of international telecommunications rates for equivalent services which, in practice, would be heavily weighted to U.S. rates. Mexican rates would be set at adjusted international rates for (a) network access plus local call service, (b) domestic long-distance service, (c) international service and (d) leased lines. The main source of international rate data being used at this time is the Siemens annual publication, "Study on National Telephone Tariffs Worldwide". Other U.S. rate data have been assembled. In particular, for leased lines, AT&T rates are the reference figures being used in revenue simulations.

2. During a transition period up to and including 1992, target Mexican telecommunications rates are proposed to be set at 80%, 80% and 110% respectively of the corresponding international rates for access/local, long-distance and international service. Starting in 1993, these target rates would be further adjusted by a "national factor" and by a quality factor. The national factor would be set with respect to Telmex' costs and profitability, and any desired changes in cross-subsidies. The quality factor would increase or decrease Telmex' permitted prices on an exchange by exchange basis according to its performance with respect to a series of quality of service indicators which Telmex is to develop and propose in 1992.

Positive Features

3. This proposal, albeit with a different adjustment formula, is comparable in basic respects to the "price-cap" approach to telecommunications rate regulation used by OFTEL in the U.K. and by the FCC for AT&T. The Mexican proposal has several attractive features: (a) Telmex would be a price-taker; therefore, in contrast to a cost-plus tariff approval process, the company has an incentive to operate efficiently; (b) the approach is intended to work automatically to the extent possible; therefore it attempts to minimize frequent political interference in rate adjustments; (c) by setting rates by reference to international rates, rates would be expected to be high enough to reward investment, and changes in relative inflation, exchange rates and trends in telecommunications productivity improvement would be reflected; (d) since, in practice, the international basket of comparison rates will be weighted to the U.S., Mexican rates will move towards the relatively low and well-structured U.S. rates; (e) adjustment of the "national factor" every four years, if this is envisaged, would permit periodic (and

approximate) adjustments in Telmex' rate of return; (f) to guard against risks of Telmex attempting to take advantage of the semi-automatic tariff adjustment process by cutting back on quality of service or network expansion, the proposal includes provisions for a quality adjustment factor and for Telmex' annual investment plan to be discussed and agreed with SCT each year.

Negative Features

4. Difficulties with the proposal include (a) the validity of the international rate comparison, (b) the difficulty in selecting unambiguously the equivalent international services and charges, (c) the potential divergence of prices from costs and possible excessive carrier profitability and (d) the uncertainties associated with the application of a quality factor.

5. With respect to the first of these, one can argue that prices outside of Mexico are not a relevant basis for setting Mexican prices. However, one could make a comparable criticism of the OFTEL/FCC "RPI-X" price cap methodologies. Thus the Retail Price Index (RPI) is only a very rough proxy for the index of British Telecom's input prices. Furthermore, "X", the projected rate of telephone company productivity improvement, cannot be forecast accurately. Nevertheless, by making British Telecom a price taker at price levels that are demanding but offer profit potential, it is given incentives for efficiency. The Mexican proposal contains this same fundamental aspect and, additionally, will move Mexican telecommunications rates towards a more appropriate level and structure. The second drawback of the Mexican proposal, that the relevant foreign services and charges for the "international basket" is ambiguous, is not a serious problem. As long as elements of the "basket" are selected reasonably, and given the heavy weighting of the fairly sound U.S. rate structure and the periodic determination of a "national factor", Mexican rates should move significantly in the right direction.

6. A third drawback of the proposal is the potential for divergence from costs and excessive profits. This same problem exists with the OFTEL price-cap methodology. The response has been that improvements in efficiency resulting from the regulatory approach are more important. Nevertheless, we should note that the RPI-X formula more explicitly provides for the carrier to pass "X" percentage points of productivity gain to customers. Furthermore, in the U.S. the Department of Justice has opposed the introduction of price caps for the local exchange carriers (i.e., the Bell operating companies plus others) because it believes the methodology is not appropriate in the absence of significant competition. A final drawback of the proposal is the uncertainty of how the determination and application of the quality factor would work in practice.

Conclusions

7. The Mexican tariff regulation proposals have some attractive features. Compared with an "RPI-X" price-cap approach, the Mexican proposal has the potential of moving the tariff level and structure more rapidly in the right direction. Furthermore, given the doubts whether traditional rate of return regulation can work effectively in Mexico, the Mexican proposal may be

the best alternative. It should be developed in considerable detail as soon as possible in order to assess its overall feasibility, possible modifications and to inform potential investors in Telmex about this key part of the proposed regulatory process. Three factors, which are already part of the Mexican sector reform proposals, will be critical to the successful functioning of the proposed rate regulation approach. First, it should be accompanied by initiatives to increase competition in the sector; second, there should be careful four-yearly reviews of results and subsequent adjustments of the "national" factor; third, the government should carefully monitor Telmex's investment plans and quality of service.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VI - REGULATION, TARIFFS AND TAXES

c) Tariffs Regulation

n/e/r/a
National Economic Research Associates, Inc.
Consulting Economists

1800 M Street, N.W.
Washington, D.C. 20036
(202) 466-3510
Facsimile (202) 466-3605

REGULATION OF TELECOMMUNICATIONS PRICES IN MEXICO

Jeffrey H. Rohlfs
National Economic Research Associates, Inc.

February 22, 1990

The Government of Mexico plans to privatize Telmex and subject the company to price regulation. This study, commissioned by the World Bank, gives my analysis and recommendations regarding such regulation. The analysis is based, in part, on interviews with a number of officials of the Mexican Government, Telmex, banks and consultants.

My analysis focuses on basic telecommunications services. These services include installation, access to the network, local usage, domestic message toll service (MTS), domestic leased circuits, international MTS, and international leased circuits. Issues involving customer premises equipment or value-added services are beyond the scope of this study.

OBJECTIVES OF PRIVATIZATION AND REGULATION

The objectives of privatization and regulation of telecommunications in Mexico are as follows:

1. Expand the availability of telephone service in Mexico.

2. Improve the quality of telephone service and the efficiency of telephone operations.

3. Ensure that the Government receives a satisfactory price for its shares of Telmex.[1]

---

[1] An additional concern is that Telmex remain under the control of Mexicans. That issue is beyond the scope of this study, which deals solely with price regulation.

In this study, I fully accept these objectives and give my recommendations on how to structure regulation so as to achieve the objectives.

Senior government officials told us that the Government also wants to minimize regulatory discretion. This objective is certainly reasonable -- given the well-documented failures of regulation in many countries. In this study, I give my recommendations on how to achieve the three primary objectives with minimal regulatory discretion. At the same time, I note that even if regulatory discretion is minimized, it cannot reasonably be eliminated altogether. In particular, regulators administering price regulation have the critical responsibility of ensuring that adequate quality of service is provided. For this reason, the Mexican government should give high priority to establishing a competent and adequately-staffed regulatory body.

DIRECT PRICE REGULATION

Under direct price regulation, the firm is not permitted to increase prices in any year by more than a certain percentage (the price cap). That percentage usually depends on general economic conditions, but it does not depend on the activities of the firm. In this regard, direct price regulation differs from rate-of-return (ROR) regulation, under which the prices are set to allow the firm to recover its actual costs, including a fair return to capital.

It is well-understood that direct price regulation, as compared to rate-of-return regulation, provides better incentives to improve efficiency and cut costs. In addition, direct price regulation can be administered with less regulatory discretion. In particular, the following regulatory activities are necessary under ROR regulation but not under direct price regulation.

1. Measuring the company's costs. In carrying out this function, regulators usually determine allowable depreciation expenses. If the company is engaged in any unregulated businesses, regulators must also allocate costs between regulated and unregulated activities.

2. Measuring the company's revenues. This involves distinguishing revenues from regulated and any unregulated activities.

3. Determining the allowable return to capital. This usually involve measuring the actual cost of debt and determining the cost of equity, based on current financial conditions.

4. Determining which expenses and investments (if any) were imprudent and should therefore be disallowed.

Largely for the reasons stated above, the Mexican Government intends to use direct price regulation for telecommunications. That decision seems very sound to me.

Direct price regulation unfortunately gives the regulated firm the incentive to provide suboptimal quality of service. Consequently, price regulation should be accompanied by a regulatory scheme to ensure adequate quality. Regulation of quality is discussed below.

FIXED PRODUCTIVITY FACTOR

A simple way to implement direct price regulation is to set the price cap equal to the percent of inflation less a productivity factor that is fixed for a term of several years. This plan can be expressed as

Eq. [1]

$$\Delta r_m = \Delta p_m - X$$

where Δ indicates annual percentage change,

r_m = the maximum permitted level of Mexican telecommunications prices (the subscript $_m$ denotes Mexico)

p_m = the general price level in Mexico, and

X = a fixed number (%/year).

This method of direct price regulation was successfully employed in the United Kingdom. In the U.S., the state of California recently adopted a similar plan to regulate Pacific Bell. The Federal Communications Commission (FCC) has adopted a complex variant of direct price regulation for AT&T.[2]

Determining an appropriate value for X is troublesome in practice. That choice obviously has critical importance and has provoked a great deal of political controversy in the U.S. and the U.K. The U.K. also had to deal with the problem of readjusting X after the initial term expired.

One possibility is to base the X factor on historical productivity growth in telecommunications relative to the general economy. In the U.S., telecommunications productivity has grown about 2 percentage points per year more rapidly than economy-wide productivity over the past fifty years. There is, however, evidence that a higher productivity factor is reasonable under direct price regulation. British Telecom was extremely prosperous with an X factor of 3%, and the factor was subsequently increased to 4.5%. Pacific Bell also voluntarily agreed to a productivity factor of 4.5%. It is, however, unclear whether a productivity factor as high as 4.5% per year is sustainable in the long run.

In any event, conditions in Mexico differ from those in the U.K. and the U.S. The Mexican plan must take those differences into account.

MEXICAN PROPOSAL

Mexican government officials have proposed a thoughtful and innovative approach to direct price regulation. According to that proposal, the price cap will depend on:

---

[2] According to that plan, AT&T passes changes in access charges and certain other exogenous cost changes on to customers. The plan also has numerous other terms and conditions that go beyond Eq. [1].

1. A factor based on an international index of telecommunications rates,
2. A "national factor," and
3. A quality of service factor.

That is, the maximal price level that Telmex is allowed to charge would be as follows:

Eq. [2]

$$r_m = if \cdot nf \cdot qf$$

where

if = the international factor,

nf = the national factor, and

qf = the quality factor.

The initial values (immediately after privatization) of nf and qf are:

Eq. [3]

$$nf(0) = 1$$

Eq. [4]

$$qf(0) = 1$$

where (0) denotes initial value.

The next three subsections consider the these three elements of the price cap mechanism.

<u>The International Factor</u>. Perhaps the most straightforward way to define the international factor is a weighted average of foreign telecommunications prices; i.e.,

Eq. [5]

$$if = \sum_j w_j \; r_j / e_j$$

where

w_j = the weight for country j, $(\sum_j w_j = 1)$

r_j = the level of telecommunications prices in country j (in foreign currency), and

e_j = the exchange rate (units of foreign currency per Mexican peso).

In Eq. [2], the foreign prices, expressed in foreign currency, are converted to pesos at the official exchange rate. Assuming that the national and quality factors remain at unity, the level of Telmex's prices would equal this weighted international average of telecommunications prices.

Although straightforward, the method of defining the international factor has serious drawbacks:

1. Eq. [5] depends on exchange rates. It can therefore change in ways that are largely unrelated to telecommunications costs. This could result either in windfall profits or financial distress for Telmex. Either of these results is undesirable.

2. Although expecting Telmex to price at international levels may be reasonable in the long run, it may not be reasonable from the start. A transition period during which Telmex prices differ from international levels may be desirable.

3. Obtaining indices for foreign telecommunications prices expressed in foreign currencies would be difficult. Indices more commonly show percentage changes from a base year.

Drawback 2 can be dealt with by specifically allowing a transition period. That would not, however, resolve either the first or the third drawback.

For these reasons, Mexican officials have developed a far better method of defining the international factor. That method (as I understand it) is described below.

Initial Rates. The initial rates are to be Telmex's current rates. These rates are expected to suffice to cover Telmex's operations and to fund its current plans for capital investment. That is,

Eq. [6]

$$r_m(0) = if(0) = \text{Telmex's current rates}$$

Changes in the International Factor. The value of the international factor is to change annually according to the following formula:

Eq. [7]

$$\Delta\, if = \Delta\, p_m - \sum_j w_j\, (\Delta\, p_j - \Delta\, r_j)$$

where p_j = the general price level in country j ($\Delta\, p_j$ is therefore the percent rate of inflation).

If the national and quality factors remain at unity, it follows that

Eq. [8]

$$\Delta\, r_m = \Delta\, p_m - \sum_j w_j\, (\Delta\, p_j - \Delta\, r_j)$$

This formula is a variant of Eq. [1]. The Mexican inflation rate $\Delta\, p_m$ appears in both equations. The summation $\sum_j$ in Eq. [8] is analogous to the X factor in Eq. [1] Instead of being fixed, as in Eq. [1], the productivity factor in Eq. [8] reflects productivity in international telecommunication relative to productivity in the general international economy. One would certainly expect telecommunications prices to rise more slowly than the general price level. Hence, the summation will likely be positive, and Telmex will not be allowed to increase its rates as much as Mexican inflation (assuming that the national and quality factors remain at unity).

The international factor defined in Eq. [7] has none of the three drawbacks discussed previously:

1. The factor does not depend on the exchange rate.
2. Since prices are originally set equal to Telmex's current prices, no transition period is needed.
3. All the price indices need to calculate the international factor in Eq. [7] can be relative indices. Δp_m, Δp_j, and Δr_j are all percentages -- not monetary amounts.

International Price Indices. The price indices Δr_j in Eq. [7] are intended to reflect prices of telecommunications services in industrialized countries. Ideally, the countries included in the index should have inflation rates that are similar to Mexico's because real productivity growth may depend in part on inflation. For stability, the index should be based on services that account for a large fraction of telecommunications revenues in large countries. Some elements that might be easily included in the international index are as follows:

1. Bureau of Labor Statistics data on telecommunications prices in the U.S.
2. The price cap for British Telecom; i.e., RPI-4.5%/year.[3]

Changing the Structure of the International Factor. Ideally, the structure of the international factor should be specified prior to privatization and not changed thereafter. That is, the countries j and the weights w_j used in the international index Eq. [7] should not be changed. The procedure for calculating the index r_j in each country also should not

[3] If RPI (the retail price index) were then used as the general price index for the U.K., the value of $(\Delta p_j - \Delta r_j)$ for the U.K. would be 4.5%/year.

change.[4] (One broad-based international index is likely to be approximately as good as another, and restructuring the index creates undesirable uncertainty.) Furthermore, as previously stated, the proposed method of constructing the international factor from the international index Eq. [7] seems very sound and would not need to be changed. Avoiding changes to the structure of the international factor would make Telmex much more attractive to investors than if the structure could be arbitrarily changed in the future. Furthermore, avoiding changes in the structure of the factor is consistent with the Government's desire to minimize regulatory discretion.

Fail Safe Mechanisms. If, after privatization, the structure of the international factor remains unchanged (as I recommend), there is the possibility that Telmex will earn excessive profits or get into financial distress at various times in the future. The privatization plan should have fail-safe mechanisms to deal with these contingencies. I would recommend that the following mechanisms be considered:

1. The sum of dividends plus repurchases of stock plus investment outside telecommunications should be limited to a certain fraction (F) of the book value of equity (net of depreciation) in telecommunications.[5] That fraction could, for example, be the rate of Mexican inflation plus 10%/year. This proviso assures that if excess profits are earned, they will be used to provide telecommunications infrastructure for Mexico -- not taken out of the industry.

2. Notwithstanding the price cap, Telmex should with regulatory permission be allowed to raise rates up to (say) 10% per year plus the

[4] The index would, of course, have to be changed if one or more of the statistical series upon which it is based is discontinued. In that case, a new series should be used and spliced into the original series (so that the change in structure does not affect the value of the factor).

[5] For purposes of this rule, depreciation could simply be straight-line over (say) a ten-year life. This would provide adequate precision and would avoid regulatory discretion in setting depreciation rates.

rate of Mexican inflation. However, until rates are brought into line with the price cap,[6] Telmex would not be allowed to

a. Pay any dividends,

b. Repurchase any stock, or

c. Make any investments outside telecommunications.

This mechanism provides a way for Telmex to continue operations and continue to invest in telecommunications -- even if it gets into financial distress under price regulation. This mechanism involves some regulatory discretion. However, the worst that can happen to ratepayers is that rates rise by the rate of inflation plus 10%/year. Telmex can avoid this exercise of regulatory discretion by pricing in accordance with the price cap.

THE NATIONAL FACTOR

Government officials have proposed that the regulatory authority use its judgment to set the national factor between 0.9 and 1.1. The factor, as I understand it is intended to deal with the contingencies that Telmex will earn excess profits or get into financial distress.

I believe that the national factor is <u>not</u> a good way to deal with these contingencies. It runs directly counter to the Government's objective of minimizing regulatory discretion. Furthermore, there is no objective standard for setting the national factor. Thus, telecommunications rates could vary by 20%, purely on the basis of subjective regulatory judgment. This allows too much scope for arbitrary decisions -- even if the Government were not determined to minimize regulatory discretion.

I believe that the fail-safe mechanisms described in the previous section are a better way to deal with the contingencies of excess profits or financial distress. If these mechanisms are

---

[6] It is not intended that Telmex would have to "pay back" the additional revenues received. However, Telmex would have to get its prices back on the <u>original</u> path. Eq. [7] would <u>not</u> be applied to the new higher level of prices.

considered unacceptable, the Government should try to develop alternative mechanisms that require less regulatory discretion than the national factor.

Quality Factor. The plan currently proposed by Mexican Government officials would allow the Ministry of Finance to discount Telmex's rates up to 40% in particular cities or exchanges if quality of service is inadequate. I believe that this approach is not a good way to ensure adequate quality. For one thing, the plan runs directly counter to the objective of minimizing regulatory discretion. Indeed, if regulatory discretion is used unwisely under the plan, the regulatory authority could ruin Telmex and critically weaken the telecommunications system in Mexico.

Furthermore, the proposed policy may turn out to be self-defeating. Improving quality of service may require substantial capital investment. Unfortunately, lowering Telmex's rates directly reduces an important source of capital; namely, retained earnings. At the same time, levying the penalties would also make new investment in Telmex unattractive. Without adequate capital, quality may decline even further.

A happy solution to this problem would be for Telmex to be taken over by new owners, who then put substantial new capital into the company. For several reasons, however, the Government should not rely on this solution:

1. The problem may not be due to managerial incompetence.

2. Even if it is, new managers may not have the expertise to do much better than the old management. Expertise would include knowledge of telecommunications technology and operations and knowledge of the Mexican market and environment.

3. New investors will be put off by the fact that the Government is levying large penalties on Telmex.

I would recommend considering alternatives to reducing Telmex's rates if quality is inadequate. One alternative to be considered is to penalize Telmex by curtailing the following activities:

1. Payment of dividends,
2. Repurchase of stock, and
3. Investments outside basic telecommunications.

Applying these penalties prevents stockholders from getting their money out of the firm. The penalties could continue to apply until satisfactory quality is provided.

The prospect of these penalties gives stockholders a great incentive to provide satisfactory service. The plan must, however, be carefully designed not to frighten potential investors. In this regard, quality standards based on measurable standards and specified prior to privatization would be extremely desirable. (Officials have indicated to us that this is the Government's intention at any event.) The standards could either be fixed numbers or based on an international index. In the latter case, the index should be broadly-based and not change over time.

There should also be a graduated schedule under which minor shortfalls in quality lead to correspondingly modest penalties. In terms of my recommendations, the ratio F (discussed under Fail-safe mechanisms) could be reduced, depending on the amount of the shortfall in quality.

Even though the penalties for inadequate quality are unpleasant for stockholders, the business can continue to function even if the penalties are actually applied. Raising new capital may be impossible under such circumstances, but the company would still have retained earnings and depreciation as sources of cash flow. Furthermore, the penalties essentially require that earnings and depreciation be reinvested in basic telecommunications.

Naturally, regulatory discretion is required to administer the penalties. However, the scope for regulatory discretion is much narrower in my recommended approach than in the plan discussed with officials. In particular, unwise regulatory decisions cannot do nearly as much harm to Telmex or to the Mexican telecommunications system.

If the proposal outlined above to ensure adequate quality is not accepted, the government should try to develop an alternative that does not deny Telmex the cash flow needed to improve quality in the event that quality is inadequate.

REBALANCING OF PRICES

Government officials propose to calculate international indices for several broad categories of service. Telmex would then be required to price each category of service in accordance with its own price cap. The price cap would reflect international prices (Δr_j in Eq. [7]) in that category.

This proposal allows Telmex to rebalance rates within a given category of service. However, Telmex would be allowed to rebalance rates across categories (i.e., raise rates in one category and lower those in another category) only to the extent that international telecommunications prices are rebalanced across categories.

This plan is certainly workable in a monopoly environment. The plan would, however, have to be changed if competition were allowed in basic services. In that case, Telmex would need greater pricing flexibility to respond to competition.

I would recommend that the Government also consider an alternative policy regarding rebalancing of rates; namely, letting Telmex rebalance all its rates, subject only to an aggregate price cap. In this plan, dislocations can be avoided by specifying that no rate element can increase by more than (say) 10% per year plus the rate of domestic inflation.

This plan allows Telmex to adjust rates to reflect its costs. It also gives Telmex sufficient flexibility to respond to competitive threats when competition is introduced into basic services. Theoretical work by Vogelsang and Finsinger[7] and Vogelsang,[8] while not conclusive, suggests that this plan would probably promote economic efficiency.

CONCLUSIONS

The Government's plan to privatize Telmex and subject the privatized firm to direct price regulation (as opposed to rate-of-return regulation) seems very constructive. Government officials have made an good start in formulating a workable and efficient regulatory mechanism.

There are several alternative ways to define the price ap under direct price regulation. Setting a fixed productivity factor (X) is certainly workable, thought it involves the controversial task of choosing the value of that factor. The international index, proposed by Mexican Government officials, is a sound alternative. Officials have developed a good way to define an international factor that does not depend on exchange rates. Alternatives that depend on exchange rates would needlessly subject Telmex to substantial risk.

Government officials propose to define a national factor for telecommunications prices. The factor is intended to deal with the contingencies of Telmex's earning excessive profits or getting into financial distress. I believe that the national factor allows too much scope for arbitrary regulatory discretion, and I suggest an alternative way of dealing with these contingencies.

Government officials propose to allow the regulator to cut Telmex's rates up to 40% if quality is inadequate. I believe that this approach may be counterproductive, denying Telmex the cash flow it would need to improve quality. I suggest an alternative way to ensure adequate quality.

---

[7] I. Vogelsang and J. Finsinger, "A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms," Bell Journal of Economics, 10, 1979.

[8] I. Vogelsang, "Price Cap Regulation of Telecommunications Services: A Long-Run Approach," The Rand Corporation, February 1988.

All in all, the Mexican Government has made considerable progress in designing an effective regulatory mechanism. I identified some problems with the details of the current proposals, but these can be worked out within the broad structure of direct price regulation envisioned by the Government.

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VI - REGULATION, TARIFFS AND TAXES

d) New Telecommunications Tariffs

New Telecommunications Tariffs were approved during December, 1989. Decree 4960 dated 7 December (Attachment 1) authorized a 5 % increase in Telephone Rental starting December 4, 1989; and Decree 5144 dated 27 December, 1989 (Attachment 2) authorized increases in per call rate and long distance. Due to conveniences in applying both changes simultaneously, TELMEX decided to make the increases effective since 1st January 1990.

The main features of the new rates, as compared with the previous rates, are:

a) increased the per call rate from around Mx $ 25 to Mx $ 300 for a 3 minute call; or to Mx $ 100 per minute when measuring equipment is available. The 4 rate rings into which the Metropolitan area is divided, and all States have different Rentals, but the same per call rate. Previously commercial rental rate was higher than residential and with 72 % IEPS instead of 60 % IEPS; the sum of the old rates plus IEPS was increased in both cases in 5 %, and these are the new rates.

b) increased national long distance rates in 80 % for short hauls and 15 to 20 % for longer ranges (average increase around 36 %). A new distance - rate curve with 13 ranges replaced the previous continuous curve (Attachment 3). There were some changes in the peak/non-peak period definitions and business customers were provided with 90 calls at a discounted rate (in October 1989 they were left without free calls included in the rental). In the conversion of the old telephone tax (IEPS) into the new rates, and due to the difference between the old taxes applicable to residential (32 %) and business customers (42 %), a weighted average IEPS was included into the new rates.

c) decreased international rates by an average of 33 % to USA/Canada and 40 % to other countries through the elimination of the telephone tax (IEPS) and additional reductions. The international rates to USA/Canada are based on terrestrial distances, with 8 distance ranges inside Mexico and 9 in USA (Attachment 4); the final rate is the sum of both plus VAT, resulting in a rate for Mexico City to US Eastern Coast larger than many satellite rates between much more distant points as charged by other administrations.

The New Telephone Tax (IPST)

The old telephone tax (IEPS), which operated through a mechanism like the VAT (with percentages depending upon the type of service and customer), was replaced by a new telephone tax equal to 29 % of total telephone revenue. (Attachment 5).

The new IPST has three main effects:

(a) introduces an incentive to investment by accepting investment as a credit against IPST for up to 65 % of the new telephone tax (IPST).

(b) avoid an undue increase in net profit distributions to employees (PTU) by reducing the income tax base in the whole value of the new telephone tax (IPST = 29 % of revenues), and

(c) increases the minimum payable tax in the case of zero or negative profit by the 35 % of IPST no creditable through investment. An amount equal to [0.35*0.29*(local + LD)], would be added to the legal minimum income tax of 2 % on Assets.

TELMEX - NET PROFIT & TAX CALCULATION

Item	New Tf. Tax	Old Tf. Tax
Revenue	100	71
Expenses	35	35
Gross Profit	65	36
Minimum IPST §0.29*0.35*(loc+LD)†	10.15	0
Financial Exp.	15	15
Sub Total	39.85	21
Income Tax 36 %	7.56	7.56
Net Profit	32.29	13.44

IPST discount to Inc Tax base	18.85	0
Income Tax Base	21	21

SECRETARIA DE COMUNICACIONES Y TRANSPORTES

SECRETARIA

1\. 4960

México, D.F., a 7 de diciembre de 1989.

LIC. JORGE LANDOIS BURGUET
DIRECTOR GENERAL DE
TELEFONOS DEL NOROESTE ,S.A. DE C.V.
P r e s e n t e.

Esta Secretaría, con fundamento en los Artículos 3o.y 49 de la Ley de Vías Generales de Comunicación y en base al oficio del 4 de diciembre de 1989 de la Secretaría de Hacienda y Crédito Público, autoriza a partir del 4 de diciembre de 1989 a la Empresa Teléfonos del Noroeste, S.A. de C.V., un incremento a las tarifas telefónicas que a continuación se indican:

Renta Básica Comercial	5.0%
Renta Básica Residencial	5.0%

Sin otro particular, reitero a usted las seguridades de mi atenta y distinguida consideración.

SUFRAGIO EFECTIVO. NO REELECCION.
El Secretario

Lic. Andrés Caso Lombardo

c.c.p. Lic. Pedro Aspe Armella, Secretario de Hacienda y Crédito Público.- Presente.
c.c.p. Lic. Francisco Gil Díaz.- Subsecretario de Ingresos de la SHCP.- Presente.
c.c.p. Ing. Carlos Mier y Terán O., Subsecretario de Comunicaciones y Desarrollo Tecnológico.- Presente.
c.c.p. Lic. Alma Rosa Moreno Razo, Director General de Política de Ingresos.- Presente.

12 DIC '89 AM

CMT/cms

SUBSECRETARIA DE COMUNICACIONES Y DESARROLLO TECNOLOGICO S. C. T.

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

SECRETARIA

1.- 4959

MÉXICO, D.F., A 7 DE DICIEMBRE DE 1989.

SR. LIC. ALFREDO BARANDA GARCÍA,
DIRECTOR GENERAL DE
TELEFONOS DE MEXICO, S.A. DE C.V.,
P R E S E N T E.

ESTA SECRETARÍA, CON FUNDAMENTO EN LOS ARTÍCULOS 3o. Y 49 DE LA LEY DE VÍAS GENERALES DE COMUNICACIÓN Y EN BASE AL OFICIO DEL 4 DE DICIEMBRE DE 1989 DE LA SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO, AUTORIZA A PARTIR DE ESA FECHA A LA EMPRESA TELÉFONOS DE MÉXICO, S.A. DE C.V., UN INCREMENTO A LAS TARIFAS TELEFÓNICAS QUE A CONTINUACIÓN SE INDICAN:

RENTA BÁSICA COMERCIAL	5.0%
RENTA BÁSICA RESIDENCIAL	5.0%

SIN OTRO PARTICULAR, REITERO A USTED LAS SEGURIDADES DE MI ATENTA Y DISTINGUIDA CONSIDERACIÓN.

12 DIC '89 AM

SUFRAGIO EFECTIVO. NO REELECCION.
EL SECRETARIO

ANDRES CASO LOMBARDO

SUBSECRETARIA DE COMUNICACIONES Y DESARROLLO TECNOLOGICO
S. C. T.

T. G.

C.c.p.- Sr. Lic. Pedro Aspe Armella.- Secretario de Hacienda y Crédito Público.- Presente.

C.c.p.- Sr. Lic. Francisco Gil Díaz.- Subsecretario de Ingresos de la SHCP.- Presente.

C.c.p.- Sr. Ing. Carlos Mier y Terán.- Subsecretario de Comunicaciones y Desarrollo Tecnológico. Presente.

C.c.p.- Srita. Lic. Alma Rosa Moreno Razo.- Directora General de Política de Ingresos.- Presente.

SECRETARIA

1. 5144

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

México, D.F., diciembre 27 de 1989

LIC. ALFREDO BARANDA GARCIA
DIRECTOR GENERAL DE TELEFONOS DE MEXICO, S. A. DE C.V. Y PRESIDENTE DEL CONSEJO DE ADMINISTRACION DE TELEFONOS DEL NOROESTE, S.A. DE C.V.
P R E S E N T E .

Esta Secretaría autoriza con fundamento en lo dispuesto por la Ley de Vías Generales de Comunicación y de común acuerdo con la Secretaría de Hacienda y Crédito Público, en los términos de su oficio No. 102.-604.-4715 del 19 de diciembre del año en curso, la siguiente reestructuración en las tarifas para servicio telefónico, que se aplicará a partir del 1o. de enero de 1990:

I. SERVICIO LOCAL:	INCREMENTO
- RENTA BASICA COMERCIAL	72%
- RENTA BASICA RESIDENCIAL	60%

Estos incrementos a las rentas básicas resultan de la conversión en tarifa del impuesto especial sobre producción y servicios aplicable al servicio telefónico, por lo que el usuario no resentirá efecto alguno por motivo de este aumento tarifario.

I.1 SERVICIO MEDIDO COMERCIAL	TARIFA
Por cada una de las primeras 60 llamadas	$117.00
Por cada una de las siguientes 30 llamadas	$219.00
Por cada llamada adicional que exceda las primeras 90	$300.00

• • •

a 16

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

I.2 SERVICIO MEDIDO RESIDENCIAL

Por cada llamada adicional que exceda las primeras 150	$300.00

I.3 SERVICIO MEDIDO SUBURBANO

Por cada llamada	$360.00

Conforme entre en operación el servicio medido por tiempo en cada Ciudad o Región, se aplicarán las siguientes tarifas en lugar de las descritas anteriormente, previa autorización por escrito de la Secretaría de Comunicaciones y Transportes para cada Ciudad o Región. Teléfonos de México, S.A. de C.V., y Teléfonos del Noroeste, S.A. de C.V., demostrarán en cada caso que el servicio medido por tiempo puede operar eficientemente para recibir la autorización.

SERVICIO MEDIDO COMERCIAL

Por cada uno de los primeros 180 minutos del mes	$ 39.00
Por cada uno de los siguientes 90 minutos del mes	$ 73.00
Por cada minuto adicional o fracción que exceda los primeros 270 minutos del mes	$100.00

SERVICIO MEDIDO RESIDENCIAL

Por cada minuto adicional o fracción que exceda los primeros 450 minutos del mes	$100.00

SERVICIO MEDIDO SUBURBANO

Por cada minuto	$120.00

* * *

a 15

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

II. SERVICIO DE LARGA DISTANCIA NACIONAL

II.1 Aplicación de tarifas por rangos de distancia de acuerdo al siguiente esquema:

	KILOMETROS			PESOS POR MINUTO TARIFA DIURNA LADA 91
1	de	0	a 25	116
2	de	26	a 50	200
3	de	51	a 75	299
4	de	76	a 100	384
5	de	101	a 125	494
6	de	126	a 150	603
7	de	151	a 175	713
8	de	176	a 200	823
9	de	201	a 300	927
10	de	301	a 500	1026
11	de	501	a 800	1097
12	de	801	a 1600	1152
13	de	1601	en adelante	1206

II.2 Estructura de Larga distancia Nacional en relación a la tarifa diurna lada 91:

CONCEPTO	DIURNO	VESPERTINO	NOCTURNO
Lada 91	100%	80%	37%
Lada 92	200%	160%	74%
OPERADORA A LUGARES SIN ACCESO AUTOMATICO			
02 T-T	100%	100%	80%
02 P-P	200%	200%	160%
OPERADORA A LUGARES CON ACCESO AUTOMATICO			
02 T-T	300%	300%	300%
02 P-P	400%	400%	400%

* * *

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

HORARIOS

LADA 91 y LADA 92

Diurno lunes a sábado de 8:00 a 16:59

Vespertino de lunes a sábado de 17:00 a 21:59

Nocturno de lunes a sábado de 22:00 a 7:59

Domingo las 24 horas tarifa nocturna.

OPERADORA A LUGARES SIN ACCESO AUTOMATICO:

Diurno lunes a sábado de 8:00 a 21:59

Nocturno lunes a sábado de 22;00 a 7:59

Domingo las 24 horas tarifa nocturna

OPERADORA A LUGARES DE ACCESO AUTOMATICO:

Diurno las 24 horas del día

III. SERVICIO DE LARGA DISTANCIA INTERNACIONAL

Se aplicarán las siguientes tarifas a las 8 bandas existentes de la porción mexicana.

LARGA DISTANCIA INTERNACIONAL
(Dólares por minuto o fracción)

BANDA TARIFARIA	LADA 95		LADA 96		OPERADORA	
	T-TD	T-TN	P-PD	P-P N	OP T-T	OP P-P
1	0.16	0.10	0.24	0.16	0.24	0.32
2	0.21	0.14	0.32	0.21	0.32	0.42
3	0.35	0.23	0.53	0.35	0.53	0.70
4	0.41	0.27	0.62	0.41	0.62	0.82
5	0.51	0.34	0.77	0.51	0.77	1.02
6	0.71	0.47	1.07	0.71	1.07	1.42
7	0.90	0.60	1.35	0.90	1.35	1.80
8	1.11	0.74	1.67	1.11	1.67	2.22

• • •

SECRETARIA DE COMUNICACIONES
Y
TRANSPORTES

IV. SERVICIO DE LARGA DISTANCIA MUNDIAL

LARGA DISTANCIA MUNDIAL
(Dólares por minuto o fracción)

	LADA 98		LADA 99		OPERADORA	
REGIONES	T-T D	T-T N	P-P D	P-P N	OP T-T	OP P-P
SUDAMERICA Y CARIBE	2.60	1.73	2.86	1.90	2.86	3.12
EUROPA	2.60	1.73	2.86	1.90	2.86	3.12
CENTROAMERICA	1.00	0.66	1.10	0.73	1.10	1.20
RESTO DEL MUNDO	3.30	2.20	3.63	2.41	3.63	3.96

V. TARIFAS DE ACCESO

No se incrementan los gastos de instalación, contratación y reglamento de prioridades.

Por otra parte, se le comunica que esa empresa deberá enviar en un plazo no mayor de 15 días, contados a partir de la fecha del presente 15 ejemplares impresos, a efecto de que se requisiten debidamente y se les devuelvan, para que sean puestos a disposición del público usuario de acuerdo a lo que señala el Artículo 70 de la Ley de Vías Generales de Comunicación.

Lo anterior, con fundamente en los Artículos 31, Fracción XV y 36 Fracción XII de la Ley Orgánica de la Administración Pública Federal; 3o., 49, 50, 51, 55, Fracción III, 70 y demás relativos de la Ley de Vías Generales de Comunicación.

Reitero a usted las seguridades de mi atenta y distinguida consideración.

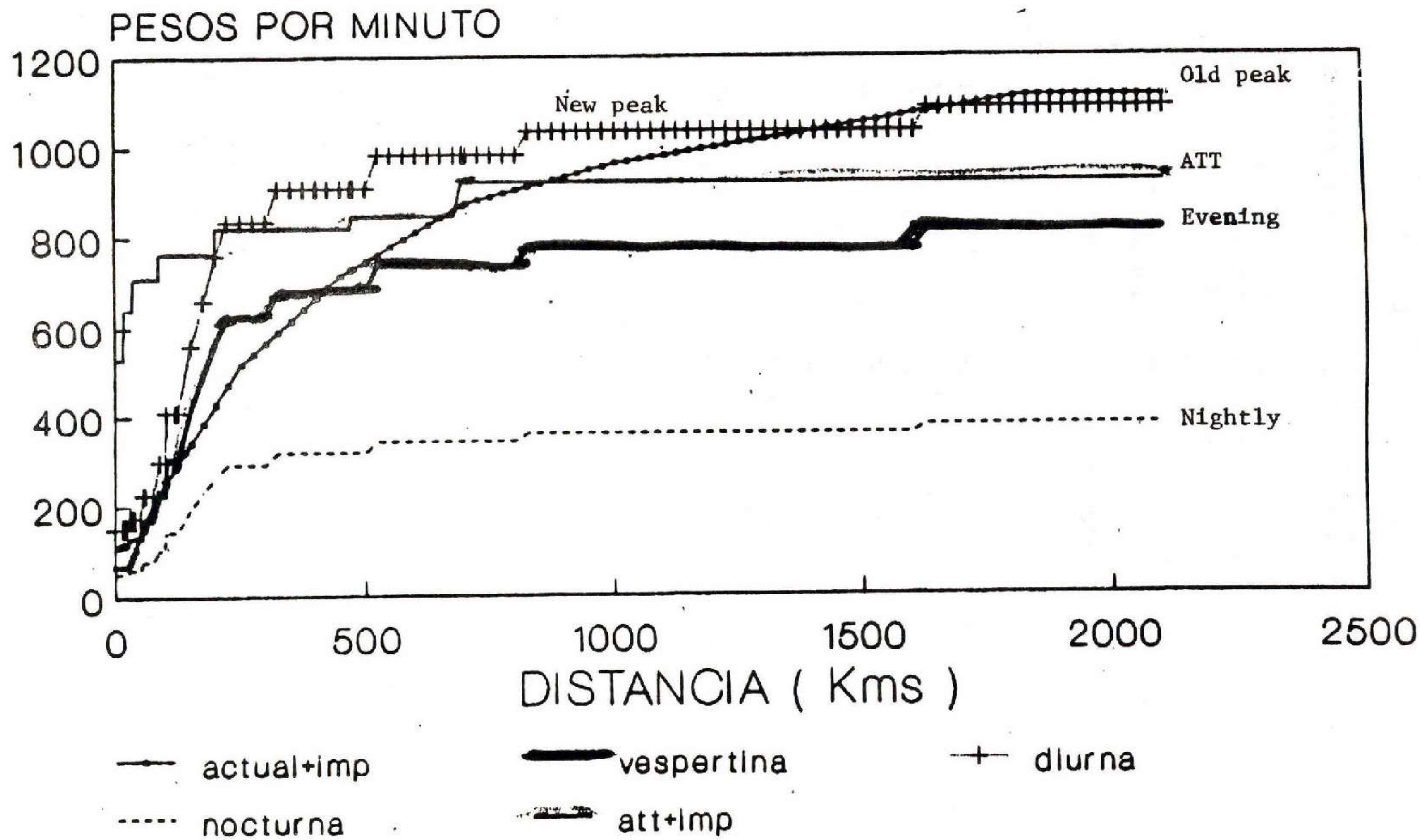
SUFRAGIO EFECTIVO. NO REELECCION
El Secretario

LIC. ANDRES CASO LOMBARDO

27 DIC '89 AM

SECRETARIA PARTICULAR
SRIA. DE COMUNICACIONES Y TRANSPORTES

TARIFA DE LARGA DISTANCIA NACIONAL
PROPUESTA DE CAMBIO ESTRUCTURAL



- 192 -

89/11/30

TABLA DE TARIFAS EUA—MEXICO
TERRITORIO DE ESTADOS UNIDOS

TARIFAS CORRESPONDIENTES A LA DISTANCIA EN MILLAS
APLICABLES AL SERVICIO TELEFONICO DENTRO DEL TERRITORIO DE LOS EUA

TARIFA EN DOLARES

MARCACION LADA, VIA OPERADORA TELEFONO A TELEFONO Y PERSONA A PERSONA

ESCALA DE MILLAS	CLAVE DE TARIFA	LADA PERIODO INICIAL 1 MIN.		VIA OPERADORA HORARIO UNICO		MINUTO ADICIONAL PARA TODOS LOS SERVICIOS	
		PLENA	REDUCIDA	T—T 3 MIN. INIC.	P—P 3 MIN. INIC.	PLENA	REDUCIDA
1 — 10	1	.21	.14	0.94	1.50	.09	.06
11 — 22	2	.24	.16	1.27	1.88	.12	.08
23 — 55	3	.36	.24	1.64	2.49	.15	.10
56 — 124	4	.42	.28	1.97	3.15	.18	.12
125 — 292	5	.54	.36	2.16	3.33	.21	.14
293 — 430	6	.60	.40	2.35	3.52	.24	.16
431 — 925	7	.63	.42	2.44	3.62	.27	.18
926 — 1910	8	.66	.44	2.54	3.71	.30	.20
1911 — 3000	9	.69	.46	2.68	3.85	.33	.22

TABLA DE HORARIOS Y DESCUENTOS

	LUN	MAR	MIER	JUE	VIER	SAB	DOM
7:00 A a 6:59 P	TARIFA PLENA					TARIFA REDUCIDA LAS 24 HORAS.	5:00 P a 11:59 P
7:00 P a 6:59 A	TARIFA REDUCIDA 33.3% DESC.						0:00 A a 4:59 P

DESCUENTOS
Se aplican al cargo total de LADA y al total de minutos adicionales para los servicios Via Operadora.

EDICION: NOVIEMBRE 2, 1987.

IMPUESTO POR LA PRESTACION DE SERVICIOS TELEFONICOS

de la Ley que Establece, Reforma, Adiciona y Deroga Diversas Disposiciones Fiscales y que Adiciona la Ley General de Sociedades Mercantiles, en vigor a partir del 1o. de enero de 1990

24- IMPUESTO POR LA PRESTACION DE SERVICIOS TELEFONICOS

Se establece un impuesto por la prestación de servicios telefónicos, a cargo de los concesionarios de dicho servicio, de conformidad con las siguientes disposiciones:

LEY DEL IMPUESTO POR LA PRESTACION DE SERVICIOS TELEFONICOS

1- SUJETOS DEL IMPUESTO

Los concesionarios de los servicios telefónicos, están obligados al pago del impuesto establecido en esta Ley.

2- TASA Y BASE DEL IMPUESTO

El impuesto a que esta Ley se refiere se calculará aplicando la tasa del 29% a la totalidad de los ingresos provenientes de la prestación de servicios telefónicos locales y de larga distancia.

ACREDITAMIENTO POR INVERSIONES Y DEDUCIBILIDAD EN LISR

Los contribuyentes de este impuesto podrán acreditar el monto de las inversiones que realicen para la prestación de los servicios señalados en el párrafo anterior, contra el 65% del impuesto que resulte a su cargo. La totalidad de este impuesto será deducible para efectos del impuesto sobre la renta.

3- DECLARACIONES PROVISIONALES Y ANUAL

Los contribuyentes de este impuesto efectuarán pagos provisionales mediante declaración que presentarán ante las oficinas autorizadas, en el mismo plazo en que deban hacer los pagos provisionales del impuesto sobre la renta.

La declaración del ejercicio, deducidos los pagos provisionales mensuales, se pagará mediante declaración que se presentará en las oficinas antes citadas, dentro de los tres meses siguientes al cierre del mismo ejercicio.

ARTICULO TRANSITORIO

1- INICIO DE LA VIGENCIA

Esta Ley entrará en vigor en toda la República el día 1o. de enero de 1990.

DISPOSICIONES DE VIGENCIA ANUAL

de la Ley que Establece, Reforma, Adiciona y Deroga Diversas Disposiciones Fiscales y que Adiciona la Ley General de Sociedades Mercantiles, en vigor a partir del 1o. de enero de 1990, aplicables a la Ley del Impuesto por la Prestación de Servicios Telefónicos

25- DISPOSICIONES CON VIGENCIA DURANTE 1990

Durante el año de 1990 se aplicarán en materia de la Ley del Impuesto por la Prestación de Servicios Telefónicos las siguientes disposiciones:

EMPRESAS CON PARTICIPACION ESTATAL MAYORITARIA

Las empresas que tengan participación estatal mayoritaria, acreditarán su inversión contra el porciento del impuesto por la prestación del servicio telefónico que autorice la Secretaría de Hacienda y Crédito Público en lugar del establecido en el artículo 2o. de esta Ley.

ARTICULOS TRANSITORIOS

de la Ley que Establece, Reforma, Adiciona y Deroga Diversas Disposiciones Fiscales y que Adiciona la Ley General de Sociedades Mercantiles, en vigor a partir del 1o. de enero de 1990, aplicables a la Ley del Impuesto por la Prestación de Servicios Telefónicos

1- INICIO DE LA VIGENCIA

La presente Ley entrará en vigor el día 1o. de enero de 1990.

2- DISPOSICIONES QUE QUEDAN SIN EFECTOS

Quedan sin efectos las disposiciones administrativas, resoluciones, consultas, interpretaciones, autorizaciones o permisos de carácter general o que se hubieran otorgado a título particular, que contravengan o se opongan a lo preceptuado en esta Ley.

....

4- ESTIMULOS FISCALES QUE QUEDAN SIN EFECTOS Y ESTIMULOS QUE CONTINUAN EN VIGOR

Se dejan sin efectos todas las disposiciones dictadas por el Ejecutivo Federal que en materia de estímulos fiscales, con excepción de las siguientes:

I. El Decreto por el que se establecen medidas que permitan impulsar la industria en la franja fronteriza norte y zonas libres del país así como en el municipio fronterizo de Cananea, Sonora, publicado en el Diario Oficial de la Federación el 31 de octubre de 1989.

II. El Decreto por el que se promueve el abasto eficiente de productos nacionales e importados en la franja fronteriza norte y zonas libres del país, así como el municipio fronterizo de Cananea, Sonora, publicado en el Diario Oficial de la Federación el 31 de octubre de 1989.

III. El Decreto que establece la devolución de impuestos de importación a los exportadores, publicado en el Diario Oficial de la Federación el 24 de abril de 1985.

Las solicitudes de estímulos fiscales pendientes de resolver, formuladas con base en las disposiciones que se dejan sin efectos, y que hubieran sido presen-

tadas antes del 1o. de enero de 1990, se tramitarán y resolverán conforme a los procedimientos previstos en dichas disposiciones.

Las personas físicas y morales que conforme a las disposiciones que se dejan sin efectos hayan obtenido certificados de promoción fiscal, podrán seguir acreditando su importe en los términos de dichas disposiciones.

Los contribuyentes a que se refiere el párrafo anterior, continuarán cumpliendo con las obligaciones que les establecieron las disposiciones que se dejan sin efectos, durante los plazos que las mismas señalan.

MEXICO

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VI - REGULATION, TARIFFS AND TAXES

e) TOR for Technical Assistance for the Telecommunications Sector

1. The program of technical assistance for the telecommunications sector to be financed by the proposed IBRD technical assistance loan (or technical assistance component of IBRD/IDB transport and telecommunications sector adjustment loan) would cover three main areas: SCT regulation of telecommunications networks and services, SCT regulation of the radio spectrum, and TELECOMM business development. Following preparation assistance in early 1990, the bulk of the program would be implemented from mid-1990 to December 1993. Up to US$ 22 million would be made available for this program under the proposed loan. Annex 1 summarizes the program in schematic form.

SCT - Regulation of Telecommunications Networks and Services

2. The objective is to assist SCT's Direccion General de Politicas y Normas de Comunicacion (DGPNC) develop its capability to regulate telecommunications services and networks. Three stages are considered, as summarized below. A suggested chronogram of main tasks is in Annex 2.

Stage I. Short-term experts on (i) price regulation of basic telephone service and (ii) licensing regime for different categories of networks and services, would provide inputs that help the government finalize the draft TELMEX franchise and the regulations for competitive services, which are conditions of processing of the IBRD/IDB adjustment loan. A total of up to 10 weeks of individual experts would be made available to SCT and other participating agencies between February and April, 1990, financed by project preparation funds administered by the IBRD and IDB. Annex 3 outlines terms of reference for these experts.

Stage II. A consulting firm would prepare a strategic plan for the development of SCT's capability to regulate telecommunications networks and services and help overview initial implementation. The work would include preparing a detailed specification and costing of technical assistance required for the first two years of implementation as Stage III. The estimated cost of about US$ 400,000 would be financed under the proposed loan. Duration: 4-6 months. Terms of reference are in Annex 4.

Stage III. Experts, training, equipment and other specialized support to SCT required to implement the first two years of the plan resulting from Stage II above. The estimated cost of about US$ 6 million (subject to revision in Stage II) would be financed under the proposed loan. Annex 5 gives further details.

SCT - Regulation of the Radio Spectrum

3. The objective is to modernize and improve SCT's capability to manage and control the use of the radio spectrum. Two stages of technical assistance are envisaged. A suggested list of main tasks and timetable is in Annex 6.

Stage I. A short-term expert would prepare a background assessment of existing capabilities, write terms of reference for consultants, and provide a tentative estimate of the composition and cost of a modernization and improvement program. The expert would be made available to SCT for about one month between February and April, 1990 financed by project preparation funds administered by IDB and IBRD. Outline terms of reference are in Annex 7.

Stage II. A consulting firm would prepare a plan for the modernization and improvement of SCT management and control of the radio spectrum, prepare a detailed specification and costing of experts, equipment and training required, and assist with the procurement of equipment and overview of its installation. The consultants will also provide specialized support to DGPNC during the first two years of implementation of the plan. The estimated consultants cost of about US$ 400,000 would be financed under the proposed loan. Outline terms of reference are in Annex 8 (full terms of reference will be prepared in Phase I). Tentatively, up to US$ 15 million could be allocated under the proposed loan for equipment, experts and training required for implementation.

TELECOMM - Business Development

4. The objective is to provide highly specialized expert advice to TELECOMM management in developing its business activities as a commercial company in a competitive environment. This would include assistance in planning the expansion and modernization of TELECOMM's domestic satellite system and other transmission facilities, assessing the market potential of new services, and exploring opportunities for joint ventures and other modalities of private investment.

5. About 15 man-months of senior corporate, marketing and technical experts would be made available to TELECOMM from mid-1990 to end 1991. The estimated cost of about US$ 0.5 million would be financed under the proposed loan. Up to about 20% of this amount could be eligible for retroactive financing (to February 1990).

Annexes

1. Schematic Summary of Technical Assistance Program

2. Proposed Tasks and Timetable of Assistance to SCT in Regulation of Networks and Services

3. Short-Term Experts on Licensing of Networks and Services and on Price Regulation - Outline Terms of Reference

4. Preparation and Initial Implementation of a Strategic Plan for Regulation of Telecommunications Networks and Services - Terms of Reference

5. Regulation of Telecommunications Networks and Services - Outline of Stage III

6. Proposed Tasks and Timetable of Assistance to SCT on Spectrum Regulation

7. Short-Term Expert on Spectrum Regulation - Outline Terms of Reference

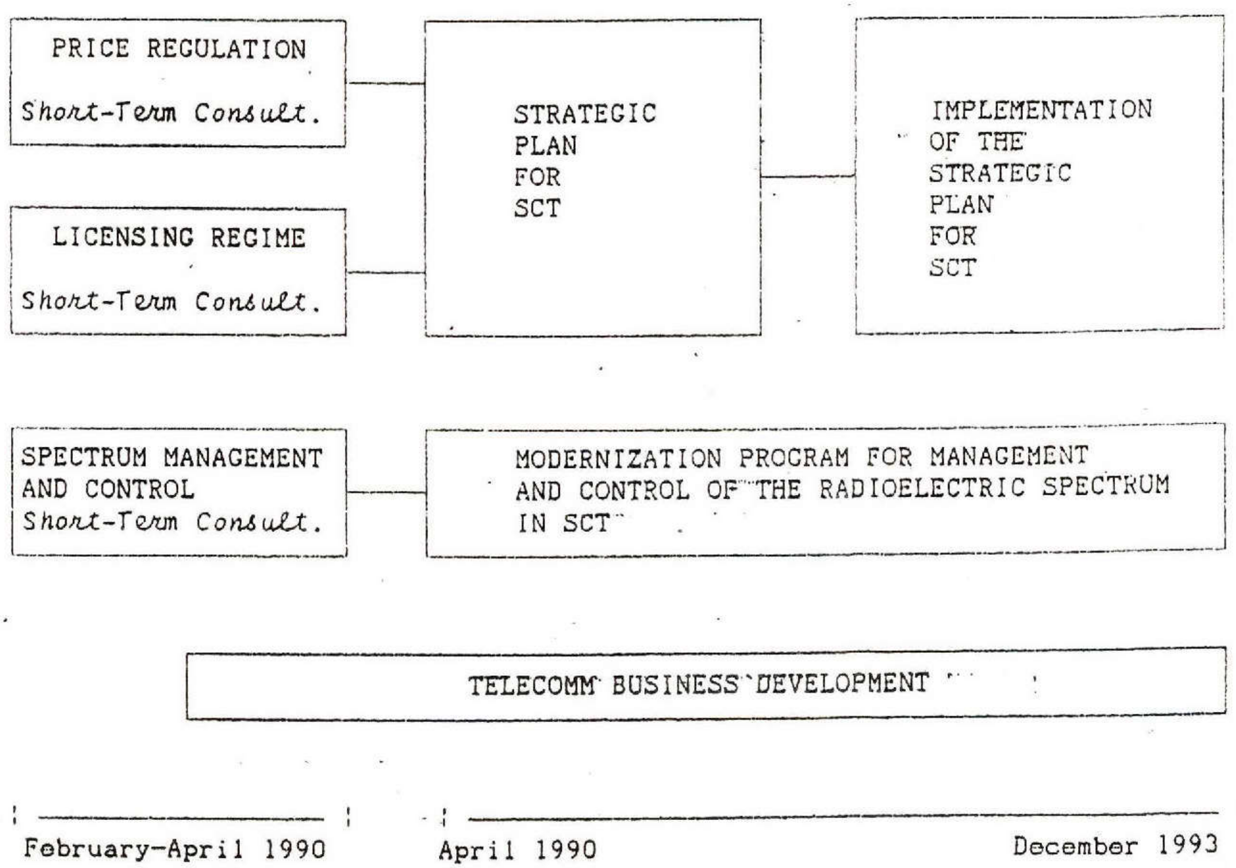
8. Preparation and Initial Implementation of a Plan to Modernize and Improve Spectrum Regulation - Outline Terms of Reference

Annex 1

M E X I C O

TECHNICAL ASSISTANCE FOR THE TELECOMMUNICATIONS SECTOR

SCHEMATIC SUMMARY OF THE PROGRAM



Annex 2

Mexico
SECRETARIA DE COMUNICACIONES Y TRANSPORTE (SCT)

REGULATION OF TELECOMMUNICATIONS NETWORKS AND SERVICES
Proposed Tasks and Timetable

Activities	1990 JFM	1990 AMJ	1990 JAS	1990 OND	1991 JFM	1991 AMJ	1991 JAS	1991 OND	1992 JFM	1992 AMJ	1992 JAS	1992 OND	1993 JFM	1993 AMJ	1993 JAS	1993 OND
I SHORT TERM CONSULTANTS																
1.0 PRICE REGULATION																
1.1 Procure Expert	=															
1.2 Undertake Assignment	=	=														
2.0 LICENSING																
2.1 Procure Expert	=															
2.2 Undertake Assignment	=	=														
II SCT STRATEGIC PLAN																
1.0 PROCURE CONSULTANTS	==															
2.0 SCT AUTHORITY																
2.1 Review Authority		=														
2.2 Make Recommendations		=														
3.0 REGULATORY REGIME																
3.1 Assess Alternatives		=														
3.2 Describe Recommended Regime		=														
4.0 REGULATORY ACTIVITIES AND ORGANIZATION																
4.1 Identify Regulatory Tasks		=														
4.2 Identify Procedures and Activities			=													
4.3 Proposed Revised Organization			=													
5.0 IMPLEMENTATION																
5.1 Prepare Implementation Plan			=													
5.2 Specify Technical Assistance			=													
5.3 Assist Initial Implementation				===												
III IMPLEMENTATION					===	===	===	===	===	===	===	===	===	===	===	===

Mexico, January 28, 1990

Annex 3

Short-Term Experts on

Licensing of Networks and Services and on Price Regulation

OUTLINE TERMS OF REFERENCE

1. Individual experts will be retained by the IBRD or the IDB to help SCT's Direccion General de Politicas y Normas de Comunicacion (DGPNC) finalize regulations for licensing telecommunications networks and services, and to assist DGPNC and other government agencies finalize a new license for TELMEX.

2. Each expert will visit Mexico on two occasions for a total of about 5 weeks (plus travel to and from Mexico) over a period of about three months.

Licensing of Telecommunications Networks and Services

3. The objective of this assignment is to assist the Mexican authorities in drafting the regulations that will govern the licensing of telecommunications networks and services.

4. The expert will:

(a) review the existing draft "reglamento" in the context of the government's "Plan de Modernizacion de las Telecomunicaciones" of September, 1989,

(b) discuss outstanding issues with SCT and other government authorities as well as with TELMEX, TELECOMM and other current and prospective service providers,

(c) propose an outline for the finalized "reglamento", including recommendations of the different categories of licenses, the main conditions of service under each category, and the criteria for allocating applications to each category, bearing in mind the need to minimize the administrative burden on both the SCT and the license applicants as well as SCT's limited staff and expertise, and

(d) review and comment on subsequent drafts of the "reglamento".

Price Regulation

5. The objective of this assignment is to assist the Mexican authorities in elaborating, reviewing and assessing alternative methodologies and approaches for the regulation of TELMEX's tariffs.

6. The expert will:

(a) help the authorities to assess the relative merits in the Mexican context of various approaches to price regulation, including:

- prices regulated by reference to international prices for comparable services,

- prices regulated on the basis of estimates of inflation and productivity gains (price cap regulation), and

- other forms of incentive regulation,

(b) through discussions with SCT, SHCP, SPP and TELMEX, help develop consensus on the approach to be adopted, and

(c) if so requested, assist in drafting sections relating to price regulation of the new TELMEX license.

Annex 4

Preparation and Initial Implementation of a Strategic Plan for Regulation of Telecommunications Networks and Services

TERMS OF REFERENCE

Background

1. In September, 1989 the Mexican government published its "Programa de Modernizacion de las Telecomunicaciones" for the period 1989-94, aimed at achieving major improvement of telecommunications services. Some of the objectives included under this program are to (i) improve service quality to approach international standards, (ii) expand service coverage in urban and rural areas, (iii) modernize and diversify services, (iv) establish competitive rates at the international level and achieve financial self-sufficiency of telecommunications providers, and (v) promote greater private investment and competition in the sector.

2. Specific initiatives towards these objectives are (i) the planned privatization of TELMEX, (ii) the creation of the state-owned, commercially-oriented TELECOMM with a mandate to operate the Morelos domestic satellite system and to provide a range of telecommunications services to businesses including some in competition with TELMEX, and (iii) promotion of increased competition in the provision of a wide range of data, value-added and other services and terminal equipment.

Objective

3. These government initiatives will require the development of a different and greatly improved regulatory capability in SCT's Direccion General de Politicas y Normas de Comunicaciones (DGPNC) in the following areas:

(a) regulatory policy;

(b) monitoring and regulation of TELMEX and other service providers in respect of their monopoly powers,

(c) authorization of the operation of different categories of networks, and

(d) development and approval of technical standards.

4. In this context the consultants, in close consultation with DGPNC and other relevant organizations, will prepare a strategic plan for the development of DGPNC's telecommunications regulatory capability, including an implementation plan and specification of technical assistance requirements until mid-1993. The consultants will assist DGPNC in the initial implementation of these plans.

Tasks

5. The following are the main specific tasks that the consultants will undertake:

(i) Review the bases of DGNPC's regulatory authority, identify problem areas and recommend changes that may be proposed to the government.

(ii) Assess the implications of recent government policies (in particular, the new TELMEX license and the regulations for the provision of competitive services) for the emerging regulatory regime, and review with DGPNC options still open for decision. This is likely to include (a) consultation with officials in other government agencies (especially SHCP and SPP), TELMEX, TELECOMM and major users, (b) organizing a series of consultative seminars including invited foreign regulatory officials and experts, and (c) providing written conclusions from these seminars.

(iii) Prepare, in close consultation with DGPNC, a written description of a recommended regulatory regime, with respect to:

(a) pricing of services,

(b) quality and conditions of service,

(c) network interconnection,

(d) provision of leased lines for resale,

(e) licensing of network facilities,

(f) licensing of resellers,

(g) application of technical standards, and

(h) sale of terminal equipment.

(iv) Identify in detail the regulatory tasks of DGPNC that correspond with the recommended regime. Regulatory tasks include insuring compliance of service providers with laws, licenses and regulations with respect to prices, quality and conditions of service, interconnection arrangements and competitive behavior.

(v) Identify the procedures, activities, functions and information necessary for DGPNC to undertake the above regulatory tasks.

(vi) Based on the findings of items (iv) and (v) above, develop and propose a revised organization structure for DGPNC that will enable it to carry out its responsibilities in an efficient and effective way. This will include a description of the roles of organizational units, staffing requirements, and necessary administrative and information systems.

(vii) Prepare a detailed implementation plan for the development of DGPNC along the recommended lines. Particular attention should be given to the development of human resources, establishment of procedures, and implementation of regulatory tasks of particular importance in the transition to a competitive privatized sector structure.

(viii) Prepare a detailed specification and cost estimates of technical assistance, proposed to be financed by the IBRD, including (a) experts and consultants, (b) secondment of experienced personnel, (c) training, and (d) equipment, computers and software. And

(ix) Assist DGPNC in the initial implementation of the recommended plan, in terms of recruitment of staff and experts, procurement of equipment, and firming up arrangements for training.

Annex 5

Regulation of Telecommunications Networks and Services

Outline of Stage III

1. In Stage III, technical assistance will support DGPNC in undertaking regulatory activities, by providing experts, on-the-job and off-site training, and equipment. The technical assistance will focus on building up a minimum core of expertise in four areas, namely (a) regulatory policy, (b) price, cost and financial analysis, (c) quality of service, investment program, technical standards and terminal equipment, and (d) administrative, legal and information systems. Tentative estimates of the minimum requirements of DGPNC professional staff, and of the requirements and costs of experts, training and equipment for the initial three years of development of these areas, are summarized in the Attachment.

Regulatory Policy

2. DGPNC must build up a capability to develop and implement regulatory policies with respect to:

(a) licensing of telecommunications newtorks facilities,

(b) licensing of resellers and other competitive service providers,

(c) provision of leased lines,

(d) anti-competitive or unduly discriminatory behavior by facilities-based service providers,

(e) network interconnection and revenue settlement arrangements and

(f) other regulatory issues.

3. The minimum number of initial DGPNC professional staff is estimated to be 3. One expert would be needed for a total of about 30 months over a three-year period. An average of at least 2 months' training per year would be needed for each DGPNC professional staff member, for a total of 18 staff-months in three years.

Price, Cost and Financial Analysis

4. DGPNC must build up a capability to :

(a) monitor, analyze and approve or reject tariff proposals,

(b) review financial projections of service providers and develop an SCT financial model of TELMEX to forecast rates of return and other financial indicators, and

(c) review methodologies and estimates of the costs of providing telecommunications services.

5. The minimum number of initial DGPNC professional staff in this area is estimated to be 6. Three experts would be needed for a total of about 90 months over a three-year period. An average of at least 2 months' training per year would be needed for each professional staff member, for a total of 36 staff-months in three years.

Quality of Service, Investment Program, Technical Standards and Terminal Equipment

6. DGPNC must develop a capacity to:

(a) establish performance indicators and systems to monitor results,

(b) assess TELMEX's investment program, depreciation and procurement policies, and

(c) establish, monitor and enforce technical standards for networks (including national fundamental technical plans) and terminal equipment.

7. The minimum number of initial DGPNC professional staff in this area is estimated to be 6. Three experts would be needed for a total of about 90 months over a three-year period. An average of at least 2 months' training per year would be needed for each professional staff member, for a total of 36 staff-months in three years.

Administrative, Legal and Information Systems

8. DGPNC must develop a capability to:

(a) operate modern administrative systems for both externally oriented needs (e.g., processing of license applications, regulatory proceedings) and internal requirements (e.g., personnel, finance, supplies),

(b) provide in-house legal advice and undertake legal actions in support of its operations, and

(c) establish and maintain information systems to support the operations of DGPNC.

9. The minimum number of initial DGPNC professional staff in this area is estimated to be 8. Four experts would be needed for a total of about 120 months over a three-year period. An average of at least 2 months' training per year would be needed for each professional staff member, for a total of 48 staff-months in three years. Equipment, including computers and standard software packages would cost about US$ 200,000.

Attachment

Summary of Minimum Human Resources Requirements

	SCT Prof. Staff	Total Months in 3 Years Experts	Training
Regulatory Policy	3	30	18
Price, Cost and Financial Analysis	6	90	36
Quality of Service, Investment Program and Technical Standards	6	90	36
Administrative, Legal and Information Systems	8	120	48
TOTAL	23	330	138

Cost Summary

	US$ thousand in three years
Experts: 330 months @ US$ 15,000 per month	4,950
Training: 138 months @ US$ 5,000 per month	690
Equipment	200
TOTAL	5,840

Mexico
SECRETARIA DE COMUNICACIONES Y TRANSPORTE (SCT)

TECHNICAL ASSISTANCE FOR MANAGEMENT AND CONTROL OF THE RADIOELECTRIC SPECTRUM
Proposed Tasks and Timetable

Activities	1990 JFM	1990 AMJ	1990 JAS	1990 OND	1991 JFM	1991 AMJ	1991 JAS	1991 OND	1992 JFM	1992 AMJ	1992 JAS	1992 OND	1993 JFM	1993 AMJ	1993 JAS	1993 OND
I SHORT-TERM CONSULTANT (Stage I)	=															
II PROCUREMENT OF CONSULTANTS (Stage II)	=	=														
1.0 ORGANIZATION																
1.1 Review of Existing Organization		==	=													
1.2 Organization to be Adopted																
(a) Description of Activities, Responsibilities, and Functional Units.			==	===												
(b) Personnel Requirements and Qualifications.				===	===											
(c) Development of Internal Procedures				===	===											
(d) Development of User Procedures				===	===											
2.0 MANAGEMENT OF THE SPECTRUM																
2.1 Regulation Proposals			===	===												
2.2 Systems for Interference Analysis and Frequency Assignment.			===													
3.0 CONTROL OF THE SPECTRUM																
3.1 Control Systems			===													
3.2 Proposals for Enforcement Systems			===	===												
3.3 Equipment and Software:																
(a) System Design and Specifications			===	===												
(b) Procurement					===	===										
(c) Installation and Testing							===									
4.0 TRAINING																
4.1 On-the-Job Training		===	===	===	===	===	===	===	===	===	===					
4.2 Foreign Training					===	===	===									
5.0 IMPLEMENTATION OF THE NEW SYSTEMS																
5.1 Internal Organization						===	===	===								
5.2 Spectrum Management. License System.								===	===							
5.3 Control and Enforcement Systems								===	===							
5.4 Supervision of the Implementation						===	===	===	===	===	===					
6.0 EVALUATION														==		

Mexico, January 28, 1990

Annex 7

Short-Term Expert on Spectrum Management

OUTLINE TERMS OF REFERENCE

1. An individual expert will be retained by the IBRD or the IDB to assist the Direccion General de Politicas y Normas de Comunicacion (DGPNC) in outlining a plan to modernize and improve the management and control of the radioelectric spectrum in Mexico.

2. The expert will visit Mexico on two occasions for a total of about 5 weeks (plus travel to and from Mexico) over a period of about three months.

3. The expert will:

(a) review, and prepare a report on, DGPNC's present functions, organization, staffing and equipment in the area of radio spectrum management and control,

(b) prepare initial estimates of the costs of the first three years of modernization and improvement of these activities and facilities, including:

-consulting services,

-long-term seconded experts,

-training, and

-equipment, computers and software,

(c) prepare terms of reference for a consulting firm that will be retained by DGPNC to develop a plan for the modernization and improvement of these activities and facilities as part of a proposed World Bank technical assistance program and loan, along the lines of a preliminary draft terms of reference prepared by DGPNC and the World Bank. The final terms of reference should include:

-objectives of the assignment,

-scope and timing of the required consulting services,

-inputs to be provided by DGPNC, and

-specification of the desired outputs,

(d) help DGPNC prepare a short list of suitable consulting firms to be invited to submit proposals for the above assignment, and

(e) help DGPNC evaluate the proposals received from consulting firms.

4. DGPNC will provide the expert with (a) full access to its staff and facilities, (b) lists and specifications of existing equipment and software, (c) information on the present organization, including descriptions of functions, organization charts, personnel statistics and qualifications, and regional division of responsibilities and resources, (d) local transportation and (e) office, secretarial support, and communication facilities.

5. The expert's contract may be extended to assist DGPNC from time to time in reviewing progress of the consultants referred to in paragraph 3(c) to 3(e) above.

Annex 8

MEXICO

SECRETARIA DE COMUNICACIONES Y TRANSPORTES

REGULATION OF THE RADIO SPECTRUM

Objectives

1. Technical assistance to SCT regarding the regulation of the radio spectrum has the following objectives:

   i. to modernize and improve SCT's administrative and technical capability to manage the use of the radio spectrum;

   ii. to establish a computer-assisted radio-frequency spectrum management and monitoring system in the country.

Project Justification

2. The following problems have been identified in the process of allocation and licencing of the radio spectrum in Mexico:

   (a) procedures for granting licenses for the use of radio frequencies and the installation of telecommunications equipment are mostly manual and take several months to process;

   (b) this low processing encourages illegal use of frequencies and results in loss of revenue to the Government;

   (c) coordination with foreign networks, particularly with the USA, cannot be adequately studied within the prescribed time periods because of its large volume;

   (d) in several areas of the country, the radio spectrum is saturated;

   (e) the data base for concessions and permits is inaccurate and fragmentary;

   (f) monitoring stations must be modernized or replaced by mobil units;

   (g) organizational changes aimed at substantially improving the attention to the public and shortening the processing of applications, at the same time assuring that multiple networks can operate under conditions free of harmful interference, are urgently required.

3. Modernization of the Mexican telecommunications network and specific government initiatives towards the privatization of TELMEX, the creation of the state-owned commercially oriented TELECOMM, and the promotion of competition in

the provision of services requires the strengthening of SCT regulatory capability in several areas, including the management and monitoring of the radioelectric spectrum.

4. The radioelectric frequency spectrum (10 kilohertz-300 gigahertz) is recognized as a natural resource that must be fairly, efficiently and economically allocated and exploited. Both national and international radio communications would degenerate in chaos without a coherent and integrated system for allocating and managing the finite number of places on the spectrum among the growing number of services and users.

5. The CCIR has stated that "with the increasing complexity of spectrum management, due to growing demands on the spectrum, administrations may find it desirable to employ computer-assisted analysis techniques to achieve more efficient spectrum utilization", and that "a substantial range of spectrum utilization problems encompass data storage, retrieval and analysis activities, and are consequently amenable to the application of computer-based methods".

Solution to the problems listed in para. 2 through the proposed technical assistance will result in improved attention to the public, an effective planning and control of revenue collection, effective and timely reaction to coordination requests, fair use of the radio spectrum, and orderly development of the telecommunications infrastructure.

Project Scope

6. The Project will comprise the following components:

(a) organization of the units under Dirección General de Políticas y Normas de Comunicaciones (DGPNC) that will manage the radio spectrum;

(b) development of computer-assisted administrative procedures for every step in the analysis of systems, granting of licenses, and collection of revenues;

(c) assistance to update or develop regulation on the use of the spectrum;

(d) assistance to update or develop enforcement procedures;

(e) development of computerized systems for interference analysis and frequency assignment;

(f) development of a topographic data base and other documentation necessary to perform the spectrum management functions;

(g) procurement and installation of a system for the purpose of automating the radio-frequency management and monitoring functions, including a computer network linking Mexico City and the state capitals, specialized operative application software, fixed monitoring stations, and mobile spectrum monitoring vehicles;

(h) implementation of the new administrative and technical systems;

(i) on-the-job and abroad training of DGPNC staff.

(j) evaluation of the new systems some time after their implementation.

The main tasks to be assumed by the consultants provided through the technical assistance are summarized in Table ---. A general chronogram of activities is shown in Annex ---.

Table ---. Consultant Tasks and Outputs

	Tasks		Output
1.0	**Organization**		
1.1	Review of existing organization	a)	Report on findings
1.2	Organization to be adopted	a)	Description of activities, responsibilities,and functional units.
		b)	Recommendations on personnel requirements and qualifications.
		c)	Development of internal procedures (flow diagrams, forms, manuals).
		d)	Development of user procedures (instructions, forms).
2.0	**Management of the Radioelectric Spectrum**		
2.1	Regulation	a)	Recommendations on regulations to be established (Networks, services).
		b)	Draft documents of proposed regulation.
2.2	Computerized systems (hardware and software) for interference analysis and frequency assignment	a)	Specifications of systems: computers, analytical tools, computer programs, selected textbooks and manuals (e.g., CCIR).
3.0	**Control of the Radioelectric Spectrum**		
3.1	Type of control to be adopted	a)	Development of alternatives.
		b)	Specification of the alternative adopted by SCT: type of installations (fixed, mobil, zones, organization and personnel requirements).
		c)	Cooperation with other agencies (e.g., spectrum control and coordination for the satellite network, with Telecomm's technical means).

	Tasks		Output
3.2	Enforcement	a)	Proposals on enforcement regulation.
		b)	Draft documents of proposed regulation.
3.3	Equipment and software	a)	Monitoring stations, computers, instruments.
		b)	Software: computer programs, procedures, instructions.
4.0	**Training**	a)	On-the-job training and seminars.
		b)	Recommendations on foreign training and visits to other administrations.
5.0	**Implementation of the new systems**	a)	Internal organization.
		b)	Spectrum management. License system.
		c)	Control and enforcement systems.
		d)	Supervision of implemented systems.
6.0	**Evaluation**	a)	Evaluation mission and final recommendations.

Mexico
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT
CHAPTER VII - DIVESTITURE OF SCT'S OPERATIONS

a) Creation of TELECOMM

1. The Government considers that administrative modernization requires to separate the operation of services from the authority functions and, consequently, that the basic telecommunications network operated by the *Secretaría de Comunicaciones y Transporte (SCT)* should be administered by a decentralized entity.

2. *Telégrafos Nacionales (Telenales)* had been created as a decentralized entity on August 20, 1986, with the telegraph service as its major function. Using this existing structure, the Government determined, by Decree issued on November 17, 1989 (See Attachment 1), to transfer form SCT the network and the responsibility for providing the corresponding services, changing at the same time the name of the entity to *Telecomunicaciones de México (TELECOMM)*. Mr. Carlos Lara has been appointed as its General Director.

3. TELECOMM is now in the process of receiving the facilities, human resources and financial resources from SCT. Due to the proximity of Fiscal Year end (December), it was decided to close books for 1989 separately for Telenales and SCT. Total staff increased from 14,000 to about 19,000, although TELECOMM estimates some 3,000-4,000 voluntary retirements in 1990. The main concern is in relation to the value of the assets received from SCT; as depreciation was not used in the Government accounting, some data like purchase dates is difficult to obtain. TELECOMM revenues now come through tariffs that do not require Congress approval.

4. A six-year plan for the new entity would be available in around 6 months. Currently, the only available document is the authorized 1990 budget, where all expenses are financed through internally generated funds.

5. Telecomm's investment program in 1990 (including maintenance works) amounts to US$ 39.5 million, according to the approved budget (See Attachment 2). Several plans are being discussed to improve this investment program. Telecomm is mainly looking for some joint ventures to bring the necessary capital in programs like the installation of an optic fiber cable network, corporate networks through Morelos satellite, and new links with the United States. Earth stations in the satellite network will be equipped for voice and data transmission. Digital microwave links Mexico-Monterrey-Matamoros and Mexico-Poza Rica will be completed and Guadalajara-Hermosillo will be modernized. Numerous open wire lines will be substituted by radio lines and satellite links. Obsolete telex equipment will be replaced and major telegraph administrations will be converted into Integrated Service Centers (telegraph, telex, facsimile, electronic mail, electronic fund transfer).

Maintenance works cover the components of the existing infrastructure summarized in Attachment 3.

DDELGADO - Mexico, January 1990

Attachment 2

Mexico
TELECOMUNICACIONES DE MEXICO (TELECOMM)

Investment Distribution in 1990 (*)

(US$ Thousand)

State	Telegraph Service Amount	%	Other Services Amount	%	Total	%
1 Aguascalientes	45.9	70.6	19.1	29.4	65.0	0.16
2 Baja California	261.7	6.8	3,593.3	93.2	3,855.0	9.77
3 Baja California Sur	60.3	47.3	67.2	52.7	127.5	0.32
4 Campeche	84.8	66.6	42.5	33.4	127.3	0.32
5 Coahuila	170.4	8.1	1,920.3	91.9	2,090.7	5.30
6 Colima	56.1	3.1	1,748.6	96.9	1,804.8	4.57
7 Chiapas	317.0	82.1	69.2	17.9	386.2	0.98
8 Chihuahua	115.1	55.1	93.8	44.9	208.8	0.53
9 Distrito Federal	0.0	0.0	7,850.8	100.0	7,850.8	19.89
10 Durango	140.3	10.6	1,178.6	89.4	1,318.8	3.34
11 Guanajuato	182.5	72.1	70.8	27.9	253.3	0.64
12 Guerrero	314.5	85.7	52.3	14.3	366.8	0.93
13 Hidalgo	117.5	78.5	32.3	21.5	149.7	0.38
14 Jalisco	381.0	15.8	2,027.5	84.2	2,408.5	6.10
15 Mexico	129.4	69.6	56.4	30.4	185.8	0.47
16 Michoacan	293.0	83.3	59.0	16.7	352.0	0.89
17 Morelos	112.5	73.9	39.8	26.1	152.2	0.39
18 Nayarit	284.8	85.5	48.4	14.5	333.1	0.84
19 Nuevo Leon	256.3	13.2	1,685.4	86.8	1,941.7	4.92
20 Oaxaca	432.5	82.1	94.0	17.9	526.5	1.33
21 Puebla	152.9	78.2	42.7	21.8	195.6	0.50
22 Queretaro	53.8	69.5	23.6	30.5	77.4	0.20
23 Quintana Roo	35.8	31.3	78.4	68.7	114.2	0.29
24 San Luis Potosi	131.2	80.5	31.8	19.5	163.0	0.41
25 Sinaloa	170.4	2.9	5,699.2	97.1	5,869.6	14.87
26 Sonora	283.9	7.2	3,650.8	92.8	3,934.8	9.97
27 Tabasco	138.1	81.8	30.7	18.2	168.8	0.43
28 Tamaulipas	147.2	6.7	2,046.0	93.3	2,193.1	5.56
29 Tlaxcala	40.5	68.5	18.7	31.5	59.2	0.15
30 Veracruz	432.3	23.9	1,373.7	76.1	1,806.1	4.58
31 Yucatan	196.8	75.5	63.7	24.5	260.5	0.66
32 Zacatecas	109.1	84.2	20.5	15.8	129.6	0.33
Total:	5,647.6	14.3	33,829.0	85.7	39,476.6	100.00

Rate of Exchange: US$1.00 = Peso 2,690
(*) Including maintenance works.

Attachment 3

Mexico
TELECOMUNICACIONES DE MEXICO (TELECOMM)
Telecommunications Infrastructure Covered by the Maintenance Program in 1990

State	(1) Earth Stations	(2) MW Stations	(3) Maritime Stations	(4) O.W. Lines	(5) Telex Concentr.	(6) Telegr. Exchng.	(7) Telepac Ports	(8) Money Tr. Node	(9) Buildng.	(10) Admnstr.
1 Aguascalientes	2	1		180	1		24			11
2 Baja California	5	19	1	200	3					32
3 Baja California Sur	19	6	1	150	1					27
4 Campeche	4	13		300	1					20
5 Coahuila	11	33		600	4		40			46
6 Colima	4	8	1	200	2					19
7 Chiapas	11	23		600	2					60
8 Chihuahua	17	28		400			32			52
9 Distrito Federal	21	26			1 (b)	2	656	2		85
10 Durango	7	17		500	1		32			41
11 Guanajuato	4	18		200	5	1	24			56
12 Guerrero	7	11	1	760	1		16			60
13 Hidalgo	4	11		390	1					34
14 Jalisco	10	18		900	1 (b)	1	72	1		106
15 Mexico	3	15		380	2		32			57
16 Michoacan	8	12		700	3					56
17 Morelos	1	7		250	1		24			28
18 Nayarit	3	7		839 (a)	1					40
19 Nuevo Leon	5	25		550 (a)	1 (b)	1	136		42	35
20 Oaxaca	17	24		1500 (a)	1		24		72	112
21 Puebla	1	10		500	1		40			56
22 Queretaro		6		250 (a)	1		24			11
23 Quintana Roo	19	12	2	90	1					12
24 San Luis Potosi	5	10		500	1					35
25 Sinaloa	5	23		615	4			24		76
26 Sonora	43	43	1	800	1 (b)	1	48	1		82
27 Tabasco	1	8		400	1		32			32
28 Tamaulipas	12	29	1	500	5		16			44
29 Tlaxcala	1	5		200						12
30 Veracruz	4	44	2	950	6	3	56			115
31 Yucatan	7	14	1	409 (a)	1		24			28
32 Zacatecas	4	7		450						33
Total:	265	533	11	15263	55	9	1352	28	114	1523

Notes:
(2) Radio and multiplex stations.
(4) Open wire lines in the telegraph network. (a) Including dismantling in some paths.
(5) Telex concentrators. (b) Telex exchanges.
(6) Automatic telegraph exchanges.
(8) Nodes in an overlay network for money transfer.
(9) Buildings
(10) Local offices (Administrations) providing telegraph service. Obsolete equipment will be replaced in some of these offices.

Mexico, January 26, 1990

Viernes 17 de noviembre de 1989 DIARIO OFICIAL

SECRETARIA DE COMUNICACIONES Y TRANSPORTES

DECRETO por el que se modifica la denominación del organismo descentralizado Telégrafos Nacionales y se reforman los Artículos 1o., 3o., 4o. y 15 del Decreto por el que se crea dicho organismo, publicado el 20 de agosto de 1986.

Al margen un sello con el Escudo Nacional, que dice: Estados Unidos Mexicanos.- Presidencia de la República.

CARLOS SALINAS DE GORTARI, Presidente Constitucional de los Estados Unidos Mexicanos, en ejercicio de la facultad que me confiere la fracción I del Artículo 89 de la Constitución Política de los Estados Unidos Mexicanos, y con fundamento en los Artículos 28, 31, 32, 32-bis, 36, 37 y 45 de la Ley Orgánica de la Administración Pública Federal; 14, 15 y demás relativos de la Ley Federal de las Entidades Paraestatales; 1o , 3o y 11 de la Ley de Vías Generales de Comunicación, y

CONSIDERANDO

PRIMERO.—Que las telecomunicaciones constituyen una infraestructura básica para impulsar la modernización del país, favorecer su integración y facilitar un desarrollo social y regional más equilibrado.

SEGUNDO.—Que dentro de la política de comunicaciones y transportes contenida en el Plan Nacional de Desarrollo 1989-1994, se señala la necesidad de modernizar a las telecomunicaciones, para lo cual el Estado, por un lado, ejercerá la rectoría en la materia y por el otro, inducirá su desarrollo con una mayor participación de los particulares.

TERCERO.—Que los Artículos 25 y 28 de la Constitución Política de los Estados Unidos Mexicanos, y 11 de la Ley de Vías Generales de Comunicación consideran como actividad reservada en forma exclusiva al Estado, entre otros, la prestación de los servicios públicos de telégrafos y radiotelegrafía.

CUARTO.—Que Telégrafos Nacionales es un organismo descentralizado con personalidad jurídica y patrimonio propios, creado por Decreto Presidencial publicado en el **Diario Oficial de la Federación** el 20 de agosto de 1986, con el objeto principal de prestar el servicio público de telégrafos.

QUINTO.—Que en el marco de modernización administrativa, se hace necesario que una red básica de conducción de señales de voz, sonido, datos, imagen y televisión a cargo de la Secretaría de Comunicaciones y Transportes, se administre en forma descentralizada por el Estado, separando así la función de autoridad, de la prestación de servicios.

SEXTO.—Que la mencionada descentralización puede llevarse a cabo aprovechando la actual estructura del organismo descentralizado Telégrafos Nacionales, lo cual facilitará la modernización y redimensionamiento del servicio público de telégrafos, así como la prestación de los servicios de conducción de señales sin necesidad de crear una nueva entidad, a fin de propiciar ahorros en el gasto y facilitar la autosuficiencia financiera del organismo.

SEPTIMO.—Que para alcanzar tales objetivos, es menester transformar al actual organismo Telégrafos Nacionales, ampliar su ámbito de competencia y como consecuencia cambiar su denominación; he tenido a bien dictar el siguiente

DECRETO

ARTICULO UNICO.—Se modifica la denominación del organismo descentralizado Telégrafos Nacionales y se reforman los Artículos 1o , 3o , 4o y 15 del Decreto por el que se crea dicho organismo, publicado en el **Diario Oficial de la Federación** el 20 de agosto de 1986, para quedar como sigue:

ARTICULO 1o.—Telecomunicaciones de México es un organismo descentralizado con personalidad jurídica y patrimonio propios, cuyo objeto principal es la prestación del servicio público de telégrafos y los de telecomunicaciones, así como los de carácter prioritario que se encuentren directamente relacionados con ellos.

ARTICULO 3o.—Telecomunicaciones de México, tendrá las siguientes funciones:

I. Proporcionar los servicios públicos de telégrafos, giros telegráficos y télex, así como instalar y conservar su infraestructura.

II. Instalar, conservar, operar y explotar una red básica para servicios de conducción de señales de voz, sonido, datos, textos, imagen y televisión, por medio de estaciones terrenas y un sistema de radiocomunicación satelital, así como una red de microondas y fibras ópticas.

III. Fomentar servicios de telecomunicaciones mediante la participación temporal minoritaria en el capital social de sociedades mercantiles.

IV. Asesorar a los gobiernos estatales y a las dependencias y entidades del Gobierno Federal en materia de sistemas de telecomunicaciones.

V. Programar, ajustándose a los programas sectoriales respectivos, organizar, operar y controlar la prestación del servicio de telégrafos y diversos a su cargo, que se encuentren establecidos en las leyes y convenios internacionales vigentes, así como en el presente Decreto.

VI. Establecer la interconexión de sistemas de telecomunicaciones a su cargo con otros de entidades o empresas nacionales o extranjeras, así como combinar sus servicios, atendiendo a las bases que fije la Secretaría de Comunicaciones y Transportes.

VII. Proponer a la Secretaría de Hacienda y Crédito Público, por conducto de la Secretaría de Comunicaciones y Transportes, las tarifas aplicables a los servicios que proporciona, con base en los estudios técnicos-económicos que lo justifiquen.

VIII. Percibir y administrar, en los términos de la legislación aplicable, los ingresos generados por los servicios que preste, así como ejercerlos conforme a su presupuesto autorizado.

IX. Participar en los organismos y foros internacionales sobre telecomunicaciones, en coordinación con la Secretaría de Comunicaciones y Transportes.

X. Administrar las Escuelas Nacionales de Telégrafos y Telecomunicaciones y establecer cursos de capacitación para su personal en México y en el extranjero.

XI. Incorporar los avances tecnológicos en la prestación de sus servicios y participar en la investigación tecnológica e industrial en materia de telecomunicaciones, a través de programas concertados con el Instituto Mexicano de Comunicaciones y otras instituciones de investigación y desarrollo.

XII. En general, realizar y celebrar los actos jurídicos necesarios para el desarrollo de sus funciones de acuerdo con las disposiciones legales aplicables.

ARTICULO 4o.—El patrimonio del organismo se integrará con:

I. ....

II. Los ingresos derivados de los servicios que preste.

III. y IV. ....

ARTICULO 15.—Conforme a lo dispuesto por el artículo 5o. de la Ley de Vías Generales de Comunicación, queda reservado a los Tribunales Federales el conocimiento y resolución de todas aquellas controversias en que sea parte el organismo Telecomunicaciones de México.

TRANSITORIOS

PRIMERO.—El presente Decreto entrará en vigor al día siguiente de su publicación en el **Diario Oficial de la Federación**.

SEGUNDO.—Se derogan todas las disposiciones que se opongan al presente ordenamiento.

TERCERO.—Los recursos materiales, humanos y financieros destinados a la Dirección General de Telecomunicaciones de la Secretaría de Comunicaciones y Transportes, que determine esta última, se transferirán al organismo descentralizado Telecomunicaciones de México.

CUARTO.—Los derechos laborales de los trabajadores que se incorporen al organismo Telecomunicaciones de México, serán respetados conforme a la Ley.

QUINTO.—Las Secretarías de Hacienda y Crédito Público, de Programación y Presupuesto, de Comunicaciones y Transportes y de Desarrollo Urbano y Ecología, tomarán las medidas necesarias para el debido cumplimiento del presente Decreto.

Dado en la residencia del poder Ejecutivo Federal, en la Ciudad de México, Distrito Federal, a los dieciséis días del mes de noviembre de mil novecientos ochenta y nueve.- **Carlos Salinas de Gortari**.- Rúbrica.- El Secretario de Relaciones Exteriores, **Fernando Solana Morales**.- Rúbrica.- El Secretario de Hacienda y Crédito Público, **Pedro Aspe Armella**.- Rúbrica.-El Secretario de Programación y Presupuesto, **Ernesto Cedillo Ponce de León**.-Rúbrica.-La Secretaria de la Contraloría General de la Federación, **Ma. Elena Vázquez Nava**.-Rúbrica.-El Secretario de Comunicaciones y Transportes, **Andrés Caso Lombardo**.-Rúbrica.-El Secretario de Desarrollo Urbano y Ecología, **Patricio Chirinos Calero**.-Rúbrica.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VII - DIVESTITURE OF SCT'S OPERATIONS

b) TELMEX - TELECOMM Relationship

TELMEX uses some 150,000 long distance circuits, 47,000 of them are leased from TELECOMM. Most of them belong to the old analog microwave network and a few are Morelos satellite circuits. TELMEX leases from TELECOMM non - multiplexed circuits (at the supergroup or mastergroup level, 60 circuits or more); these circuits packages are split down (multiplexed) to the voice channel level by TELMEX, and TELECOMM leases back from TELMEX some 5,000 voice channel level circuits. This total transaction represents around Mx $ 150,000 million (US $ 55 million) which amounts to 50 % of total revenues for TELECOMM, but it represents only 1.5 % of total TELMEX revenues. Due to this unbalance the negotiation of leased circuits is essential to TELECOMM and only marginal to TELMEX.

On Monday 25 October 1989 the then TELMEX's Chairman of the Board (then Mr. Andres Caso Lombardo) instructed the 2 entities to reach a new agreement to be signed on Wed 25 October 1989, last day of his Chairmanship. The draft agreement was signed by the working staff but not by the Director Generals, Mr. Joaquin Munoz and Mr. Caso Lombardo, because a new Director General had been nominated for TELMEX and was going to take office the next day.

That draft agreement did not impose on TELMEX the obligation to rent circuits from TELECOMM; it said: "the present agreement in NO way limits the freedom of TELMEX to build its own circuits,... except that the national interest has to be considered in the case of existing routes...", but in the current situation where TELMEX hopes to be privatized and independent from government in the near future, and TELECOMM feels free to initiate new ventures, both entities are planning huge investments in fiber optic long distance networks to replace the analog microwave circuits and provide for the large number of new channels to be required by the planned network expansion.

The on-going negotiation is based upon the Annex to the October 1989 Draft Agreement (see Attachment 1) which basically stated:

<u>I. Permanent Services.</u> It established a price for non - multiplexed (around 30 % of the AT&T price) and for multiplexed circuits (around 80 % of the AT&T price) according to the length of the circuit.

There is agreement on:

a) that MUX means voice level channel,

b) that rates are in Mx $ not in US $, because the rates TELMEX charges to public are in Mx $ and most of the equipment is well depreciated with minimum maintenance in US $.

There is no agreement on :

a) TELECOMM would like to review in relation to costs the rates per km range established in the draft agreement and to renegotiate the values per distance range

b) TELMEX insists that this agreement refers to terrestrial circuits, with no relation to satellite circuits. The previous contract forced TELMEX to take 5,000 Morelos satellite circuits.

II. Non - Permanent Services. There is no agreement on the definition of these services; for TELMEX these are services provided by TELECOMM to third parties on an occasional basis, then they would fall in the Commercialization of Services category (see next paragraph)

III. Commercialization of Services. TELECOMM ask for a 20 % discount on TELMEX rates when circuits are to be leased by TELECOMM to third parties; TELMEX offers a 5 % fee for a year on old circuits, and a 10 % fee for a year for new circuits commercialized by TELECOMM.

CUOTAS, DISPOSICIONES Y PROCEDIMIENTOS SOBRE LOS CIRCUITOS A QUE SE REFIERE EL CONVENIO DE INTERCAMBIO ENTRE TELECOM Y TELMEX.

I. Servicios Permanentes

Las siguientes tarifas mensuales por circuito analógico o digital de voz punto a punto interurbano utilizado a través de sistemas de microondas, se aplicarán exclusivamente para la infraestructura y servicios que se intercambian TELECOM y TELMEX.

I.1. Servicio Permanente sin equipo múltiplex. (30% ATT)

RANGO (Kilómetros)	CARGO FIJO (pesos)	CARGO POR Km. (pesos)
1 - 80	62,000	1,100
81 - 160	111,000	500
161 - 800	144,000	300
801 - 1600	270,000	200
1601 - +	270,000	200

I.2. Servicio permanente con equipo múltiplex: (80% ATT)

RANGO (Kilómetros)	CARGO FIJO (pesos)	CARGO POR Km. (pesos)
1 - 80	165,000	3,000
81 - 160	300,000	1,300
161 - 800	385,000	800
801 - 1600	720,000	600
1601 - +	720,000	600

La aplicación de estas cuotas a la longitud de cada circuito no es acumulativa. Cada rango excluye a los anteriores.

Las cuotas se actualizarán mensualmente manteniendo su equivalencia con respecto al dólar de los Estados Unidos de América (paridad del mes determinada por el Banco de México para uso de dependencias oficiales), a partir de la fecha de la firma de este convenio.

II. Servicios Eventuales.

Las cuotas que aplicarán para los servicios nacionales con duración de un día o más, por circuito serán:

	Porciento de la cuota mensual del servicio permanente.
1. Primero y segundo días, por cada día	10%
2. Del tercero al décimo día, por cada día	5%
3. Del décimo primer día en adelante, por cada día	4%

La suma de estas cuotas no será superior al importe de la cuota mensual del servicio permanente.

III. Comercialización de Servicios.

Cuando TELMEX proporcione a TELECOM circuitos interurbanos y líneas privadas para que ésta comercialice a terceros, se aplicará un descuento del 20% sobre las tarifas al público que tenga autorizadas TELMEX.

IV. Otros Servicios.

Las cuotas de otros servicios que se intercambien TELMEX y TELECOM, serán las mismas que se apliquen al público usuario y que estén autorizadas por las Secretarías de Comunicaciones y Transportes y Hacienda y Crédito Público.

El presente anexo entra en vigor a partir del primero de enero de 1990, une vez que se haya cumplido con la legislación correspondiente.

México, D.F., a 25 de octubre de 1989

F I R M A S

POR TELECOM

LIC. ANDRES CASO LOMBARDO
C. SECRETARIO DE COMUNICACIONES
Y TRANSPORTES

POR TELMEX

C.P. JOAQUIN MUÑOZ IZQUIERDO
DIRECTOR GENERAL

Mexico
ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

CHAPTER VIII - LIST OF OTHER DOCUMENTS AVAILABLE IN PROJECT FILES

Government - Secretaría de Comunicaciones y Transportes

1. Secretaría de Comunicaciones y Transportes. Programa 1989-1994. Julio, 1989.

2. Programa de modernización de las telecomunicaciones. September, 1989.

3. Términos de referencia para la realización del estudio: Planeación estratégica de la Dirección General de Políticas y Normas de Comunicaciones. Octubre, 1989.

4. Términos de referencia para la realización del estudio: Planeación estratégica de la Dirección General de Políticas y Normas de Comunicaciones. Noviembre, 1989.

5. Instructivo para integrar la solicitud de concesión servicio de radiotelefonía móvil celular. Noviembre, 1989.

6. Programa de desregulación económica. Proyectos de desregulación económica del subsector telecomunicaciones - Asistencia técnica e inversión privada en infraestructura. Noviembre 6, 1989.

7. Reglamento de servicios telemáticos, complementarios y de comunicación de voz, datos y videoconferencia por satélite o por redes superpuestas. Documento preliminar. November, 1989.

8. Decreto que reforma el Reglamento Interior de la Secretaría de Comunicaciones y Transportes. Agosto 20, 1986.

9. SCT: Redes y servicios de telecomunicaciones. 1986.

10. Secretaría de Comunicaciones y Transportes. Ley de vías generales de comunicación y Reglamentos. Ley del servicio postal mexicano. 1987.

11. SCT. Dirección General. Memoria Sexenal 1983-88.

12. SCT. Proyectos a financiarse por el BID. Mayo 16, 1988.

13. Secretaría de Comunicaciones y Transportes. Ley de adquisiciones, arrendamientos y prestación de servicios relacionados con bienes muebles, y material normativo complementario. Julio, 1988.

14. México y el Grupo de los Ocho: Comunicaciones y transportes. 1989.

15. Dirección General de Normatividad y Control de Comunicaciones. Instructivo para la presentación de solicitudes de concesión para prestar el servicio de localización de personas.

16. SCT. Telecomunicaciones nacionales. Programa 1989-1994. Documento preliminar. Julio, 1989.

17. Dirección General de Fomento a las Telecomunicciones e Informática: Estrategia de fomento a la calidad de los servicios en el sector de las comunicaciones en México. Noviembre, 1989.

Telmex

1. Telmex. L.D. en cifras 1988.

2. Teléfonos de México. Informe anual 1988.

3. Estrategia de desarrollo de Telmex 1989-1994. Junio 30, 1989.

4. Telmex. Desarrollo y perspectivas. Septiembre, 1989.

5. Telmex. Implicaciones de la cartera tarifaria construida con base en los precios de las administraciones telefónicas norteamericanas. Octubre 23, 1989.

6. Modificación al titulo de concesión de Teléfonos de México, S.A. de C.V. Octubre 25, 1989.

7. Plan de modernización de Telmex. Edición 1989.

8. Telmex: Plan de 45 días para el mejoramiento del servicio telefónico. 1989.

9. Telmex: Decisión 1991 y Plan Sexenal 1989-1994.

10. Telmex. El proceso de planeación de filiales. Lic. Alfonso de Garay Arellano.

11. Cambio estructural tarifario de Teléfonos de México, S.A. de C.V. y de Teléfonos del Noroeste, S.A. de C.V. December 18, 1989.

Telecomm

1. Decreto por el que se crea un organismo descentralizado denominado Telégrafos Nacionales. Agosto 20, 1986.

2. Telégrafos Nacionales. Estados Financieros. 1987.

3. Telégrafos Nacionales. Estados Financieros. 1988.

4. Telégrafos Nacionales. Manual de organización. Mayo, 1989.

5. Telégrafos Nacionales. Estados Financieros. Agosto, 1989.

6. Integración del organismo público descentralizado Telecomunicaciones de México.

7. Propuesta del cambio estructural del organismo descentralizado Telégrafos Nacionales.

8. Telenales. Programa de mediano plazo 1989-1994.

9. Telecomunicaciones de México. Programa de trabajo 1990.

Internal Reports

1. Informe Misión Orientación - Aspectos Técnicos. Proyecto de Ampliación y Mejoramiento de las Telecomunicaciones. SCT - México.

2. November 8, 1989 Request for Bids for Cellular Telephone Systems and Related Documentation. Robert R. Bruce. December 22, 1989.

3. Observations on Proposed Draft License. January 1990.

4. Outline Terms of Reference for Regulation of the Radio Spectrum. January 28, 1990.

5. List of Persons Met. January 1990 Mission.

M E X I C O

ROAD TRANSPORT AND TELECOMMUNICATIONS SECTOR ADJUSTMENT PROJECT

TELECOMMUNICATIONS SECTOR TECHNICAL REPORT

ANNEX 1 - NEW RULES FOR THE PROVISION OF TERMINAL EQUIPMENT

FECHA 9 ENE. 1990 | EXCELSIOR EL PERIODICO DE LA VIDA NACIONAL | SECCION F | PAGINA 3 | COLUMNA 4

El Acuerdo se Refiere a Modems, Facsímiles, Parabólicas, Entre Otros

Eliminó la SCT Permisos Para Instalar Equipos

Reproducción del documento oficial, que entró en vigor el 22 de diciembre de 1989

ACUERDO sobre la instalación y operación de los equipos terminales de telecomunicaciones, así como disposiciones para los prestadores de servicios públicos que se indican.

F-3-4

Al margen un sello con el Escudo Nacional que dice: Estados Unidos Mexicanos.–Secretaría de Comunicaciones y Transportes.

ANDRES CASO LOMBARDO, secretario de Comunicaciones y Transportes, con fundamento en lo dispuesto en el artículo 36 de la Ley Orgánica de la Administración Pública Federal, en relación con los artículos 1°, 2°, 3°, 40, 41, 51, y demás relativos de la Ley de Vías Generales de Comunicación y

CONSIDERANDO

I. Que el Plan Nacional de Desarrollo 1989-1994 establece que la indispensable modernización y expansión de las telecomunicaciones requerirá de grandes inversiones que deberán financiarse con participación de los particulares.

II. Que el Estado ejercerá la rectoría en las telecomunicaciones e inducirá su desarrollo, mediante un nuevo marco regulador que tenga en cuenta el cambio tecnológico habido en los últimos años que la regulación dará la debida seguridad jurídica a los participantes en el sector.

III. Que la dinámica en materia de telecomunicaciones propiciada por el acelerado desarrollo tecnológico establece distintas opciones a través de empresas fabricantes o distribuidores en cuanto a equipos, dispositivos y aparatos.

IV. Que es facultad de la Secretaría de Comunicaciones y Transportes introducir todas aquellas modalidades que con vista al interés público sean necesarias incorporar a la prestación de los servicios que autoriza, por lo que es necesario facilitar y modernizar las prácticas administrativas y operacionales de los servicios, permitiendo a los particulares en su calidad de usuarios que elijan los equipos, dispositivos y aparatos que mejor convengan a sus intereses, por lo que he tenido a bien dictar el siguiente

ACUERDO

ARTICULO 1°–Los siguientes equipos terminales de comunicaciones propiedad de los usuarios que se conecten a las redes o sistemas de servicios de telecomunicaciones autorizados por la Secretaría de Comunicaciones y Transportes, no requerirán de permiso previo para su instalación y/o operación.

1. Los equipos facsímil y de telefonía, terminales telex y teleimpresoras, modemas y terminales y equipo de cómputo.

2. Los equipos telefónicos multilíneas y conmutadores.

3. Los equipos terminales de usuarios como teléfonos, unalíneas, contestadores telefónicos automáticos, discriminadores y controladores de larga distancia, multiplexores y controladores de larga distancia, multiplexores y demás accesorios y dispositivos de telecomunicaciones instalados en los inmuebles de los usuarios que para su operación requieran de interconectarse a una vía general de comunicación.

4. Los equipos terminales de los servicios públicos de radiocomunicación autorizados, como radioteléfonos celulares, radiolocalizadores de personas y radioteléfonos de portadora común.

5. Los equipos terminales de radiocomunicación que operen en las frecuencias radioeléctricas asignados por la Secretaría para el servicio en la banda civil.

6. Las estaciones terrenas propiedad de particulares para el uso doméstico destinados a la recepción vía satélite de señales incidentales de televisión, así como miniestaciones terrenas de los usuarios que utilicen en forma compartida estaciones maestras autorizadas para conducir señales de voz y datos.

ARTICULO 2°–Los equipos terminales de telecomunicaciones mencionados, que se conecten o utilicen una vía general de comunicación, deberán estar previamente homologados ante la Secretaría de Comunicaciones y Transportes por los fabricantes a proveedores, con objeto de garantizar la seguridad del usuario, evitar daños a los redes que se conecten, no inferir con los servicios establecidos ni equipos de otros usuarios, y satisfacer los requerimientos técnicos y de operación estipulados por las normas nacionales.

ARTICULO 3°–Los prestadores de servicios públicos de telecomunicaciones autorizados por la Secretaría de Comunicaciones y Transportes están obligados a conectar a sus redes o sistemas los equipos terminales que sus usuarios adquieran arrienden a terceros, siempre y cuando sean compatibles y hayan sido debidamente homologados por esta Secretaría, por lo que no deberán obligar a sus suscripciones a adquirir los equipos con ellos, ni otros bienes o servicios, como condición para proporcionarle el servicio solicitado.

Los prestadores de servicios de telecomunicaciones podrán negarse a prestar el servicio únicamente si el equipo no estuviese homologado o el usuario no compruebe la propiedad y legal estancia en el país del equipo terminal.

ARTICULO 4°–La Secretaría de Comunicaciones y Transportes conforme a las facultades que le concede la Ley de Vías Generales de Comunicación, vigilará por conducto de la Dirección General de Políticas y Normas de Comunicaciones el estricto cumplimiento del presente acuerdo.

TRANSITORIOS

PRIMERO.–El presente Acuerdo entrará en vigor el día siguiente de su publicación en el Diario Oficial de la Federación.

SEGUNDO.–Se derogan todas las disposiciones administrativas que se opongan al presente ordenamiento.

Sufragio Efectivo. No Reelección.

Dado en la ciudad de México, Distrito Federal, a los once días del mes de diciembre de mil novecientos ochenta y nueve.–El secretario, Andrés Caso Lombardo.–Rúbrica.

ACUERDO por el que se delegan en el ciudadano Director General de Servicios y Recursos Materiales de la Secretaría de Hacienda y Crédito Público, las facultades que se indican.

Al margen un sello con el Escudo Nacional, que dice: Estados Unidos Mexicanos.- Secretaría de Hacienda y Crédito Público.- Secretaría Particular.- 101-1933.

ACUERDO POR EL QUE SE DELEGAN EN EL C. DIRECTOR GENERAL DE SERVICIOS Y RECURSOS MATERIALES DE LA SECRETARIA DE HACIENDA Y CREDITO PUBLICO, LAS FACULTADES QUE SE INDICAN

CONSIDERANDO

Que de conformidad con lo establecido en la Ley Orgánica de la Administración Pública Federal los titulares de las Secretarías de Estado y Departamentos Administrativos, para la mejor organización del trabajo, podrán delegar sus facultades en los funcionarios que establezca el Reglamento Interior de cada Dependencia, siempre que no sean de las consideradas legalmente como indelegables;

Que la delegación de facultades constituye uno de los instrumentos jurídicos con que cuentan las dependencias de la Administración Pública Federal, incluida la Secretaría de Hacienda y Crédito Público, para la asignación de las atribuciones que les corresponden, así como para impulsar y fomentar la simplificación administrativa, lo que conlleva a revitalizar la gestión administrativa;

Que la Ley de Obras Públicas establece en su Artículo 6 Bis que los titulares de las dependencias y entidades, incluidos los de las Secretarías de Estado serán responsables de que, en la adopción e instrumentación de los sistemas y procedimientos para la realización de las acciones, actos y contratos que deban llevarse a cabo en cumplimiento de esta Ley, se observen criterios para proveer la simplificación administrativa, reducción, agilización y transparencia de los procedimientos y trámites;

Que dentro de los objetos fundamentales del Programa de Simplificación Administrativa de la Administración Pública Federal, en materia de Obra Pública, figura el reducir y agilizar los procedimientos y trámites relativos a la adjudicación, contratación, ejecución y formulación de convenios;

Que esta Secretaría requiere de la realización de los servicios de conservación y mantenimiento de los bienes inmuebles, así como la adaptación de los mismos y de las instalaciones necesarías para el buen funcionamiento de las unidades administrativas de la propia dependencia; con fundamento en lo dispuesto por los Artículos 14, 16 y 31 de la Ley Orgánica de la Administración Pública Federal, 4 y 6 fracción XXII del Reglamento Interior de esta Secretaría de Hacienda y Crédito Público, he tenido a bien emitir el siguiente

ACUERDO

UNICO.—Se delega en el C. Director General de Servicios y Recursos Materiales, de la Secretaría de Hacienda y Crédito Público, la facultad de llevar a cabo la adjudicación, firma y ejecución de los contratos de obra pública que la propia Secretaría requiera para la conservación, mantenimiento y adaptación de los bienes inmuebles y de aquellas obras que se realicen al amparo del Programa de Inversiones autorizado, observando para ello lo dispuesto por el Artículo 134 de la Constitución y demás disposiciones legales aplicables, así como apegándose a las disponibilidades presupuestales de las unidades administrativas correspondientes

TRANSITORIO

UNICO.—El presente acuerdo entrará en vigor el día siguiente al de su publicación en el Diario Oficial de la Federación.

Atentamente.

México, D.F., a 14 de diciembre de 1989.- El Secretario de Hacienda y Crédito Público, Pedro Aspe.- Rúbrica.

SECRETARIA DE COMUNICACIONES Y TRANSPORTES

[redacted] así como disposiciones para los prestadores de servicios públicos que se indican.

Al margen un sello con el Escudo Nacional, que dice: Estados Unidos Mexicanos.- Secretaría de Comunicaciones y Transportes.

ANDRES CASO LOMBARDO, Secretario de Comunicaciones y Transportes, con fundamento en lo dispuesto en el artículo 36 de la Ley Orgánica de la Administración Pública Federal, en relación con los artículos 1o., 2o., 3o., 40., 41., 51., y demás relativos de la Ley de Vías Generales de Comunicación y

CONSIDERANDO

I. Que el Plan Nacional de Desarrollo 1989-1994 establece que la indispensable modernización y expansión de las telecomunicaciones requerirá de grandes inversiones que deberán financiarse con participación de los particulares.

II. Que el Estado ejercerá la rectoría en las telecomunicaciones e inducirá su desarrollo, mediante un nuevo marco regulador que tenga en cuenta el cambio tecnológico habido en los últimos años que la regulación dará la debida seguridad jurídica a los participantes en el sector.

III. Que la dinámica en materia de telecomunicaciones propiciada por el acelerado desarrollo tecnológico establece distintas opciones a través de empresas fabricantes o distribuidores en cuanto a equipos, dispositivos y aparatos.

IV. Que es facultad de la Secretaría de Comunicaciones y Transportes introducir todas aquellas modalidades que con vista al interés público sean necesarias incorporar a la prestación de los servicios que autoriza, por lo que es necesario facilitar y modernizar las prácticas administrativas y operacionales de los servicios, permitiendo a los particulares en su calidad de usuarios que elijan los equipos, dispositivos y aparatos que mejor convengan a sus intereses, por lo que he tenido a bien dictar el siguiente

ACUERDO

ARTICULO 1o.—[redacted] de comunicaciones [redacted] se conecten a las redes o sistemas de servicios de telecomunicaciones autorizados por la Secretaría de Comunicaciones y Transportes, [redacted]

[redacted]

[redacted]

3. Los [redacted] de usuarios [redacted] dispositivos de telecomunicaciones instalados en los inmuebles de los usuarios que para su operación requieren de interconectarse a una vía general de comunicación.

4. Los [redacted] de radiocomunicación autorizados, como [redacted]res[redacted]s y [redacted]

5. Los equipos terminales de radiocomunicación que operen en las frecuencias radioeléctricas asignadas por la Secretaría para el servicio en la banda civil.

6. Las [redacted] culares para uso doméstico destinados a la recepción vía satélite de señales incidentales de televisión, así como miniestaciones terrenas de los usuarios que utilicen en forma compartida estaciones maestras autorizadas para conducir señales de voz y datos.

ARTICULO 2o.—Los equipos terminales de telecomunicaciones mencionados, que se conecten o utilicen una vía general de comunicación, [redacted] ante la Secretaría de Comunicaciones y Transportes por los fabricantes o proveedores, con objeto de garantizar la seguridad del usuario, evitar daños a las redes que se conecten, no interferir con los servicios establecidos ni equipos de otros usuarios, y satisfacer los requerimientos técnicos y de operación estipulados por las normas nacionales.

ARTICULO 3o.—Los prestadores de servicios públicos de telecomunicaciones autorizados por la Secretaría de Comunicaciones y Transportes están obligados a conectar a sus redes o sistemas los equipos terminales que sus usuarios adquieran o arrienden a terceros, siempre y cuando sean compatibles y hayan sido debidamente homologados por esta Secretaría, por lo que no deberán obligar a sus suscriptores a adquirir los equipos con ellos, ni otros bienes o servicios, como condición para proporcionarle el servicio solicitado.

Los prestadores de servicios de telecomunicaciones podrán negarse a prestar el servicio únicamente si el equipo no estuviese homologado o el usuario no compruebe la propiedad y legal estancia en el país del equipo terminal.

ARTICULO 4o.—La Secretaría de Comunicaciones y Transportes conforme a las facultades que le concede la Ley de Vías Generales de Comunicación, vigilará por conducto de la Dirección General de Políticas y Normas de Comunicaciones el estricto cumplimiento del presente Acuerdo.

TRANSITORIOS

PRIMERO.—El presente Acuerdo entrará en vigor el día siguiente de su publicación en el Diario Oficial de la Federación.

SEGUNDO.—Se derogan todas las disposiciones administrativas que se opongan al presente ordenamiento.

Sufragio Efectivo. No Reelección.

Dado en la Ciudad de México, Distrito Federal, a los once días del mes de diciembre de mil novecientos ochenta y nueve.- El Secretario, Andrés Caso Lombardo.- Rúbrica.

Document of
The World Bank

FOR OFFICIAL USE ONLY

LN 2918-ME

Report No. P-4646-ME

REPORT AND RECOMMENDATION
OF THE
PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED AGRICULTURAL SECTOR LOAN
IN AN AMOUNT EQUIVALENT TO US$300.0 MILLION
TO
NACIONAL FINANCIERA, S.N.C.
WITH THE GUARANTEE OF
THE UNITED MEXICAN STATES

February 22, 1988

Currency Unit - Peso (Mex$)

On February 19, 1988, the exchange rate in the controlled market was US$1 = Mex$2,261; the free market exchange rate stood at US$1 = Mex$2,300

Fiscal Year

January 1 - December 31

Weights and Measures

1 hectare (ha) = 10,000 square meters (m2) = 2.47 acres (a)
1 kilometer (km) = 0.62 mile (mi)
1 square kilometer (km2) = 0.39 square miles = 100 ha
1 kilogram (kg) = 2.2[illegible] pounds (lbs)
1,000 kilograms = 1 metric ton (t) = 0.98 long ton
1 liter (l) = 0.26 gallons (gal)

Abbreviations

ACF	-	Average Cost of Funds to Banks
ASL	-	Agricultural Sector Loan
BANCOMEXT	-	Foreign Trade Bank
Azucar, S.A. de C.V.	-	National Sugar Company
CETES	-	Treasury Bills
CONASUPO	-	National Basic Food Company
DICCONSA	-	Retail Affiliate of CONASUPO
FERTIMEX	-	National Fertilizer Company
FIRA	-	Agricultural Trust Funds in Bank of Mexico
GATT	-	General Agreement on Tariffs and Trade
GDP	-	Gross Domestic Product
GIRA	-	General Interest Rate Agreement
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
LICONSA	-	Milk Producing and Distributing Affiliate of CONASUPO
NAFIN	-	National Finance Agency
PAC	-	Program of Adjustment and Structural Change
PEMEX	-	National Petroleum Company
PIDER	-	Integrated Rural Development Program
PSBR	-	Public Sector Borrowing Requirement
QR	-	Quantitative Restriction on Trade
SAP	-	Special Action Program
SARH	-	Ministry of Agriculture and Water Resources
SECOFI	-	Ministry of Commerce and Industrial Promotion
SEMIP	-	Ministry of Parastatal Industries
SHCP	-	Ministry of Finance
SPP	-	Ministry of Planning and Budgetting
TPL	-	Trade Policy Loan
TRICONSA	-	Wheat Processing Affiliate of CONASUPO

FOR OFFICIAL USE ONLY

MEXICO

AGRICULTURAL SECTOR LOAN

Table of Contents

Page No.

TABLE OF CONTENTS (CONTINUED)

MEXICO

AGRICULTURAL SECTOR LOAN

Loan and Program Summary

Borrower: Nacional Financiera, S.N.C.

Guarantor: United Mexican States

Amount: US$300.0 million equivalent.

Terms: 15 years, including 3 years of grace, at the standard variable interest rate.

Loan and Program Description: The proposed sector loan is the first of a series of such loans to promote greater efficiency and higher productivity in the agricultural and agro-industrial sectors. It is an important part of the package of external financing linked to implementation of Mexico's economic reform program. The proposed loan supports a program of continuing reforms and of achievements in the areas of consumer food subsidies and their targetting, improvement of producer pricing policies, privatization of parastatals, agricultural and agro-industrial trade liberalization, streamlining and decentralizing of the Ministry of Agriculture, rationalization of public investments in agriculture, and reduction of input subsidies. The loan would finance general imports with priority given to agricultural inputs and foodstuffs.

Benefits and Risks: The benefits of the reform program would consist of rising productivity and allocative efficiency in both agriculture and agro-industry, as adjustments in pricing make the incentive structure correspond more closely to economic opportunity costs. In addition, fiscal savings to the Mexican Government would be substantial while remaining subsidies would be more selective and targetted to the poor. An expanded food stamp program for urban areas and targetting of food price subsidies only to stores in poor neighborhoods and economically depressed rural areas would buffer the impact of the adjustments of food prices on the urban poor and on poor rural groups that do not produce their own food. The result of the studies included in the loan would assist the Government in designing a program of further reforms.

The risks of the project derive from the political resistance to some of the reforms and the stability of the macroeconomy. Also, the general growth of the macroeconomy will influence the prosperity of the agriculture sector. These risks are mitigated by the substantial forms that the Government has already taken up front and the strong commitment of the Government to continuing reform, liberalization of the economy, and sound macroeconomic management.

Estimated Disbursments: The loan would be disbursed in two tranches. The first US$25 million of the first tranche (US$100 million) would be available upon effectiveness, with first tranche disbursements thereafter contingent upon removal of export controls on exportable rice and quality cuts of beef and agreement on terms of reference for certain studies, discussion of which is a second tranche release condition. The second tranche of US$200.0 million would be released upon fulfillment of specified conditions related to each of the policy areas and satisfactory completion and discussion with the Bank of all studies. Loan proceeds may be used for retroactive financing of import expenditures incurred after November 22, 1987, up to a ceiling of US$60 million.

Schedule of Disbursements:

Amounts in US$ Millions

Bank FY	88	89
First Tranche	100.0	
Second Tranche		200.0
Cumulative	100.0	300.0

Appraisal Report: This is a combined President's and Staff Appraisal Report.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED AGRICULTURAL SECTOR LOAN TO
NACIONAL FINANCIERA, S.N.C.
WITH THE GUARANTEE OF THE UNITED MEXICAN STATES

---

1. I submit the following report and recommendation on a proposed Agricultural Sector Loan (ASL) to Nacional Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States, for the equivalent of US$300 million in support of the Government's program of agricultural policy reform. The loan would be repaid over 15 years, including 3 years of grace, at the standard variable interest rate.

PART I - THE ECONOMY

2. An Economic Report on Mexico (Mexico: After the Oil Boom: Refashioning a Strategy for Growth. No. 6659-ME) was distributed to the Executive Directors on June 23, 1987. It assesses the implications of the rapid policy changes underway in Mexico, particularly from mid-1985 through early 1987.

A. Background

3. Mexico experienced three decades of high and stable growth from the 1940s to the 1960s, based on an inward-looking growth strategy. By 1970, however, Mexico had largely exhausted the easy possibilities for import substitution, and growth started to slow down. The Government attempted to foster growth through an expansion of public sector expenditures, and the encouragement of high-cost, capital-intensive import substitution. This strategy failed to sustain sound economic growth, and in 1976 Mexico experienced a serious financial and economic crisis. The exchange rate was devalued, and an International Monetary Fund (IMF) stand-by program implemented. New oil revenues led to a quick economic recovery in 1977, and greatly enlarged Mexico's access to foreign borrowing. Starting in 1980, rapidly rising public expenditures, unmatched by gains in revenue, generated huge increases in public sector deficits. Although inflation rose rapidly, no significant pressure was felt to adjust, because of burgeoning oil export earnings and abundant foreign financing. As imports increased rapidly and non-oil exports declined, an appreciating real exchange rate and lagging domestic interest rates encouraged capital flight. However, the increasing precariousness of the balance of payments was masked for a time by a frenzy of borrowing, which nearly doubled the level of external debt in just two years from US$40 billion in 1979 to US$78 billion in 1981.

4. The crisis came to a head in 1982. Public sector expenditures reached the unprecedented level of 47.5% of GDP, while the deficit reached

nearly 18% of GDP. In February, the Bank of Mexico stopped supporting the peso, which then experienced a 40% devaluation. But a large wage adjustment, continuing slack in the oil market, and lax fiscal and monetary policies largely nullified the intended benefits of the devaluation and kept the balance of payments under strain. Inflation measured in consumer prices nearly quadrupled, from 29% in 1981 to 99% in 1982. Commercial banks, which had granted Mexico substantial credit in previous years, declined to commit new funds in the amounts required. These factors led to a second devaluation of 35% in August 1982 and the suspension of amortization payments on most of Mexico's external public debt. The nationalization of the domestic private commercial banks in September 1982 and the forced conversion of foreign currency accounts into pesos at a controlled exchange rate, dealt additional blows to private sector confidence. The flight of capital abroad continued at a high rate.

5. With the support of an Extended Fund Facility (EFF) from the IMF, the new administration of President Miguel de la Madrid undertook a stabilization program beginning in late 1982 based on a large contraction of domestic demand, mainly through fiscal, exchange rate, and monetary policies. The peso was depreciated by an immediate 30% (in addition to the 64% cumulative depreciation carried out by the preceding government in 1982), and quantitative restrictions were extended to cover all imports. Over the next two years, public sector expenditure, excluding interest payments, declined from a high of 39% of GDP in 1982 to about 29% in 1984, while revenues rose from about 30% to 33% of GDP. Public sector investment was cut from an average of around 10% of GDP in the late 1970s to 7.5% in 1984, a contraction of over one-quarter in real terms. Between 1982 and 1984, the public sector borrowing requirement declined from 17.7% of GDP to 8.4%, while the inflation-adjusted fiscal deficit (excluding the inflationary component of interest payments on domestic debt) shifted from a deficit of 8.2% to 3.0% of GDP. Real wages fell 20-25%, while most public sector prices were raised sharply in real terms. And a massive foreign debt restructuring was successfully negotiated in 1983 and again in 1984.

6. The results of the 1983-84 stabilization effort were initially impressive. In those two years, nominal imports fell cumulatively by 25%, non-oil export earnings (including the earnings of in-bond industries) rose 54%, and the balance of trade on goods and non-factor services showed unprecedented surpluses averaging around 9% of GDP. Despite declining oil prices, net foreign reserves increased from US$2.0 billion to US$6.5 billion between the end of 1982 and the end of 1984. And a strong turn-around in economic activity from -5.3% in 1983 to 3.7% in 1984 led many to believe a long-term recovery was underway. However, a large part of the adjustment took the form of drastic cuts in imports and investment. In contrast, long-term obstacles to growth were not confronted. The anti-export bias of the trade regime was actually intensified with the introduction of additional import controls. Nor was the system of industrial incentives overhauled in ways which might have enhanced Mexico's international competitiveness.

7. The optimism generated by Mexico's initial adjustment success soon started to fade. The declines in inflation became smaller and smaller, until the trend began to reverse in 1985. As the Government prepared for

the mid-term Congressional elections of July 1985, monetary policy became accommodating, the fiscal deficit rose well above program targets, and the exchange rate appreciated rapidly in real terms. Optimism turned to disenchantment, as it became clear that stabilization in the absence of more fundamental structural reforms could not restore either sustainable economic growth or stable prices.

8. Most IMF program targets were missed in 1985. The fiscal deficit rose to 9.5% of GDP, inflation increased to 63.7%, non-oil export earnings declined by over 10% from their 1984 levels, and most components of the balance of payments deteriorated. Speculative pressures on the exchange rate increased, and net foreign reserves declined by US$3.4 billion. The crowding out of the private sector in credit markets became severe toward the end of the year, as financial disintermediation accelerated and the share of the public sector in total credit reached unprecedented levels, in excess of 75%.

9. Following the elections, a policy shift occurred. Macro-stabilization measures were complemented with the structural reforms needed to deal with Mexico's long-term development problems. At the heart of these reforms was the Government's desire to increase the efficiency of Mexican industry through greater exposure to international competition, to reduce the economy's dependence on oil exports and foreign borrowing, and to create a new stimulus for growth. The first major reforms included removing import licensing requirements from 40% of merchandise imports, merging, liquidating, or selling several hundred smaller state-owned companies, and starting the rationalization of major parastatal operations in steel, fertilizers, agriculture, petrochemicals, trucks and sugar.

10. As for the macro-stabilization measures, the Government introduced further spending cutbacks in the public sector, and eliminated some 25,000 full-time positions. Sustained positive real interest rate levels were restored, the controlled exchange rate was devalued by 20%, and a flexible daily crawl introduced which responded to developments in the balance of payments, rather than, as before, to a pre-announced schedule. The new exchange rate policy greatly narrowed the margin between the controlled and free rates and, combined with tighter domestic credit, helped bring capital flight to a virtual halt toward the end of 1985.

11. This new adjustment <u>cum</u> structural reform effort received a set-back in early 1986 with the collapse of oil prices. As a result of this, Mexico lost revenues equivalent to 6.[illegible]% of GDP (i.e., over US$8 billion). However, instead of closing the economy, as in 1983, the Government now accelerated its structural reforms. To lend credibility to its commitment for integration with the world economy, the country joined the General Agreement on Tariffs and Trade (GATT), announced a three-year program to lower tariffs to a maximum of 30%, and promised to further reduce non-tariff barriers (NTBs). Foreign investment procedures were simplified and public finances strengthened through tax reform, price adjustments, and spending cuts. The restructuring of the parastatals began in earnest, with the closure of a major steel plant in Monterrey and the privatization, liquidation, or transfer of some 600 smaller publicly-owned companies. The Government restructured the finances of the state-owned agricultural marketing enterprise, CONASUPO, and sharply reduced general food subsidies.

Fiscal performance in 1986 was in line with IMF targets, even though due to an acceleration of inflation the public sector borrowing requirement rose from 9.5% to 15.6% of GDP. In spite of the drastic reduction in oil revenues, the inflation-adjusted fiscal deficit increased only from 4.0% GDP in 1985 to 6.2% of GDP in 1986. The real devaluation of the peso was accelerated, real interest rates rose to exceptionally high levels, and a squeeze on credit to the private sector helped turn around capital flows, resulting in the repatriation of as much as US$3.0 billion during the period from September 1986 to mid-1987. However, 1986 inflation reached 106%, and real GDP contracted by some 3.8%.

12. Mexico's program was supported by a financial package signed in March 1987, which will provide up to US$10.7 billion in net flows, including a US$5 billion parallel commercial bank new money facility carrying a World Bank guarantee of US$750 million, US$1 billion in cofinancing, a US$0.5 billion Growth Facility, and an IMF stand-by and contingent oil facilities. Because oil prices have not dropped below an agreed threshold during 1987 the oil facility was cancelled in December 1987. Also, the Growth Facility has not been activated as of the end of February 1988. Some US$68.7 billion commercial bank debt was restructured, with new maturities varying between 8 and 20 years, and grace periods between 4 and 9 years. US$1.8 billion in official bilateral debt was also rescheduled. The current status of the multi-facility is shown in Annex 11.

B. Recent Economic Developments

13. Over the past five years, Mexico made important progress in solving its fundamental macro imbalances. Progress was especially impressive in the external accounts, as manufactures export earnings grew at over 20% annually, the trade surplus ranged between 7-10% of GDP and net official reserves were raised from -US$2 billion at the end of 1982 to roughly US$9 billion at the end of 1987, the highest level in Mexican history. On the internal front, major parastatals, including FERTIMEX and CONASUPO, are in various stages of restructuring, roughly 600 smaller firms have been divested, price controls have been loosened, significant reforms of the value-added and corporate income taxes have been introduced, and global food and credit subsidies have been sharply reduced.

14.. However, other developments have not been as favorable. After decades of economic growth averaging over 6% annually, cumulative real output contracted by about 2% during 1983-87, while real per capita consumption declined by about 14%, and real investment by 20% (40% since 1980). And not least among these disappointments was the failure to reduce inflation. Having inherited a then-record rate of 100% in 1982, the current Government reduced this to under 60% by 1984. However, since then, inflation has risen to nearly 160% in 1987. The unfavorable terms of trade shock and the heavy burden of Mexico's external debt have had, in the short run, negative effects on Mexico's overall economic performance.

15. Behind inflation lies the large, seemingly intractable public sector borrowing requirement (PSBR), estimated at 16.6% of GDP for 1987, i.e., almost as large as in 1982 during the height of Mexico's balance of payments crisis. However, this high PSBR masks a significant adjustment in

the inflation-adjusted fiscal deficit, which has fallen from 8.2% of GDP in 1982 to 3.0% in 1984, before rising under pressure of oil-export related losses to 6.2% in 1986. It fell sharply once again to an estimated 1.1% of GDP in 1987 (although, if transitory fiscal gains like the public sector's abnormally low real borrowing costs and the upswing in oil export income were removed from the calculation, the 1987 inflation-adjusted deficit would have been closer to 5% of GDP).

16. Other fundamentals whose behavior worried financial markets in 1987 included the October collapse of world stock markets, which triggered a 75% decline in the Mexican bolsa in just a month and a half; an acceleration in the size and frequency of wage adjustments since 1986, which, combined with growing labor unrest and electoral campaign pledges, had convinced many economic agents that wage policy could become a pro-inflationary factor for the first time since 1981; increasing distortions in relative prices, due to seriously delayed adjustments of controlled prices in the public sector and agriculture; declining real interest rates; and a small, but worrisome appreciation of the real exchange rate, albeit from a very favorable starting level at the end of 1986.

17. In this climate of growing malaise about the economic fundamentals, any major unexpected economic developments were almost certain to be destabilizing. One such development--the sharp decline in world stock market values in October--was previously mentioned. A second, which occurred at roughly the same time, was a one-time opportunity for private companies to buy up their external debt at discounts of 50% or more, as part of a debt rescheduling agreement signed with foreign commercial banks. A huge temporary additional demand for foreign exchange put strong pressure on the free exchange rate in October and in the first half of November. Initially, the Central Bank tried to dampen this pressure by selling foreign reserves. But after losing over US$1 billion in one month, the monetary authority withdrew from the market on November 19, triggering a one-day depreciation of the free exchange rate of nearly 60%. Panic buying, demands by labor for an emergency wage increase of 46%, and continued speculative attacks on both the free and controlled exchange rates intensified the crisis, leading eventually to wholesale revisions of the 1988 budget and macroeconomic program.

18. On December 14, the Government announced:

i) a 22% one-step depreciation of the controlled exchange rate from Mex$1,803/US$1 to Mex$2,200/US$1, accompanied by;

ii) a reduction in the maximum import tariff rate from 45% to 20%.

This was followed the next day by the announcement of an Economic Solidarity Pact signed by representatives of labor, farming, industry, and the Government, which contained additional features, namely:

iii) an immediate increase of all wages by 15%, with a second increase in the minimum wage of 20% granted on January 1, 1988. Contractual wages come up for their annual negotiations in large numbers during this period, but efforts will be made to limit floor adjustments to the 20% increase granted for the minimum wage. With that allowance, all wages are then to be frozen until March 1, 1988, at which time they are to be adjusted monthly in line with the projected average price changes in an index of basic goods and services. Monthly wage adjustments would continue, so long as inflation remained above a 2% monthly rate. In the event the forward-looking monthly adjustments of basic goods prices were to lag observed inflation by more than 5 percentage points cumulatively, a catch-up increase for the full differential would be granted to wage earners.

iv) immediate increases of 17-85% in the prices of key public goods and services, after which public prices are to be frozen until March 1, 1988, and then adjusted in line with wages;

v) corrective price increases for basic consumer goods and guaranteed farm prices before the end of 1987, followed by a 2-month freeze, and then by subsequent price adjustments in line with wages and public goods. Guaranteed farm producer prices for 1988 are to be maintained at 1987 levels in real terms. Increased public sector imports of basic goods are to be used to combat shortages, while sanctions for hoarders and price control violators have been promised;

vi) an increase of the primary fiscal surplus by 2.9% of GDP in 1988 to a level of 8.3% of GDP, though approximately equal increases in revenues and reductions in non-interest public spending.

vii) a program of accelerated divestment of state-owned companies, of which 52 new companies have already been placed for sale, including a copper company valued at roughly US$1 billion;

viii) a ceiling on domestic banking credit to the private sector outstanding by lending institutions equal to 90% of the average nominal balance of December 1987 for January and 85% of the December nominal balance for February; and

ix) sharp increases in treasury bill and other short-term nominal interest rates from 8% monthly in October to over 13% in January 1988.

19. The sequencing of the Mexican stabilization program can be split into two periods. The first period, lasting until the end of February 1988, is transitional, during which the once-and-for-all impact of relative price corrections would be felt. The second period would start in March 1988, and, if all goes well, last some 9-10 months. Major nominal prices (wages, basic goods, and public prices) would follow a concerted declining pathway geared toward reducing inflation, while preserving a rebalanced and

essentially fixed structure of relative prices. While the Government is committed to reducing consumer price controls in the long run, during this period it will have to use the instruments of consumer price controls selectively.

20. Following the adjustment of wages, public tariffs and prices, and the exchange rate in December, the Government predicted that inflation would accelerate significantly in January (indeed, it subsequently reached 18.2% at the producer level, 15.5% at the consumer level), to be followed by a marked deceleration in February to around 7-8%. The transitional phase is designed to correct major disequilibria in relative prices (real wages, real public utility and basic commodity prices, and the real exchange rate), and, then, to maintain them from March 1988 onwards through forward-looking adjustment of the major nominal variables.

21. Assuming the behavior of inflation during February confirms approximately to Governmental expectations, then the subsequent adjustment of wages, public and basic prices, and the exchange rate uniformly, and in a declining monthly pattern, will provide a strong nominal anchor which, with support from the strong monetary, fiscal, and import adjustments the Government has committed to, can gradually break the inertial components of inflation.

22. The Economic Solidarity Pact reflects a carefully thought ou stabilization strategy which draws upon the lessons learned from exp nce in other countries, adapting them to Mexican circumstances. It quite rightly elevates the goals of attacking high inflation and correcting severely distorted relative prices to priority objectives, needed to consolidate the structural reforms and continue an export-led growth strategy. This effort will be reinforced by accelerated public enterprise reforms, and accelerated import liberalization which goes well beyond the earlier commitments the Government undertook in connection with TPL I and II.

23. Needless to say, policy fine-tuning is extremely difficult at high rates of inflation with volatile private sector expectations. The chances of unintended, but critical, policy errors are, correspondingly, high. Ultimately, a successful stabilization effort will largely depend on whether policymakers demonstrate a strong preference to err on the side of caution. If the impact of the program on economic activity were immediately and strongly adverse, steady, calm support for continuing the basic lines of the Pact would be crucial. Corrective policies could be adopted only gradually, so as not to risk undermining the credibility of the original commitment to the Pact, while avoiding over-reaction.

C. Development Prospects

24. Provided the Government is persistent in pursuing its current stabilization program, accompanied by the major structural adjustment policies already described and a reasonably favorable international environment, the fundamentals for future recovery look promising. First, Mexico has a rich natural and human resource base and close proximity to the world's largest market. Secondly, the rationalization of the trade regime of the last two years and the recent policy announcements about its

future direction have created a set of incentives favoring international competition. Thirdly, the drastic fall in the terms of trade is beginning to turn around now that world oil and other commodity prices significant for Mexico's exports have partially recovered. This improvement in the terms of trade should have significant salutary effects on fiscal, financial, and balance of payments performance, as well as on growth, investment, and employment. Fourthly, the over 40% decline in real wages since 1981 has made Mexican unit labor costs highly competitive internationally, well below those of Southeast Asia. Therefore, under moderately favorable external and domestic conditions, Mexico's economic growth could reach 4-5% a year in the early 1990s.

25. Progress in the areas of poverty alleviation and social sector development has slowed in the wake of the 1982 crisis. As the economy gradually begins to recover, it is possible to foresee a significant increase in the emphasis on social sector issues in Mexico. Given the continued stringency of public budgetary resources, this increased emphasis will depend heavily upon better cost-recovery and improved efficiency in the targeting and delivery of social services.

26. Historically, ecological and natural resource management issues have ranked low on the list of policy priorities. However, in recent months, pollution control, soil erosion, deforestation, and other issues in Mexico's management of its ecology and natural resources have received increasing Governmental and Bank attention.

D. <u>External Debt and Creditworthiness</u>

27. Mexico's gross external public and private debt increased by nearly US$17 billion during 1983-87, but net debt by only about US$6 billion, taking into account the roughly US$11 billion improvement in net official reserves over that period. The debt service ratio fell from 61% in 1982 to 50% in 1987. At the end of that year, the Bank's share of Mexico's long-term debt was 7.1%, and its share of Mexico's long-term debt service was 7.4%. The Bank's exposure in Mexico was 8.1% of its total portfolio. With its expanded assistance program in Mexico, this latter ratio is expected to rise somewhat by the end of this decade, but will remain below 10% of the Bank's total portfolio. In the expectation that sound economic policies continue, and that the external environment remains favorably for the execution of these policies, Mexico is considered creditworthy for Bank lending.

PART II - THE AGRICULTURAL SECTOR

A. Performance

28. In the 1970s and 1980s agriculture has turned in a largely lackluster performance relative to its historically dynamic role. From the end of World War II to the mid-1960s, Mexican agriculture was a success, growing faster than in any other Latin American country, largely because cultivated and irrigated areas expanded. More specifically, in the 1950 to 1965 period, agricultural GDP growth averaged 4.3% per annum. However, beginning in the late 1960s several factors began to converge to retard growth. As the costs of bringing marginal land into production rose, expansion of irrigated areas slowed down. In the 1970s, exchange rate and pricing policies discriminated against agriculture and further contributed to the deceleration of the growth of agricultural production. As income growth in other sectors and rapid population growth of over 3% per year expanded the demand for food, food imports increased and the sector's share of exports fell. While before 1970, Mexico produced sufficient food to feed its population and export substantial surpluses, by the end of the 1970s, it had become a major importer of basic foodstuffs. These adverse circumstances resulted in a growth rate of agricultural GDP averaging 2.3% per annum between 1970 and 1980, compared to overall GDP growth of around 5% and industrial GDP growth of around 7%.

29. In March 1980, the Government resorted to drastic measures to reverse the decline of agriculture by making use of the growing revenues from oil. Higher support prices, more input subsidies, and expansion in subsidized credit, coinciding with favorable weather, led to substantial increases of agricultural production of 6% in 1980 and in 1981. However, with declining oil prices, rising interest rates and debt service, and growing consumer subsidies, these Government actions in support of agriculture proved to be unsustainable. In 1982, when farmgate prices were allowed to fall in real terms in the face of high inflation, agricultural production declined by 1%. At the end of 1982, the costly push for agricultural recovery was largely abandoned; the set of policies designed to solve food problems by channeling a large share of the country's new petroleum wealth into the sector and into providing cheap food for urban dwellers was an early victim to Mexico's continuing economic crisis.

30. Beginning in 1983 and through the 1985 crop year, agricultural production recovered moderately to an average growth of about 2.5%, primarily due to a supportive exchange rate and favorable weather. However, in 1986, agricultural production fell by close to 3%. Crop output declined by 3.5%, partly due to poor weather, while livestock production fell as demand for meat and milk contracted dramatically (a result of falling incomes and the high income elasticity of demand for these products) and higher costs of production and price controls made it difficult to maintain profits in this sector. However, increasing exports (led by coffee and fresh fruits and vegetables) and declining consumption of higher valued products (particularly meat and, thus, imported feedgrains), produced a substantial agricultural trade surplus estimated at over US$1 billion. This was the first agricultural trade surplus since 1979. For the first half of 1987, the agricultural trade balance deteriorated by about 15% but remained in surplus primarily due to strong performance in the manufactured foods sector (exports up by over 40%).

31. The Government continues to seek remedies to critical rural and agricultural problems. Instead of reverting to the kinds of costly subsidies used in the early 1980s, the Government has turned its attention to improving the effectiveness of public investments, reducing and targetting remaining subsidies, and limiting its intervention in the market. In this c . ext, the Government has been implementing policy reforms that will bring about greater sectoral efficiency.

B. Status of Current Bank Lending and the Policy Dialogue for Agriculture

32. Current Bank lending in agriculture is directed at supporting the Government's program to improve the efficiency of agricultural infrastructure and production. Proposed loans currently under preparation or appraisal include projects to rehabilitate and enhance the efficiency of irrigation systems, to revitalize and promote small- and medium-scale agro-industrial development, to expand and conserve forestry resources, and to improve efficiency and productivity in dairying. Furthermore, a recently approved loan would assist in improving the efficiency and impact of agricultural research and extension. In addition, a Ninth Agricultural Credit Project that addresses financial self-sustainability of apex financial institutions (e.g., FIRA) and the question of interest rate subsidies, is being implemented. The Fertilizer Sector Project being presented to the Board in parallel with the ASL aims at restructuring the fertilizer industry and reducing subsidies. And the second Trade Policy Loan, combined with further tariff reductions of the Pact, further reduced industrial protection and improved the internal terms of trade for the agriculture sector.

33. An active policy dialogue is also being pursued to support the Bank's lending strategy in the agricultural sector. A critical juncture in this dialogue for agriculture was reached in 1986. As part of the Bank's overall policy dialogue, a paper on agricultural sector issues was presented to the Mexican Government in mid-January 1986. This paper, prepared for the Country Programming and Implementation Review, proposed a sector adjustment loan in agriculture to assist the Government in achieving and reinforcing its policy objectives in the areas of (a) agricultural export promotion and trade reform; (b) subsidy control and targetting; (c) price deregulation; (d) marketing deregulation; and (e) public sector investment and expenditure in agriculture. The paper indicated that, if the Government was prepared to implement a program of policy initiatives and reforms to achieve these objectives, the Bank would consider a quick-disbursing policy loan to support the Government's program. Officials of the Mexican Government indicated an interest in this approach. Subsequent missions followed and significant headway on a program of policy reform began to emerge after January 1986. These reforms were supported and reinforced by two Trade Policy Loans (TPL's) and the entry of Mexico into GATT, which began the reduction of industrial protection and provided the basis for improved internal terms of trade for agriculture and thus better incentives to this sector. The Bank proposes to reinforce the momentum building up behind the initial policy reform program by means of the ASL.

PART III - POLICY OBJECTIVES SUPPORTED BY THE PROPOSED AGRICULTURAL SECTOR LOAN

34. As a consequence of the economic crisis facing Mexico, the Government has begun a far-reaching program to restructure the economy to achieve greater allocative efficiency and equity. An integral part of this restructuring is a program of agricultural and food policy reforms that include: (a) sharply reducing global consumer subsidies and better targetting remaining subsidies so that they benefit the truly needy; (b) bringing agricultural producer prices closer in line with prices; (c) rendering the storage, processing, distribution and marketing activities of parastatals more efficient including, where appropriate, privatization of these; (d) moving towards economic prices for agricultural inputs (e.g., fertilizers and water); (e) liberalizing, over time, the trade regime with regard to the import and export of agricultural inputs and products (including not only progress in the removal of prohibitions and quantitative restrictions but also providing the private sector greater access to import activities); (f) diminishing credit subsidies by moving towards market-determined interest rates; (g) achieving a sound investment program; (h) rationalizing pricing and promoting privatization and efficiency in the sugar sector; and (i) restructuring and decentralizing the Ministry of Agriculture with an eye to reducing superfluous employment and to having a higher percentage of Ministry staff directly assisting farmers.

35. To assist the Government in achieving these objectives, the Bank is furthering the policy dialogue through sector work and project and policy lending, and, in particular, through a series of proposed agricultural sector adjustment loans. The basis of the first proposed ASL described in this report is an agricultural sector policy statement that provides the framework for the Government's policy with respect to the sector. This statement, prepared by the Ministry of Agriculture with the assistance of the Ministries of Finance, Planning and Budget and Commerce, is in congruence with the policy objectives of the Bank's dialogue with the Government. The statement is included in Annex 9 of this report.

36. The Government has already made important reforms in many of the areas outlined in its policy statement. Some of these reforms represent radical departures from previous approaches to the sector and are important--and politically difficult--steps in the right direction. The proposed loan would support the Government in continuing to implement this program. In the following paragraphs, the policy objectives, the progress in achieving these objectives and the steps to be further supported by the proposed loan are presented. Summary backgrounds to the policies are also included to help set the context for the Government's reforms. A Policy Matrix in Annex 5 provides an overview of the policy objectives and reforms. The basis for the loan would be the Government's sectoral policy statement, comprised of the text in Annex 9 and the Policy Matrix of Annex 5.

A. Removal of Global Food Subsidies and Targetting of Remaining Subsidies

37. Background. Global subsidies on food products--that is, subsidies available to all consumers, regardless of income--became particularly pronounced during the early 1980s. While guaranteed producer prices were raised to stimulate domestic production of basic foods, consumer food prices were held down to avoid upward pressure on wages. The difference between producer and consumer prices led to large food subsidies on such products as maize (for tortilla production), wheat, sorghum, soybeans, sugar, rice, barley, beans, cooking oil, powdered milk, and noodles. All subsidies, except for that on sugar, were administered by the state-owned National Basic Foods Company, CONASUPO, through one of two mechanisms: either by selling the products at reduced prices to processors (who themselves were subject to controlled prices on outputs) or by reimbursing processors directly for costs not covered by sales revenue. By 1983, global food subsidies exceeded 1% of GDP. With spending of the poorest 30% of the population accounting for only 15% of national food expenditures while that of the richest 30% accounted for about 50% of these expenditures, these global subsidies represented enormous transfers to the upper income groups while benefiting much less the poorest in Mexico's urban and rural areas.

38. Achievements to Date. As shown in Annex 6, Table 1, the real value of food subsidies administered by CONASUPO has been reduced dramatically during the past several years, reflecting the major changes that have been made to reduce the drain of subsidies on the government budget. Global subsidies have been phased out for all products except sugar and (in some years) maize 2/. The real prices of many foodstuffs have more than doubled. This major reduction in CONASUPO subsidies already achieved, up front, constitutes a major break with the past. Indeed, it is the single most significant subsidy reduction effort undertaken by the de la Madrid Administration. By the end of 1986, subsidies administered by CONASUPO were running at an annual rate of only about 0.02% of GDP while the sugar subsidy was about 0.05% of GDP.

39. Despite the fact that the poor gained relatively less than the rich from global subsidies, the near elimination of food subsidies has harmed many of the poor. As global food subsidies have been phased out since 1983, increases in the prices of basic products have eroded the real purchasing power of the poorest 20% of the population by about 6.5%. Aware of this effect on the poors' consumption, the Government has recently instituted a system of food coupons ("tortibonos") that allow recipients to purchase a fixed amount of tortillas (approximately 2-3 kg per day per family) for less than 25% of the market price. The Government is distributing coupons through CONASUPO's stores (DICCONSA and LICONSA) in poor urban areas to families with total income less than twice the legal minimum wage (or under US$5 per day). A small percentage of the coupons (15%) are also currently being distributed through trade unions.

2/ The Government is currently studying how to revise its sugar pricing policies (para 64) to reduce or eliminate subsidies in this area as well, and conditionality contained in the ASL (para 68) will ensure that there is no back-tracking in this area.

40. Further Steps to be Taken under the Sector Loan. Because of the precarious nutritional status of the poor in Mexico (over 30% of preschoolers suffer from serious malnutrition), the elimination of all global food subsidies without a sufficiently funded, targetted program of food subsidies for the poor would threaten to create a serious breach in the social safety net. If this happened, it would cause great suffering, and could also undermine support for the Government's program of reforms and put pressure either to reintroduce global subsidies or to reduce prices to farmers. The Mexican Government has already begun to address this issue through the use of food coupons for tortillas and targetted distribution of reconstituted milk in urban areas. However, these programs are limited, under-budgetted, and deficient in controlling targetting and review of eligibility. Furthermore, targetted food subsidies are largely not available to rural communities where the need is greatest.

41. The proposed ASL would support expanding the food coupon and milk programs through increasing the number of families covered in urban areas and developing selective price subsidies on certain basic foods in poor urban neighborhoods and economically depressed rural areas. It would also support the development of other targetted food programs in poor areas. It would seek to minimize manipulation and diversion of the subsidies from the target population through better supervision and monitoring of existing and future programs. It would change the manner in which the food coupon program operates, so that the coupons' purchase price would be tied to the market price. It would support a food subsidy budget for targetted programs that should largely compensate for the effects of the policy reforms on the very poor. If targetted to the poorest 20% of the population (16 million persons), a funding level of US$250 million would be approximately sufficient to raise their purchasing power to the levels of 1983, before subsidies began to be phased out. To the extent possible, the program would be designed to reach the rural as well as the urban poor. Specifically, as a condition of second tranche release, the Government would be required to demonstrate that in 1988 it had: (a) funded targetted food programs at a level sufficient to compensate the poor for the effects of the elimination of global subsidies between 1983 and 1986 (US$250 million); (b) implemented administrative procedures to minimize the diversion of subsidies from the target group; (c) expanded targetted food subsidies to needy rural areas on a pilot basis; (d) revised the criteria for eligibility in urban areas to correspond more closely with need (e.g., using anthropometric measurements) and to recognize budget constraints; (e) linked the price of tortilla food coupons to the price of tortillas so as to make the subsidy transparent and controllable and maintain it in real terms at a constant level per recipient to levels not higher than those existing as of the date of effectiveness of the loan, so as to maximize the number of beneficiaries; (f) studied expansion of other food programs to relieve the impact of the adjustment program on the poor (study to be carried out under terms of reference to be agreed with the Bank by May 31, 1988); and (g) presented a satisfactory action plan for expansion of the program of nutritional monitoring, including representative samples of both rural and urban areas (See Annex 10 for more details). While this loan would not seek commitments beyond the current administration's horizon (commitments that the administration would be incapable of realistically making), it is envisioned, based upon projected food prices, that the cost of these programs should not exceed approximately 0.2% of current GDP (around US$335 million annually) by 1991.

B. Reducing Government Intervention in Establishing Producer and Consumer Prices

42. Background. For major agricultural products, both the prices paid by consumers and those received by producers are set or determined by the Government using direct consumer price controls, Government procurement from producers at guaranteed prices, export and import controls, and (until very recently) direct subsidies to private and parastatal processors. The major decisions related to pricing and trade controls are made by the Agricultural Cabinet and by the Ministry of Commerce and Industrial Promotion (SECOFI), which has considerable discretion to decide what products are placed under these controls, as well as what ceiling is set for each price and what quantity is authorized for imports and exports of each product under controls. Based upon projections of domestic supply for a product, the Government decides simultaneously on domestic prices (at farmgate and levels further along in the processing chain) for the product, and how much should be imported or exported to sustain that price. Importers of major basic commodities such as maize, sorghum and oilseeds must also be processors and are given authorization to import a fraction of the global quota corresponding to their share of purchases of the total domestic production. Export controls are used to reinforce consumer price controls that maintain domestic prices at levels below international levels.

43. The Government's most important objective in these interventions in the market has been to keep consumer food prices low as part of its development strategy of encouraging industrial development through low-cost labor. As a secondary objective, throughout the 1970s and especially during the early 1980s, the Government attempted to raise rural incomes and achieve "food sovereignty" by setting farmgate prices through Government procurement at higher levels than those that would have prevailed given the low consumer food prices. The losses occurring from this pricing policy were absorbed by direct and indirect transfers from the Government to both private and parastatal firms. However, in response to the current crisis, the Government has had to phase out subsidies both to private and parastatal processors, so that the current low levels of controlled retail prices are tending to depress producer prices. Furthermore, restrictions on exports and imports are inhibiting investments in agro-industry.

44. Consumer Price Controls. Before the introduction of the temporary Economic Solidarity Part, an estimated 48% of domestic production were under some form of price control at the consumer level. Although price controls covered a wide set of goods, food prices were generally the most strictly controlled. Even though global food subsidies were largely eliminated, retail prices for many foodstuffs remained below equivalent world levels due to these price controls. Prices were controlled through four lists. The first list was for products under strict price control. For these products, no price changes were permitted without the approval of the SECOFI and adherence to the controls was monitored by special inspectors. Twenty-one products, almost exclusively food and agro-industrial products (representing approximately 15% of national production value), were under strict price controls. Of these 21 products (e.g., wheat flour, maize flour, edible oils, rice), 10 had export controls. Of the 16 products where international price comparisons are meaningful, 13 had prices below international levels. Survey data (1984-85) comparing

official prices with market prices in Mexico City show that price controls were generally binding.

45. The second list, introduced in October 1985, consisted of prices that could be automatically adjusted up to 95% of the rate of inflation. Producers wishing to raise prices more had to show that the increase was "justified" by increased costs of production. This list consisted primarily of industrial products, mainly consumer durables.

46. A third list consisted of goods that required only ex ante registration of price changes. Besides submitting a statement of cost changes, no other more formal justification of price changes was required. For goods on the fourth list, the only requirement was that the seller notify SECOFI within ten days after increasing prices.

47. Under the temporary Economic Solidarity Pact, the strict control list has been extended to all basic commodities as part of the anti-inflationary strategy for 1988. These controls will expire at the end of 1988. The intention of the Government is to return to the previous system of controls at the expiration of the Pact and then to gradually phase out controls in the long run.

48. Farmgate Prices. On the producer side, the Government has in the past set guarantee or minimum prices for 13 crops, including basic food grains, major animal feeds and oilseeds, and actual prices received by farmers have tended to follow guarantee prices closely. These guarantee prices are administered by CONASUPO. Sugar prices are also set by the Government but not administered by CONASUPO, and are currently above international levels. The Government currently sets guarantee prices for 12 crops, having stopped setting a specific price for feed barley since it is only a by-product of malt barley. These prices are intended to cover a weighted average of production costs for a variety of representative technologies and areas. International prices are intended to serve only as a reference. Because production costs vary widely in Mexico, the setting of guarantee prices supposedly based on costs of production in reality has been a political process, a struggle between farmer interests on one hand and urban and agro-industrial interests on the other, with the Ministries of Finance (SHCP) and of Planning and Budget (SPP) attempting to minimize the consequences of these deliberations on the Government's budget. As a consequence, international prices, representing the opportunity costs of domestic procurement to processors, have historically been important criteria in setting prices for only some crops, such as soybeans, for which imports and agro-industrial interests are large.

49. More generally, the levels of producer prices relative to international prices have varied across time and crops (Annex 6, Graphs 2-7), depending on the state of the exchange rate (i.e., under- or over-valued), the Government's priorities, and its fiscal ability to support a differential between low consumer and high producer prices. The Government's inability to subsidize this differential caused farmgate prices to fall significantly in 1986, so that the ratio of producer to international prices were at the lowest levels of recent history: 1.01 for maize, 0.85 for wheat, 0.75 for rice and 0.75 for soybeans (Annex 6, Tables 3 and 4). Since that time, some prices have increased substantially relative to international prices with others lagging still further behind, creating great dispersion among crops. In recent periods

of high inflation, the guarantee price, which is maintained constant in nominal terms over a growing season, is steadily eroded in real terms until it is increased for the following season.

50. Producer prices are set at the same level in all parts of Mexico, effectively penalizing production in areas close to consumption centers (which in a free market would tend to have higher prices because of the low cost of transporting the product to market) and subsidizing production in areas far away. This pan-territorial pricing has also encouraged the location of agro-industry in the consuming, rather than producing areas. Furthermore, while prices are occasionally adjusted (generally semi-annually), the adjustments are not based on economic criteria such as the cost of storing the crop, and are far too infrequent in a period of rapid inflation. Thus, over the course of the year, the real support price steadily falls for a number of months due to inflation, then makes a large discrete jump when a new procurement price is announced. This pan-seasonal pricing distorts production decisions and makes storage unprofitable. As a consequence, storage remains primarily in the hands of the public sector.

51. Producer prices for fruits and vegetables, coffee, cotton and tobacco are not determined by the Government. Because of dependence on export markets, they are closely aligned with international prices, and thus their production is strongly influenced by exchange rate policies and international market forces.

52. Producer prices for other products, including sugarcane, are subject to Government intervention to varying degrees. For example, producer prices for sugar are set by the SHCP in consultation with the public and private sector industry.

53. Achievements to Date. With regard to consumer price controls, prior to the Economic Solidarity Pact the Government had been reducing the number of goods under price control. Table 2 in Annex 6 gives a breakdown of how the production coverage has shifted from 55% in December 1982 to 48% in September 1986. With regard to producer prices the Government has pledged, as part of its Economic Solidarity Pact, to set all crop guarantee prices on March 1, 1988, at their average levels (in real terms) for 1987, and then to adjust them monthly at the rate of inflation. This will avoid the problem of continual intrayear erosion mentioned above.

54. Further Steps to be Taken under the Sector Loan. The ASL tackles pricing issues in several ways. First, on the producer side, it reinforces the Government's commitment under the Economic Solidarity Pact to maintain guarantee prices during 1988 at real 1987 levels throughout the year. For 1989 the Government will create a price band around international price levels (90-125%) for each crop with a ceiling as well as a floor, for all guarantee prices administered by CONASUPO except maize and beans. This would be a condition of second tranche release. The price band is designed with an upper limit of 125% of international prices to give the Government flexibility to raise agricultural prices to levels that would redress any biases in the industrial-agricultural terms of trade that might be created by use of the 20% maximum tariff to protect the industrial sector. International prices would be adjusted for transport costs, quality differentials and processing margins.

Mexican maize prices are currently well above international maize prices. But Mexico produces largely white food-quality maize while international trade is largely in yellow feed-quality maize, and the world market for white maize is poorly developed. Yellow maize is only an imperfect substitute for white maize and price comparisons are therefore not straightforward. For beans, it is even more difficult to make meaningful comparisons between domestic and international prices as beans are a heterogeneous commodity and Mexico possesses some monopoly power in a very thin international market. 3/ At a time when the previously highly-protected industrial sector has seen its pricing brought more closely in line with international levels, the producer price conditions of the loan will ensure that internal industrial-agricultural terms of trade are close to international levels, furthering the Government's objectives of making the Mexican economy efficient and competitive in world markets.

55. The loan would also require a thorough review of the guarantee price system. This review would include sections aimed at determining which of the 12 crops that currently have guarantee prices should continue in the system, how prices could be adjusted over time and geographical area to simulate pricing patterns in a free market, and how the price band system established under the loan can be fine-tuned. So that work can begin quickly, agreement on the terms of reference for the studies would be reached as a condition of disbursements exceeding US$25 million of the first tranche, with satisfactory completion of the studies and discussion of the results being a condition of second tranche release. These results will then be available to the Government and the Bank to form the basis of future dialogue on agricultural pricing policy.

56. With respect to food prices at the consumer level, the anti-inflation measures included in the Economic Solidarity Pact make it infeasible to seek further liberalization of consumer price controls at this time. However, the loan's conditionality on producer prices and on limits to the CONASUPO budget available for general food subsidies does ensure that food prices will not be kept artificially low. As described above, producer prices will be linked to international prices. Transfers to CONASUPO to cover operating losses will be specifically limited in 1988 and 1989 to their budgetted 1988 levels (para 66). Since CONASUPO's ability to borrow from external sources is severely circumscribed by previous agreement with the Government, the limit on operating losses means that it would be unable to finance the global food subsidies through artificially low consumer prices, as was done in the past. The loan also specifically requires that no global food subsidies be introduced through institutions other than CONASUPO (para 66). Thus, the loan ensures that consumer food prices, although still formally under control, will move in line with producer prices.

C. Reducing the Role of Parastatals in Agricultural Marketing, Storage and Processing

57. Background. The Government's involvement in agricultural marketing, storage, and processing is mainly through CONASUPO, some parastatals controlled by the Ministry of Agriculture (SARH) and the public sugar company, AZUCAR, S.A. de C.V. Although some of the parastatals are well-managed and operated,

3/ How to use international prices as a yardstick to domestic price policy is therefore an issue for further study.

many of these enterprises have suffered financially from restrictive pricing and subsidy policies and operationally from bureaucratic and political burden while inhibiting effective and flexible allocation of resources, including private investment.

58. CONASUPO and its affiliates (collectively referred to here as "CONASUPO") have acted as the Government's agents for exercising control over the market for basic food products, other than sugar. They procure crops from farmers at prices set by the Government, process some of the crops into food products, and sell them to consumers, also at Government-established prices. In the period before subsidies were eliminated, that is, when consumer prices were set far below producer prices and costs of processing and distribution, CONASUPO's role as purchaser, processor, and distributor entailed significant losses. It incurred further losses from other sources as well. First, it sold some crops it had procured to processors at subsidized prices. Second, it paid subsidies to processors who procured directly from farmers to reimburse them for losses they would otherwise incur because of Government policies that kept the price of their raw material high relative to the price of their finished product. And finally, CONASUPO had sole authority to import basic food products, for which it had to pay international prices, while selling them at much lower prices domestically. Through its role as a monopoly importer, it incurred a large dollar-denominated debt in the early 1980s, and this debt became increasingly burdensome as rapid devaluations created sizeable exchange rate losses.

59. As CONASUPO's role in the economy grew and its debt mounted, the Government was forced to increase its fiscal transfers to the parastatal. These rose (in constant 1980 pesos) from 9.9 billion (0.3% of GDP) in 1977 to 54.6 billion (1.21% of GDP) in 1984, before being reduced to 32.4 billion (0.74% of GDP) in 1986. This need for ever-increasing transfers was a key factor in the Government's decision to impose limits on CONASUPO's role in the economy.

60. Besides CONASUPO, forty parastatals under the control of SARH are involved in production, marketing and processing of coffee, tobacco, forestry and wood products, animal feed, cotton, seeds, vegetable oils, and fruit. Fiscal transfers to these companies in 1986 were under US$50 million (less than 0.02% of GDP).

61. Another significant parastatal involvement in agriculture is in the sugar sector. Azucar, S.A. de C.V. is the state-owned enterprise responsible for operation of 52 of the country's 70 sugar mills and 75% of production. It is heavily supported by Government transfers; in 1985 the budgeted transfer was 107.2 billion pesos (about US$200 million, or 0.05% of GDP).

62. Achievements to Date. The Government has recently taken major steps to restructure CONASUPO, as outlined in the agreement ("convenio") between CONASUPO and the Government concluded April 15, 1986. Through this and subsequent agreements, the Federal Government assumed over 80% of CONASUPO's accumulated debt, equalling US$1.8 billion. CONASUPO in return promised to abide strictly by the budget approved by the Chamber of Deputies and to make basic structural changes in its operations, including: (a) reducing its level of intervention in the market for basic crops to that necessary for the

enforcement of price regulations, while promoting private sector participation; (b) eliminating subsidies by closing the differential between purchase and sale prices; (c) reorganizing CONASUPO itself and merging some affiliates to reduce costs and increase efficiency; (d) eliminating sales on credit; and (e) establishing an information system to permit more careful monitoring of operations and finances. In addition to the internal financial and structural changes outlined in the agreement, the role of CONASUPO in importing has been altered significantly (para 74).

63. Some progress has also been made with respect to SARH's parastatals. Since 1985, the number of public sector bodies under the control of SARH has been reduced. From a total of 89 entities, 31 non-operating entities had been liquidated by the end of 1986, including 18 companies with a majority state share-holding, 3 with a minority holding and 10 trust funds.

64. Progress that promises to be significant has also been achieved with respect to the sugar sector. In August 1985, an agreement was signed between the Federal Government, Financiera Nacional Azucarera, and Azucar, S.A. de C.V. The agreement specifies a number of important steps that will be taken to strengthen the operations and improve the financial status of the sugar industry. The rationalization of capacity, including the closure of high-cost mills, the reduction of staffing levels, the improvement of the cane purchasing systems, and the restructuring of pricing policy are identified as essential steps to allow the efficient operation of the industry on a self-sustaining basis.

65. Progress has already been made towards a sounder sugar sub-sector. Staff reductions of 2,800 have been made, mainly in administrative areas. Four mills have closed since 1986. The cane planting program has been marginally reduced, in order to help move production into line with consumption, but there has been no progress on efforts to change the method of cane purchase to one based on cane quality.

66. Further Steps to be Taken under the Sector Loan. The proposed ASL would sustain these reforms. Specifically, as a condition of second tranche release, the Government would limit fiscal transfers to CONASUPO (other than for debt service, investment, the food stamp program, LICONSA's milk program, or other targetted subsidies) to less than US$85 million in 1988 and 1989. (These transfers were estimated to have been about US$215 million in 1987). The loan would also require, as a condition of second tranche release, that no global food subsidies be introduced through institutions other than CONASUPO. In addition, as a condition of second tranche release CONASUPO would close or move to poor neighborhoods 500 major retail outlets of CONASUPO's retail affiliate, DICCONSA, that are now in middle or high income urban areas, and would liquidate CONASUPO's wheat processing affiliate, TRICONSA, which controls about 5% of the market in Mexico City.

67. With respect to the parastatals in the agricultural sector, a condition of second tranche release would be satisfactory progress in the sale or closure of 15 parastatals. The 15 companies represent 2.6% of total parastatal budget and 0.8% of fiscal transfers to such public companies in the agricultural sector. As such, they are not significant entities in terms of budgetary allocations but represent a symbolically important additional step in

the privatization and liquidation of sectoral parastatals. The remaining parastatals, in particular INMECAFE, TABAMEX, ALBAMEX, ALGODONERA and PRONASE, but also including a number of other entities that are recipients of fiscal transfers, would need to be addressed in subsequent loans.

68. With respect to the sugar sub-sector, a condition of second tranche release would be satisfactory progress in the closure or sale of an additional 2 mills. (Four mills have been closed already). A further condition of second tranche release would be discussion with the Bank of the results of a study to design a rational policy of pricing for sugar cane and for sugar at the factory and consumer stages. The policy would aim at reducing subsidies and would eventually allow financial self-sufficiency of efficient mills and companies, while taking into account international measures of efficiency. Draft terms of reference for this study are included in Annex 8.

D. Progress Toward Agricultural Trade Liberalization

69. Background. Historically, the Government has used trade policy to reinforce internal policies, such as consumer price controls. For basic imported foods, including maize, wheat, sorghum, beans, rice, oilseeds, soybeans, barley, and powdered milk, the state exercised control by giving CONASUPO exclusive importation rights. For a few exports as well (notably coffee and sugar), parastatals have monopolized foreign trade. For other products, the Government has controlled foreign trade indirectly, by the use of quotas, licensing requirements, and tariffs.

70. Imports of almost all major agricultural commodities and exports of some commodities are subject to quotas. For basic grains and oilseeds, import quotas are set every six months by estimating the size of the coming domestic harvest and the amount of imports that will be necessary to satisfy domestic demand.

71. Imports and exports of all goods with quotas, and many other goods as well, can be carried out only with licenses issued by SECOFI. Import licenses are required for products that comprise over 86% of agricultural production and 22% of livestock production. In the GATT negotiations, the Mexican Government stated explicitly that it had no intention of eliminating licensing requirements for its major agricultural imports. Exportation of some products (including cattle, shrimp, coffee, and a number of grains and vegetables) require licenses from both SECOFI and some other ministry, such as the Secretary of State.

72. Most agro-industrial and many agricultural product categories are subject to import duties, in some cases in addition to licensing requirements. Basic food imports are generally free of tariffs, being regulated by quotas and licensing. Although many products are subject to export controls, export duties are few. They include a 0% to 30% tax on coffee exports (depending on the international price) and a tax of 0.5% on exports of cotton lint.

73. Achievements to Date. Agricultural trade liberalization in Mexico is complicated by the following: (a) effective rates of protection for many agricultural and agro-industrial products appear to be negative, with agriculture being taxed relative to international prices; (b) a system of

stable guaranteed prices requires some level of variable protection since international prices fluctuate widely; and (c) the internal terms of trade have historically been biassed against agriculture, with protection substantial for industrial products.

74. Nevertheless, the Government has made major progress on trade liberalization on several fronts. Beginning at the end of 1984, it eliminated CONASUPO's import monopoly on all goods except powdered milk. The private sector has responded, and the division between private and public imports in 1986 is estimated by CONASUPO to be as follows:

1986 Estimated Imports
(In '000 tons)

	CONASUPO	PRIVATE SECTOR
Maize	1,800	700
Wheat	0	0
Sorghum	750	900
Beans	200	0
Rice	0	0
Oilseeds	0	2,561
Barley	0	0
Milk Powder	122	0

Mexico has also reduced tariffs on at least 66 categories, mainly on items not produced in Mexico or in shortage--seeds, milk, fats, raw skins and hides. With support from the Bank's TPLs, the maximum tariff rate has been reduced from 100% to 20%. The Government has also eliminated the use of official reference prices, which were maintained at artificially high level in order to indirectly tax imports at rates above official tariff levels. In their place, the Government is substituting a modern system of protection against dumped goods. Under TPL I, the Government reduced coverage of licensing requirements by 5% of national production, of which 2.82% came from agricultural or agro-industrial product categories. Furthermore, the list of items for which applications for import licenses are automatically denied, which formerly included a number of agricultural commodities, has been eliminated completely. Finally, export licensing requirements have been eliminated for wheat, some meats, and some other agricultural commodities.

75. Licensing has been an important bureaucratic impediment to free entry of firms into importing and to the establishment of agro-industries that require imported inputs. Also, licensing provides the potential for the imposition of high and non-transparent levels of protection. The Bank, therefore, has continued to support the Government's program of steady reduction in coverage under these restrictions. As part of the TPLII, the Government has agreed to reduce the coverage of licensing requirements for both agricultural and manufactured goods from coverage of 49.8% of national production (after the second tranche of TPLI in November of 1986) to 43.1%. Of this reduction, approximately 5% of national production coverage is likely to come from agricultural and agro-industrial product categories.

76. Further Steps Sought under the Sector Loan. The proposed ASL would support a continuation of this liberalization process. First, as a condition of second tranche release, approximately 5% of national production in agricultural and agro-industrial product categories would be freed from import licensing requirements. (This 5% would also be counted toward the liberalization requirements of TPLII). This will reduce the production coverage of quantitative restrictions from 54% before TPLII, to 39% of production in these sectors. As shown in Annex 6, Table 5, this could be achieved by elimination of licensing for agro-industrial products or by a combination of reduction in licensing for agro-industrial products and agricultural goods.4/ Second, for some basic grains, beans and oilseeds that would most likely remain under licensing, a study would be conducted that would address the administrative feasibility of implementing a variable tariff for these commodities. (Annex 8 contains draft terms of reference for this study and other studies on pricing issues required under the loan.) It would also determine how to implement transparent and non-arbitrary anti-dumping regulations for agricultural commodities. The study would be confined to agricultural commodities, which receive special treatment under GATT. Satisfactory completion of these studies and discussion of the results with the Bank is a condition of second tranche release. Removal of export controls on quality cuts of beef and high quality rice (representing less than 0.8% of national production value) would be a condition of disbursements exceeding US$25 million of the first tranche. Fruits and vegetables have been one of the most dynamic export-oriented agricultural subsectors in Mexico, and have responded strongly to trade liberalization. The Government's intervention in the sector has been minimal compared with other sectors, though it has imposed selective export restrictions, either as a means of setting quality standards for exports or to control domestic supply (as in the case of chilies). The system of export control is now essentially self-regulated by producer-exporters. The ASL would ensure continuation of this status by requiring as a condition of second tranche release that the Government refrain from controlling exports while encouraging farmer organizations to set quality standards for exports.

E. Reducing Subsidies on Agricultural Inputs

77. Background. As noted before, agricultural prices have been maintained at low levels as part of the Government's industrial development policy. To counterbalance this discrimination against agriculture, the Government has resorted to compensating input subsidies. Almost all inputs to agricultural production--including fertilizer, fuel, credit, water, and crop insurance--are subsidized by the Government.

78. The most important subsidies--fertilizer, credit and water--have distorted resource use and have had detrimental effects on the institutions supporting agriculture, in addition to burdening the fiscal situation. The fertilizer subsidy has promoted use of inappropriate levels and types of fertilizer while supporting an inefficient and ponderous parastatal, FERTIMEX.

4/ Table 6 of Annex 6 displays the specific product groups tentatively proposed for liberalization by SECOFI in discussions regarding two possible scenarios under the TPLII. The percentage of agricultural production that will be removed from quantitative restrictions has been discussed extensively by missions for both the proposed ASL and the TPLII.

FERTIMEX received a direct transfer from the federal government in 1985 equal to almost 0.3% of GDP, and an indirect transfer of almost 0.1% of GDP in the form of low ammonia prices. The subsidy received by farmers, measured by the difference between world prices and the prices paid by farmers was about 0.2% of GDP as of the end of 1986. The credit subsidy, which was around 0.7% of GDP in 1985, has over-capitalized some aspects of agriculture while inhibiting the building of self-sustainable financial intermediaries. The water subsidy, equal to around 0.05% of GDP in 1981, has contributed to salinity problems and the raising of the water table in the commercial northern irrigated areas. Lack of sufficient funds for operation and maintenance (in part caused by inadequate cost recovery) has also contributed to a deterioration of irrigation canals and drains.

79. The proposed Fertilizer Sector Adjustment Loan is seeking institutional reforms and further reductions in input subsidies for the fertilizer sector. Specifically, it seeks agreement on a program and timetable to liberalize fertilizer distribution and to raise prices to farmers toward international equivalent prices by reducing fiscal transfers (so as to achieve financial self-sufficiency of FERTIMEX), and by requiring that FERTIMEX pay for ammonia a price that would cover the costs of ammonia production, with natural gas valued at its domestic price to users. (FERTIMEX already pays international prices for two out of the three primary raw materials used -- phosphate rock and sulphur.) Furthermore, the loan would ensure that fertilizer could continue to be imported by anyone without non-tariff restrictions. These important adjustments would ensure that efficiency objectives are furthered, whilst eliminating the sector's huge fiscal subsidy. Based on the phasing in of ammonia price increases, the Government would have to increase fertilizer prices by an estimated 12.3% per year in real dollar terms for 5 years. The proposed ASL is integrally linked to the Fertilizer Sector Adjustment Loan, since the increases in fertilizer price envisioned under the latter must be accompanied by the increases in crop prices that are a condition of the former. Otherwise, the fertilizer price rise could have a detrimental impact on agriculture.

80. Achievements to Date. Specific subsidies for various inputs that have been reduced are outlined below:

(a) Fertilizer. Prices of fertilizers are fixed by SHCP with the approval of the Economic Cabinet. In 1986, the ex-factory equivalent fertilizer prices for nitrogen and phosphate were about 25% of border prices.[5/] These prices at the railhead (including transportation and distribution) were about 50% of the equivalent border prices of nitrogen and phosphate fertilizer (respectively accounting for 71% and 23% of total nutrient use). The subsidy on potassic fertilizer, accounting for the remaining 6% of total use, has now been eliminated. With respect to nitrogen and phosphatic fertilizer, in

---

5/ The price of fertilizer is set at the same level, whether the buyer picks it up at the factory or has it delivered to the railhead near its final destination. For this reason, virtually no fertilizer is sold at the factory. The "ex-factory equivalent" price was derived by subtracting approximate distribution costs from the railhead price.

spite of declared intentions, the Government has not been able to close the gap significantly between domestic and international prices and has, at best, only maintained domestic prices in real terms.

(b) Interest Rates. Significant adjustments are being made to interest rates. In 1984, the Bank and the Government of Mexico negotiated a General Interest Rate Agreement (GIRA), in which the Government agreed to raise lending rates in relation to the Average Cost of Funds (ACF) and make them variable. The ACF was chosen as a benchmark rate because it is the closest proxy for an index of a market borrowing rate that is readily available in the heavily regulated environment in Mexico. While the Government sets the rates that determine the ACF, its freedom to manipulate the rate is tightly constrained by the ease with which capital can be taken out of the country if rates paid to savers move out of line with international market rates. Thus, the ACF generally approximates these rates (adjusted for exchange rate movements) and is positive in real terms. GIRA requires semi-annual adjustments relative to a variable ACF.

(c) Irrigation Water Charges. The percentage of irrigation operation and maintenance costs covered by water charges has increased on a national basis from about 12% in 1982 to 36% in 1986. The stated goal of the Government is that irrigation charges eventually cover all operation and maintenance costs in commercial areas and 60% of such costs in marginal areas. Recent legislation has been passed that provides the legal basis for achieving these objectives but progress in implementing the goal has been slow.

81. Further Steps to be Taken under the Sector Adjustment Loan. Because of their large size, high visibility, and political sensitivity, input subsidies have been, and will continue to be, difficult to deal with. Nonetheless, reform in this area must be an important component of a program to improve productive efficiency. For water charges, the ASL would require as a condition of second tranche release a satisfactory plan of action (based on a study under the loan) to implement at the district level the Government's program for 100% recovery of operation and maintenance costs in commercial and export-oriented areas and 60% in marginal production areas except under any specific circumstances provided under Mexican law. This plan would form the basis for further dialogue on operation and maintenance cost recovery issues. Issues of capital cost recovery will be dealt with through the proposed Northwest Irrigation Project and future irrigation projects.

F. A Satisfactory Public Investment Program in Agriculture

82. Background. Public investment in agriculture and rural development[6/] in Mexico has been falling as the result of current economic

---

6/ Public investments in agriculture and rural development include rural roads, water systems for urban areas, potable water, capital expenditures for universities and research, etc., besides more directly productive investments such as in irrigation works. About 40% of the public investments directly administered by SARH for the sector fall into the directly productive category.

difficulties. After averaging about 15 percent of total public investment during the 1970-1982 period, agriculture's share of public investment in 1987 came to only about 12% (about 0.7% of GDP). The budget for agricultural public investment in 1988 is budgetted at about US$331 million (only about 60% of its 1986 level) excluding an allocation of US$104 million from the growth contingency (Annex 11).

83. Within the sector, a major shift has occurred as to who executes public investment. In the past, SARH undertook the bulk of investment, mainly in an ambitious program of irrigation works. More recently, however, a growing share of agricultural public investment has been carried out by the states in keeping with a federal government decision to "divest" increasing power and responsibility for expenditures to the states. The SPP finances these state-executed agricultural investments under what is, in effect, a revenue sharing scheme, but it otherwise exercises very little control over state-executed projects. About half of Mexico's agricultural public investment is federally-executed--by SARH--with the other half in the hands of state governments.

84. Achievements to Date. Because of the strict budgetary restraints, SARH has devoted priority to finishing projects nearing completion; stopping long gestation, lower-return large scale projects in their early stages; and emphasizing small-scale projects that would yield immediate benefits or promote exports. SARH is now carefully planning its investments and subjects all its projects to a rigorous cost-benefit analysis. In the process, it has made major headway in cleaning up its portfolio. In 1987, only 6% of SARH projects were uneconomic versus 26% in 1986. None of the uneconomic projects could be classified as "white elephants", either by size (the largest constituted less than 2% of total SARH investment costs) or by economic return (only 0.8% of investment costs had a benefit-cost ratio of less than 0.8). SARH's 1987 investment portfolio for irrigation, drainage, and rehabilitation had an estimated average benefit-cost ratio of 1.9 (based upon a 12% opportunity cost for capital) and with a net present value of over US$200 million. SARH's 1988 investment budget has been reviewed and together with funds from the Growth Facility of the international financial package (Annex 11), is satisfactory to the Bank in both quality of projects and total funding with sufficient funding for Bank-financed projects.

85. The quality of state-executed agricultural public investment is much less clear. SPP requires that each project be analyzed on an economic and/or social cost-benefit basis at the state level. Because these investments are carried out by states and most of the projects are scattered and small, it is virtually impossible for the Bank to evaluate the portfolio systematically. The Bank's experience--through the PIDER projects where an ex-post analysis revealed that Bank-financed stated-executed investments had an economic rate of return of 27%--suggests that many of these investments are sound. However, this sample is too small to conclude that state-executed agricultural investments on a country-wide basis are satisfactory.

86. Further Steps to be Taken under the Sector Loan. Since the 1988 investment budget has already been reviewed and deemed satisfactory to the Bank, the ASL would concentrate on the 1989 budget. Although the Government

cannot make unequivocal commitments regarding a future budget, which may be changed by Congress, it has agreed as a condition of second tranche release to do the following. First, in order to revise the alarming decline in the agricultural investment program since 1986, the Government will submit a 1989 budget request to Congress that would increase SARH's investment budget by at least US$200 million in real terms over the base 1988 level of US$331 million. (The budget request will include funding for the planned Northwest Irrigation Project to be financed partially by the Bank.) Second, Government will establish procedures to solve a problem that has arisen in the past because of the fungibility of funds within the budget of the Ministry of Agriculture. Because of this fungibility under an overall budget ceiling, the Ministry can reallocate funds to projects which receive no external funding and therefore has little incentive to execute the program supported by external funds. The budgetting procedures to be developed by the Government under this loan will create the proper incentives for SARH to execute externally-funded projects.

G. Decentralization and Reduction of Staff of the Ministry of Agriculture

87. Background. The Ministry of Agriculture (SARH), has been characterized as over-staffed, too bureaucratic, overly politicized, and insufficiently dispersed throughout the country. As of 1982, SARH employed about 152,000 people, with about 33,000 (21.5%) of them in the capital. Agencies and departments dealing with closely related areas, such as agriculture, livestock, and forestry, were separated and uncoordinated. Because so much ministerial authority was concentrated in Mexico City, officials at the local level were unable to make even simple decisions or to process straightforward administrative requests from primary producers or agro-industry. One of the principal objectives of the current Minister of Agriculture has been to rectify this situation.

88. Achievements to Date. SARH has made significant progress in meeting its goals. Some of the more important steps taken already include the following: (a) in spite of the political cost of reducing staff in a period of such high unemployment, SARH cut its payroll from 152,000 in 1982 to about 114,000 in 1988; (b) remaining staff have been and are being decentralized. Staff in Mexico City was reduced from about 33,000 (21.5% of all employees) to about 18,000 (13.5%) between 1982 and the end of 1985; (c) fourteen agricultural parastatals are being moved out of Mexico City. In this process, about one-third of their work-force will be eliminated; (d) an internal reorganization in SARH has eliminated some of the bureaucratic overlap and lack of coordination among departments. In the process, several commissions that are no longer needed have been eliminated; (e) authority to handle 231 routine procedural requests from producers and agro-industry has been delegated to the local level. In some cases, this has reduced the required processing time from 6 months to 15 days. Routine administrative and budgetary decision-making has also been delegated to the local level; and (f) a program has been started to improve the training of extension workers. Furthermore, extension and research are now multidisciplinary in their approach and extension staff operate a system of routine visits with technical support from district level subject matter specialists. The focus

is on rural development and the administrative elements are similar to the training and visit system.

89. Further Steps to be Taken under the Sector Adjustment Loan. After SARH's continuous progress throughout the period of appraisal and negotiation of the ASL, it provided to the Bank at negotiations budget and other information indicating that its objectives in decentralizing, restructuring, and streamlining have been achieved. Combined with the planned restoration of the agricultural investment budget, a highly desirable shift will also occur in the balance of recurrent versus investment expenditures.

PART IV - HISTORY AND PROCEDURES OF THE PROPOSED LOAN

A. Loan History

90. As described more fully in previous paragraphs, the Government over the last several years has acted to loosen its control over the economy, to increase its integration into the world economy and encourage the private sector to assume an increasingly important role. These reforms have been politically difficult for the Government and have imposed considerable costs on certain segments of the population, while improving prospects for future growth. Similar reforms planned for the future promise similar costs but long-term benefits for the economy at large. Consequently, to assist in the reform process, the Government requested that the Bank provide financial and technical support for the structural adjustments in agriculture and other sectors. The Bank responded by sending a pre-appraisal mission for the proposed Agricultural Sector Loan in October and November 1986, followed by an appraisal mission in April and May 1987. Negotiations took place in Washington, D.C. in December 1987 and February 1988, with the Mexican delegation led by Jorge Delgado. The proposed loan is envisioned as the first of several agricultural sector adjustment loans that will support a continuing series of reforms in the sector, some of which would be based on the results of studies supported under this loan.

B. The Borrower

91. The borrower for the proposed loan would be Nacional Financiera, S.N.C. (NAFIN). NAFIN has also been the borrower for other loans to the agriculture sector, the most recent of which was the Agricultural Extension Project (Ln. 2859).

C. Disbursement, Procurement, Administration and Auditing

92. The proposed ASL would disburse quickly, financing general imports. The ASL would be disbursed in two tranches: the first of US$100 million and the second of US$200 million. Financing would be retroactive to November 22, 1987 with a cap of US$60 million. The first tranche would

become available upon effectiveness 7/, and the second upon fulfillment of specific conditions related to each of the policy areas described in Part III. If these latter conditions remain unfulfilled by March 31, 1989, the second tranche will be cancelled, unless otherwise agreed between the Borrower and the Bank.

93. The proceeds of the ASL would be used to reimburse 100% of the foreign exchange cost of eligible general imports, with preference given to agricultural inputs, including agricultural chemicals, pesticides (with a negative list excluding certain pesticides according to Bank guidelines), seeds, machinery, agro-industrial inputs, and storage and transport equipment. Ineligible imports include goods financed from other official multilateral or bilateral sources, goods intended for military or paramilitary use, goods subject to quantitative restrictions, and certain luxury goods. Both private and public sector imports would be eligible for financing. Contracts under US$5 million each would be awarded on the basis of the normal procurement practices of the purchaser. Contracts for other goods and services, estimated to cost US$5 million or more each, will be procured through international competitive bidding in accordance with Bank Guidelines.

94. NAFIN would be responsible for maintaining loan accounts and for the preparation and submission of withdrawal applications. In accordance with disbursement procedures adopted under the First Trade Policy Loan, disbursements from the proposed loan would be made on the basis of a summary from the Banco de Mexico detailing individual transactions in each relevant period in respect of eligible imports, together with a certification of payments of the amounts involved, and of their eligibility under the loan. Applications for withdrawals would be consolidated and submitted in amounts not less than US$1 million. The disbursement procedures would be coordinated with that of the Trade Policy Loan II and the proposed Fertilizer Sector Adjustment Loan to ensure that these loans do not disburse against the same transactions.

95. Audits of the supporting documentation for the statements of expenditure used for disbursements will be carried out annually by independent auditors acceptable to the Bank. The audit reports would be submitted to the Bank within six months of the end of the fiscal year.

D. Effectiveness and Tranche Release

96. The loan would be declared effective when the Mexican Government provides to the Bank evidence that its macroeconomic policy framework is consistent with the agricultural sector adjustment program and completes the appropriate contractual arrangements with NAFIN. The second tranche of the ASL would be conditional upon satisfactory fulfillment of the conditions in each of the policy areas described above and in Annex 5, and upon satisfactory progress in carrying out the macroeconomic program supportive of

---

7/ Certain conditions of the loan that are very close to fulfillment (removal of export controls on quality cuts of beef and high quality rice) or are necessary in order to assure successful completion of the loan (agreement on terms of reference for studies and provision for procedures to coordinate disbursement) have been designated as conditions of disbursements exceeding US$25 million of the first tranche.

agricultural growth. It is anticipated that this would be completed by March 31, 1989.

E. Monitoring and Reporting

97. The Bank will monitor the Government's progress in implementing its reform program through regular supervision and exchange of views with the borrower and the Government covering both policy instruments and performance targets in each of the policy areas touched by the proposed loan. NAFIN will prepare and submit every three months to the Bank a report on progress in implementing the loan and trends in the agricultural sector including domestic and cif and fob prices of both inputs and outputs and policy actions implemented by the Government. An exchange of views with the Government in connection with the release of the second tranche would take place by January 1989. Draft Terms of Reference for studies that must be completed and discussed before disbursements exceeding US$25 million of the first tranche (sugar pricing, variable tariffs, and territorial and seasonal pricing issues) are attached to this report as Annex 8.

F. Benefits and Risks

98. The benefits of the reform program would consist of rising productivity and allocative efficiency in both agriculture and agro-industry, as adjustments in pricing make the incentive structure correspond more closely to economic opportunity costs. In addition, fiscal savings to the Mexican Government would be substantial while remaining subsidies would be more selective and targetted to the poor. Changes in the Government's fiscal outlays would come from several sources: the decreased subsidies on inputs (mainly fertilizer, paras 77-81), the changes in consumer subsidies (paras 37-41), the reduction of CONASUPO's operating losses (paras 57-68), and the changes in sugar pricing and subsidy policy (paras 57-68). The net effect of all of these would be an annual fiscal cost reduction of between US$1 billion and US$1.2 billion, depending on the year of the program (see Annex 7). The loan would also result in studies that would be useful to the Government in designing a program of further reforms, as well as to the Bank in advancing its dialogue with the Government on agricultural sector issues. The risks of the project derive from the political resistance to some of the reforms and the stability of the macroeconomy. While the current government has demonstrated its willingness to push forward with many reforms that are not politically popular, a new administration is likely to take office before second tranche release. While there are indications that the current policies will be carried over, there will certainly be political pressure to reverse the course. On the other hand, discussion of the second tranche conditions will also provide the Bank with an early opportunity to discuss the broad agricultural strategy with the incoming government. Also, the general vitality of the macroeconomy will influence the prosperity of the agriculture sector and hence the impact of the reforms. Furthermore, if there is a substantial appreciation of the real exchange rate, the viability of tradeable sectors such as agriculture could be harmed. These risks to the proposed loan are mitigated by the substantial steps that the Government has already taken up front (as described in this Report, many of the conditions proposed for a sector adjustment loan since January 1986 and during the preparation of the loan have already been fulfilled, while many of the others--for example sale of parastatals--are in advance stages of

implementation) and the strong commitment of the Government to continuing reform, liberalization of the economy, and sound macroeconomic management.

G. Social Impact of Agricultural Sector Adjustment

99. The structural adjustment process for agriculture will have both positive and negative impacts, though the former will far outweigh the latter. The major positive impact will be felt by: (a) the Government in the form of fiscal savings, efficient public investments, a reduced parastatal sector, and better information and analysis in its policy making and evaluation; and (b) producers in the form of improvements in the operation of SARH, higher farmgate prices, and greater productive efficiency. The negative impact, much of which has already been felt, will be borne by high and middle-income consumers, while the impact on the poor will be redressed for now and in the future by a targetted food stamp program and other food and nutrition programs.

100. An important question about the program envisioned in the ASL is whether the subsidies targetted to the poor will be sufficient to offset the effects of rising food prices, as consumer prices are raised above producer prices at the same time that producer prices are themselves increasing. Based upon the purchasing patterns of the poorest 20% of the population (16 million persons), and the assumption of administrative costs and leakages of 25%, the initial subsidy of US$250 million annually, as contemplated by the ASL, would restore the purchasing power of the poor eroded by price increases since 1983. The subsequent increases up to 0.2% of GDP in 1991 would then compensate for projected increases in the prices of basic foods each year (see Annex 7).

101. Another important issue is whether farm output prices would compensate for fertilizer price rises without reducing producers' net income and without excessive fiscal costs and nutritional declines. Regarding the impact on profitability, it is important to note that over the course of the adjustments envisioned by the loan, three factors would be simultaneously having some impact on producer profitability. First, the increase in fertilizer prices would tend to depress profitability, all other things being equal. Second, at the same time, the Government would be modifying its pricing system so that output prices would be at least at international levels, while, third, these prices being linked at their minimum to international prices would themselves be changing. Based on projected changes in international prices, through 1991 the net impact of all these factors on profitability would be positive for each of five crops that comprise over 90% of harvested area and almost 60% of production value. The average of the change in the ratio of price to production cost for all of these crops, with each weighted by its share in production value, indicates that overall profitability would increase by 12.5% (see Annex 7).

PART V - BANK GROUP OPERATIONS IN MEXICO

A. Bank Operations

102. As of September 30, 1987, Mexico had received 103 loans from the Bank, amounting to US$9.7 billion, net of cancellations and terminations; of these, 70 loans totalling US$4.7 billion were fully disbursed. The Bank held US$7.3 billion, of which US$2.47 billion had not yet been disbursed. Some 35% of Bank lending has been for agriculture and rural development, 20% for industry, 8% for power, 16% for transportation and 5% for policy-based lending; the remaining 16% has been for water supply, tourism, urban development, and vocational training.

103. Of the US$9.7 billion total lending, about US$5.35 billion was for establishing or strengthening institutions for channelling credit to areas where credit supply was deficient or non-existent, and setting up in the commercial banking system the ability to carry out project-related appraisal investments in agriculture, industry, and tourism. These credit programs have facilitated lending to low-income farmers and small- and medium-scale industrial and tourism enterprises.

104. Adequately funded and properly monitored, Bank-assisted projects had been implemented satisfactorily until mid-1982. Disbursements, as a result, rose from US$91 million in FY78 to US$448 million in FY82. However, the 1982 financial crisis caused delays in the provision of counterpart funds; consequently, disbursements declined to US$389 million in FY83. A Special Action Program (SAP) was established in early 1983 to help the Government by alleviating the counterpart funding constraints on development projects. A total of 18 Bank-financed projects (including the US$350 million first Export Development Loan approved in mid-1983) received support under the Program. Partly as a result of the SAP, disbursements improved, reaching US$528.87 million in FY84, about 35% over the levels disbursed in FY83, and increased further by about 49%, to US$787.93 million, in FY85. But, disbursements dropped by about 18% to US$656.7 million in FY86. This decline is attributed mainly to the acute shortage of counterpart peso funding, lack of credit demand, and the delays in declaring some projects effective. However, disbursements picked up again, increasing in FY87 by about 53%, to US$1.22 billion. This increase can largely be attributed to the fast disbursement of the Trade Policy Loan, which became effective in November 1986.

B. IFC Operations

105. As of September 30, 1987, IFC had made investment commitments in 32 companies in Mexico, for a total of US$831.7 million, of which US$650.9 million had been sold, repaid, or cancelled. IFC has been working together with the Bank to: (a) identify investment opportunities which would best suit the needs of the private sector in the current phase of Mexico's growth-oriented adjustment program; and (b) assist the Government in reviewing the requirements of the country's capital markets, both through economic sector work and specific proposals for venture capital operations. The IFC has carried out three operations in the motor vehicle and cotton seed business. The provision of foreign exchange and export production have been principal objectives of these operations.

C. Bank Strategy

106. The Bank's major objectives in Mexico prior to the 1982 crisis were to: (a) support policies and programs leading to a wider distribution of the benefits of economic growth; (b) help finance projects that, directly or indirectly, contributed significantly to output and employment; (c) help reduce Mexico's urban/regional imbalances; and (d) help free bottlenecks which prevent rapid growth. These continue to be important objectives of Bank assistance to Mexico. However, following the 1982 economic crisis and a reassessment of the Bank's role in Mexico, the Bank management concluded that (a) increased Bank lending, critical to Mexico's recovery, must be linked to central policy reforms; and (b) the Bank should play a central role in assisting Mexico's return to voluntary lending by commercial banks. In its new role, the Bank has intensified and broadened its economic and sector work. Specific policy reforms that are being pursued through a dialogue with the Mexican Government cover priority macroeconomic and cross-sectoral issues, such as trade liberalization, rationalization of preferential credit systems, improvement in public sector pricing and investment, and subsidy reduction. Traditional lending incorporating project- or sector- specific policy issues is being conducted in parallel with policy dialogue on cross-sectoral or macro policy issues.

107. As a result of these initiatives, the Bank contributed to Mexico's external financing needs in 1986-87 in a very especial way through continued project lending and quick-disbursing operations in support of policy reforms and structural adjustment in key sectors. The Bank's annual commitments in 1987 reached US$1.7 billion, assisting Government initiatives in trade, export development, agriculture, industry, transport, and manpower training. To lend broader support to Mexico's adjustment process, the Bank has, with the Board's authorization, put in place guarantees for the commercial banks' cofinancing and growth-contingency facilities up to a total of US$750 million.

108. Because of the difficult structural problems of agriculture and the sector's crucial importance for one-third of the nation's population living in rural areas, the Bank has made agriculture the leading sector for its lending. The Bank's agricultural lending program in Mexico aims at: (a) a more efficient and rational use of natural resources to increase production; (b) productivity improvements of cultivated lands, with emphasis on the productivity of small farmers; and (c) promotion of employment-generating investments in rural areas. To support these goals, infrastructure investments in Bank-assisted projects have been complemented with support services, such as extension, marketing programs, and credit. The Bank has made 16 loans in FYs 80-87 totalling US$2,638.93 million, for irrigation, rural and agricultural investment projects, and agro-industrial and livestock credit programs. Projects for irrigation rehabilitation, extension and forestry, and agro-industry are in various stages of preparation. Special emphasis has been placed in recent years on the development of rainfed areas.

109. The Bank's long-term policy objectives in Mexico's agricultural sector are to help the Government: (a) to reduce consumer subsidies and better target remaining subsidies so that they benefit the truly needy; (b) to phase out price controls on foodstuffs; (c) to render more efficient CONASUPO's and other parastatals' storage, processing, distribution and

marketing activities including, where appropriate, privatization of these; (d) to move towards economic prices for agricultural inputs (e.g., fertilizers and water); (e) to bring domestic producer prices in line with international prices; (f) to liberalize, over time, the trade regime with regard to the import and export of agricultural products and foodstuffs (this includes not only progress in the removal of prohibitions and quantitative restrictions but also providing greater access to import activities to the private sector); (g) to diminish credit subsidies by moving towards market-determined interest rates; (h) to achieve a sound investment program; (i) to rationalize pricing and promote privatization and efficiency in the sugar sector; and (j) to restructure and decentralize the Ministry of Agriculture with an eye to reducing superfluous employment and to having a higher percentage of Ministry staff actually coming into contact with farmers. The proposed loan would support the above policy orientation.

110. Bank lending for industry between FYs 80-87 amounted to US$1,572.25 million, covering areas of small- and medium-scale industry, mining, capital goods industries development, industrial technology development and export development. After the 1982 crisis, a US$350 million loan was approved to assist in Mexico's non-oil export sector. The loan contributed to an intensive and continuous policy dialogue between the Bank and Mexican authorities regarding: (a) export promotion and trade liberalization policies; (b) administrative and institutional aspects of export promotion; and (c) financial support for non-oil exports. Based on the lessons of experience under that sector adjustment operation and broad economic sectorwork, a new comprehensive assistance strategy has been formulated to guide the Bank's lending work for industry. This strategy supports: (a) trade policy reform to move towards greater uniformity of incentives and greater international competitiveness; (b) complementary financial sector policies to reverse the prolonged contraction experienced by Mexico's financial system, including its securities market; and (c) measures and programs required to encourage adequate supply responses, particularly in export promotion and industrial restructuring.

111. Working towards the objectives of its strategy, the Bank has, in FY88, processed a US$135.0 million Highway Maintenance Loan, a US$80.0 million Manpower Training Operation and a US$500.0 million Second Trade Policy Loan (TPL II), which were complemented by a US$400.0 million Steel Sector Restructuring Project. TPL II disbursed US$94.0 million from the first tranche. Projects in industrial restructuring include the Fertilizer Sector Loan and operations in the steel, automotive parts, textile, and agroindustry sectors which are under preparation, and would help achieve the strategy objectives over the medium term. The proposed Industrial Restructuring Loan (IRL) is intended to provide financing to firms undertaking restructuring operations in subsectors or product lines that are being freed of Non-Tariff Barriers (NTBs), price controls, domestic content requirements, and the like. Finally, restructuring of subsectors dominated by parastatals are being undertaken under the proposed loan, the Fertilizer Sector Loan being processed in parallel, and the Steel Sector Restructuring Loan that was submitted for Board action on March 1, 1988. In addition to trade and pricing issues, these operations also address issues of private sector involvement, decentralization, and management autonomy and accountability.

112. Bank lending for transport has focussed on regional development, strengthening of institutions, and rationalization of public investment outlay and pricing policies. Between FYs 80-87, six loans amounting to US$752.84 million were approved, including two in each of the following three subsectors: highways, railways, and ports. Additional projects to support similar goals in the urban sector were undertaken. During FYs 80-87, ten loans were approved, totalling US$1,263.50 million, in the fields of water supply and sewerage and urban development, including a first US$125.0 million Urban Transport Project, which was approved on May 28, 1987. In response to Mexico's 1985 earthquake emergency, the Bank processed a US$400 million Earthquake Rehabilitation Project, which the Executive Directors approved in March 1986. A federal Highway Maintenance Project was approved in October 1987. Additional projects are under consideration in the transport and urban sectors, which would aim at strengthening the various institutions in the areas of planning, management, and finance.

113. The Economic Development Institute (EDI) is assisting Mexico through various courses/seminars dealing with policy alternatives and institutional reforms. EDI training is specifically directed at courses/seminars on water supply and sanitation sector management, transport policy, agricultural policy, industrial development and finance, and macro policy analysis.

114. The Inter-American Development Bank (IDB) is the second largest source of multilateral aid to Mexico. The IDB has made loans to Mexico totalling US$3.54 billion as of June 30, 1987. Over 50% of the total has gone to agricultural and rural development projects, and the balance to transportation, industry, water supply and sewerage, tourism infrastructure, education, municipal development, and preinvestment. The IDB and the Bank have coordinated their assistance on several projects. Each has made loans for the national integrated rural development program (PIDER), agricultural and livestock credit, small- and medium-scale industries development, and hotel development projects. The IDB is also providing a program of assistance for earthquake rehabilitation and reconstruction, and two loans in the health sector, totalling US$41.3 million, were approved on June 27, 1986. A loan of US$100.0 million was provided for a tourism hotel in the private sector in December 1986. The International Fund for Agricultural Development (IFAD) has approved a loan of US$22.0 million for a rural development project in the State of Oaxaca, which was appraised by the Bank's staff and for which the Bank is acting as executing agency.

PART VI - COLLABORATION WITH THE IMF

115. Since 1982, the IMF has supported Mexico through: (a) an Extended Fund Facility (EFF) negotiated in late 1982 for a total of SDRs 3.6 billions, covering the three years through December 1985; because of non-compliance with some of the performance criteria for the second and third quarters of 1985, this facility became inoperative, with about SDRs 908 million undrawn; (b) a special emergency assistance drawing, for SDRs 291 million, in support of Mexico's earthquake reconstruction needs approved in early 1986; (c) and 18- month stand-by for SDRs 2.4 billion, approved in November 1986.

116. Performance under the stand-by program was satisfactory in 1986 and the first three quarters of 1987. Final information for December 1987 is not yet available, and therefore the IMF end-of-year review is still in progress. Details of the performance on the stabilization program in 1986 and the macroeconomic framework for 1987 are presented in Part I above. Coordination between the two institutions has and will continue to be close on monitoring of the macroeconomic program and the harmonization of lending programs.

PART VII - RECOMMENDATION

117. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the proposed loan.

Barber B. Conable
President

Attachments
Washington, D.C.
February 22, 1988

MEXICO - ECONOMIC INDICATORS

Mid-1987 Population (mils.) 81.3
1986 Per Capita GNP in US$: 1850

	A. Shares of Gross Domestic Product (from current price data)						B. Growth Rates (% per annum) (from constant price data)				
	1965	1973	1980	1985	1986	1987p	1965-73	1973-80	1980-85	1986	1987p
Gross Domestic Product c.p.	100.0	100.0	100.0	100.0	100.0	100.0	6.9	6.2	0.8	-3.8	1.0
Net Indirect Taxes	4.3	5.0	8.3	..	..	..	..	..	..	..	..
Agriculture	14.4	11.6	8.4	9.0	9.0	..	3.1	3.4	2.3	-3.3	..
Industry	31.1	20.4	37.3	39.8	38.6	..	8.3	7.0	0.3	-5.3	..
(of which Manufacturing)	21.0	23.7	23.0	24.7	25.5	..	8.3	6.7	-0.9	-5.4	..
Services	54.4	56.4	54.4	51.2	52.4	..	6.8	6.2	0.8	-2.6	..
Resource Balance	-1.0	-1.1	-0.9	5.2	3.6	..	..	..	..	..	..
Exports of GNFS	9.3	8.4	12.6	16.1	16.9	..	6.2	8.5	8.8	5.2	10.1
Imports of GNFS	10.3	9.5	13.5	10.9	13.2	..	4.3	9.9	-5.6	-12.3	-0.7
Total Expenditures	101.0	101.1	100.9	94.8	96.4	..	6.8	6.3	-2.2	-5.5	2.1
Total Consumption	79.2	79.7	72.8	73.6	74.3	..	6.5	5.9	0.1	-4.7	2.6
Private Consumption	72.2	70.5	62.0	64.1	64.3	..	6.2	5.6	-0.4	-5.5	2.8
General Government	7.0	9.2	10.8	9.5	10.0	..	8.7	7.3	3.3	1.2	1.0
Gross Domestic Investment	21.7	21.4	28.1	22.2	22.1	..	8.5	7.8	-9.0	-9.2	-4.4
Fixed Investment	17.6	19.3	24.2	..	..	..	9.5	7.2	-10.6	-11.7	..
Changes in Stock	4.2	2.1	4.0	..	..	..	..	..	..	6.4	..
Gross Domestic Saving	20.8	20.3	27.2	26.7	25.3	26.5	8.5	8.6	-3.4	-17.2	-1.6
Net Factor Income	-0.6	-1.3	-3.2	-4.7	-6.1	-4.4	..	..	..	..	..
Net Current Transfers	..	0.2	0.1	0.1	0.4	0.7	..	..	..	..	..
Gross National Saving	..	19.2	23.7	22.1	19.6	21.8	17.4	7.8	-5.6	-23.0	1.9
In millions of LCU's (at constant 1980 prices)	1965	1973	1980	1985	1986	1987					
Gross Domestic Product	1603	2758	4276	4628	4452	4497	6.9	6.2	0.8	-3.8	1.0
Capacity to Import	130	225	537	506	357	..	6.7	12.3	-2.3	-29.4	..
Terms of Trade Adjustment	-68	-107	0	-268	-468	-413	..	..	..	..	..
Gross Domestic Income	1535	2651	4276	4360	3983	4084	6.9	6.5	-0.8	-8.6	2.5
Gross National Product	1508	2723	4138	4419	4228	4309	7.8	6.0	0.4	-4.3	1.9
Gross National Income	1439	2616	4138	4151	3760	3893	7.9	6.3	-1.2	-9.4	3.5

C. Price Indices	(1980 = 100) 1980	1983	1984	1985	1986	1987	Inflation Rates (% p.a.) 1965-73	1973-80	1980-85	1986	1987p
Consumer Prices (IFS 64)	100.0	410.2	679.0	1047.7	1859.7	4314.4	4.3	20.3	60.0	77.5	132.0
Wholesale Prices (IFS 63)	100.0	402.7	686.0	1053.4	1984.4	4675.8	4.0	22.3	60.1	88.4	148.0
Implicit GDP Deflator	100.0	394.6	638.1	984.5	1746.0	4049.0	4.0	22.3	66.2	77.5	132.0
Implicit Expenditures Deflator	100.0	397.8	658.8	1029.0	1919.0	..	3.6	8.0	7.5	3.4	..

D. Other Indicators	1965-73	1973-80	1980-85
Growth Rates (% p.a.):			
Population	3.3	3.0	2.6
Labor Force	..	..	..
Gross National Income p.c.	4.4	3.2	-3.7
Private Consumption p.c.	2.8	2.6	-2.9
Import Elasticity:			
Imports (G+NFS) / GDP (mp)	1.0	1.6	-19.5
Marginal Savings Rates:			
Gross National Saving	..	..	..
Gross Domestic Saving	19.7	38.3	16.2
ICOR (period averages):	2.8	3.5	15.9

Share of Total Labor Force in:	1965	1973	1980	1985
Agriculture	34.7	30.4	26.1	26.6
Industry	20.7	22.1	23.5	20.9
Services	44.6	47.5	50.4	52.5
Total	100.0	100.0	100.0	100.0

Notes:

Data on the Economic Indicators tables should follow the definitions and concepts of the Standard Tables and Standard Attachments. The indicators should include data through the most recently completed calendar year (or fiscal year in the case of fiscal year countries). Staff estimates may be used if final or preliminary actuals are not yet available. The use of estimates and preliminary figures should be indicated by

p = preliminary data

MEXICO - ECONOMIC INDICATORS

E. Merchandise Exports	Volume Index (1980 = 100): 1980	1983	1984	1985	1986	1987p	Value at Current Prices (millions US$): 1980	1983	1984	1985	1986	1987p
Petroleum	100.0	185.0	185.0	173.0	155.0	153.5	9898.0	15143.0	15196.0	14766.0	6307.0	8700.0
Cotton	100.0	42.4	73.2	38.3	68.9	..	[illegible]16.7	115.8	208.2	98.7	72.4	55.0
Coffee	100.0	135.4	141.9	158.8	284.0	..	422.4	385.7	424.4	512.0	819.0	463.0
Manufactures	100.0	150.0	192.2	186.4	223.7	277.2	2651.0	4582.7	5452.3	4978.0	7115.7	9774.0
Other Exports	100.0	109.1	130.3	121.2	106.1	104.5	2777.9	2084.8	2915.1	1308.3	1726.9	1952.0
Total Merchandise Exports FOB	100.0	159.0	163.9	162.0	151.2	167.3	16066.0	22312.0	24196.0	21663.0	16041.0	20944.0

F. Merchandise Imports	1980	1983	1984	1985	1986	1987p	1980	1983	1984	1985	1986	1987p
Consumer Goods	100.0	17.7	21.9	27.1	21.4	21.9	2449.6	613.8	848.1	1081.7	846.4	1023.0
Intermediate Goods	100.0	49.3	60.9	70.1	55.4	56.7	11208.7	5740.4	7833.4	8965.7	7631.9	8942.0
Capital Goods	100.0	27.5	31.1	38.6	30.5	31.2	5174.0	2296.7	2572.8	3164.8	2954.0	3056.0
Total Merchandise Imports CIF	100.0	39.8	48.3	56.6	49.5	50.7	18832.3	8550.9	11254.3	13212.2	11432.3	13021.0

G. Terms of Trade (1980 = 100)	1980	1983	1984	1985	1986	1987p
Merch. Exports Price Index	100.0	87.4	91.9	83.2	66.0	77.9
Merch. Imports Price Index	100.0	114.1	123.7	124.0	122.6	136.4
Merchandise Terms of Trade	100.0	76.6	74.3	67.2	53.8	57.1

US$ millions (at current prices):

H. Balance of Payments	1980	1983	1984	1985	1986	1987p
Exports of Goods and NFS	23456	27179	30156	27624	22006	28214
Merchandise (FOB)	16066	22312	24196	21663	16041	20944
Non-Factor Services	7390	4867	5960	5961	5965	7270
Imports of Goods and NFS	25620	12691	16079	18368	16307	17987
Merchandise (FOB)	18832	8551	11254	13212	11432	13021
Non-Factor Services	6788	4140	4825	5156	4875	4966
Resource Balance	-2164	14488	14077	9256	5699	10227
Net Factor Income	-6209	-9372	-10247	-9021	-7449	-6689
(Interest per DRS)	4590	8154	10268	9436	8342	7959
Net Current Transfers	275	302	411	1002	490	830
(workers remittances)	...	...	...	...	...	...
Current Account Balance	-8098	5418	4241	1237	-1260	4368
Long-Term Capital Inflow	7754	4736	2451	-400	144	5328
Direct Investment	2186	461	390	491	905	2500
Official Capital Grants	...	...	...	...	...	...
Net LT Loans (DRS data)	6839	2381	1603	-561	955	3928
Other LT Inflows (Net)	-1271	1894	458	-340	-1716	-1100
Total Other Items (Net)	1302	-6904	-4542	-3568	130	-3096
Net Short-term Capital	5135	-5830	-3527	-1693	1412	-1100
Capital Flows N.E.I.	0	0	0	0	0	0
Errors and Omissions	-3834	-1074	-1015	-1875	-1282	-1996
Changes in Net Reserves	-958	-3250	-2150	2731	986	-6600
Net Credit from IMF	-136	1039	1100	610	917	650
Other Reserve Changes (- indicates increase)	-822	-4289	-3250	2121	69	-7250
As shares of GDP:						
Resource Balance	-1.2	10.2	8.2	5.2	4.7	8.2
Interest Payments	3.3	5.7	7.0	6.1	6.8	6.4
Current Account Balance	-4.4	3.8	2.5	0.7	-1.0	3.5
Memorandum Items:						
Internat'l Reserves (mil. US$)	2960	3913	7372	4906	5670	..
Reserves incl. Gold (mil. US$)	4197	4789	8011	5691	6684	..
Official X-Rate (LCU's/US$)	22.95	120.09	167.83	256.87	611.77	1462.70
Index Real Eff. X-R Base 1980	100.00	71.71	83.80	86.25	60.40	55.51
GDP (millions of current US$)	186331	142736	171298	177358	127136	121933

Notes:

Data on the Economic Indicators tables should follow the definitions and concepts of the Standard Tables and Standard Attachments. The indicators should include data through the most recently completed calendar year (or fiscal year in the case of fiscal year countries). Staff estimates may be used if final or preliminary actuals are not yet available. The use of estimates and preliminary figures should be indicated by:

p = preliminary data

MEXICO - ECONOMIC INDICATORS

I. Consolidated Public Sector	Shares of GDP (%) 1980	1983	1984	1985	1986	1987p	Growth Rates (% p.a.) 1980 - 84	1985	1986	1987p
Current Receipts	26.3	31.8	31.3	30.4	29.3	30.3	4.1	-5.8	-6.2	..
Current Expenditures	24.9	36.7	35.5	36.1	40.5	42.4	8.3	1.9	21.4	..
Current Budget Balance	1.4	-4.9	-4.2	-5.7	-11.2	-12.1	..	..	..	..
Capital Receipts	..	..	..	..	..	..				..
Capital Expenditures	-9.4	-4.5	-4.2	-3.8	-4.4	-4.5	-8.5	-8.7	-3.2	..
Overall Deficit	-8.0	-9.4	-8.4	-9.5	-15.6	-16.6	..	..	..	..

J. External Capital Flows, Debt and Debt Burden Ratios	Net Disbursements (US$ millions) 1980	1983	1984	1985	1986e	1987e	Debt Outstanding & Disbursed (US$ mil.) 1980	1983	1984	1985	1986e	1987e
Public & Publicly Guaranteed LT	5139	2365	1158	948	1295	5970	33987	66759	70071	72510	74962	83972
Official Creditors	797	-263	804	686	1372	1765	4481	6744	7469	8607	10714	13580
Multilateral	501	-520	670	705	979	943	3189	4203	4830	5754	7029	7972
of which IBRD	333	178	419	483	648	516	2063	2870	3289	3772	4418	6890
of which IDA	..	..	..	..	..	..	..	..	..	..	..	..
Bilateral	296	257	134	-19	393	822	1292	2541	2639	2853	3685	5508
Private Creditors	4343	2628	353	262	-77	4205	29507	60021	62667	63559	64248	70392
Suppliers	-52	171	-156	8	-1	181	257	363	205	228	218	313
Financial Markets	4395	2443	509	257	-76	4024	29250	59658	62462	63331	64030	70079
Private Non-Guaranteed LT	1700	0	384	-620	-290	-560	7300	14800	17500	16500	16100	12500
Total LT	6839	2365	1542	328	1005	5410	41287	81559	87571	89010	91062	96472
IMF Net Credit	-136	1039	1100	610	917	650	0	1260	2360	2969	4060	4678
Net Short-Term Capital	5136	-5830	-3527	-1693	40	-1100	16163	10139	6440	5450	6308	3102
Total including IMF & Net ST	11839	-2426	-885	-755	1962	4960	57450	92958	97371	97429	101430	106158

Bank and IDA Ratios	1980	1983	1984	1985	1986e	1987e
Share of Total Long-Term DOD						
1. IBRD as % of Total	5.00	3.52	3.76	4.24	4.85	7.14
2. IDA as % of Total	0.00	0.00	0.00	0.00	0.00	0.00
3. IBRD+IDA as % of Total	5.00	3.52	3.76	4.24	4.85	7.14
Share of Total LT Debt Services						
1. IBRD as % of Total	2.73	3.07	3.11	4.32	5.80	7.44
2. IDA as % of Total	0.00	0.00	0.00	0.00	0.00	0.00
3. IBRD+IDA as % of Total	2.73	3.07	3.11	4.32	5.80	7.44
DOD-to-Exports Ratios						
1. Long-Term Debt/Exports	176.02	300.08	290.39	322.22	413.81	341.93
2. IMF Credit/Exports	0.00	4.64	7.83	10.75	18.45	16.58
3. Short-Term Debt/Exports	68.91	37.30	21.36	19.73	28.66	17.75
4. LT+IMF+ST DOD/Exports	244.93	342.02	322.89	352.70	460.92	376.26
DOD-to-GDP Ratios						
1. Long-Term Debt/GDP	22.16	57.14	51.12	50.19	71.63	79.12
2. IMF Credit/GDP	0.00	0.88	1.38	1.67	3.19	3.84
3. Short-Term Debt/GDP	8.67	7.10	3.76	3.07	4.96	2.54
4. LT+IMF+ST DOD/GDP	30.83	65.13	56.84	54.93	83.20	85.20
Debt Service/Exports						
1. Public & Guaranteed LT	32.08	40.04	34.93	36.90	39.50	..
2. Private Non-Guaranteed LT	5.89	5.40	14.26	11.25	11.53	..
3. Total LT Debt Service	37.97	45.44	49.19	48.15	51.03	..
4. IMF Repurchases + Serv Chgs.						
5. Interest Only on ST Debt						
6. Total (LT+IMF+ST Int.)	46.90	45.44	47.20	49.30	56.70	50.40

Notes:

Data on the Economic Indicators tables should follow the definitions and concepts of the Standard Tables and Standard Attachments. The indicators should include data through the most recently completed calendar year (or fiscal year in the case of fiscal year countries). Staff estimates may be used if final or preliminary actuals are not yet available. The use of estimates and preliminary figures should be indicated by:

p = preliminary data

STATUS OF BANK GROUP OPERATIONS IN MEXICO 1/

A. Statement of Bank Loans
(As of September 30, 1987)
(US$ million)

Loan No.	Fiscal Year	Borrower	Purpose	Amount Less Cancellations	Undis- bursed
		70 loans fully disbursed		4,700.01	
1788-5	1979	NAFINSA	Irrigation	92.00	30.12
1865-5	1980	NAFINSA	Irrigation	70.00	30.89
1913	1981	BANOBRAS	Water Supply	125.00	44.43
1939	1981	BANOBRAS	Urban Development II	104.00	52.04
2043	1982	NAFINSA	Integrated Rural Dev.	175.00	28.38
2142	1982	NAFINSA	Capital Goods Industry	152.30	70.78
2154	1982	NAFINSA	Pollution Control	25.00	11.91
2194	1983	BANOBRAS	Urban Engineering	9.20	5.07
2282	1983	NAFINSA	Agricultural Marketing	115.00	48.45
2281	1983	BANOBRAS	Third Water Supply	190.30	58.93
2325	1983	NAFINSA	Third Sm/Med Industry	175.00	8.03
2331	1983	BANCOMEXT	Export Development	350.00	58.25
2428	1984	BANOBRAS	Highways	200.00	100.91
2450	1984	BANPESCA	Ports	76.30	63.73
2525	1985	NAFINSA	Chiapas Rural Roads	22.00	19.95
2526	1985	NAFINSA	Chiapas Agric Dev.	90.90	77.94
2546	1985	NAFINSA	Sm/Med Scale Mining II	105.00	91.69
2559	1985	NAFINSA	Vocational Education	81.00	62.68
2575	1985	BANOBRAS	Railways V	300.00	232.89
2610	1986	NAFINSA	Agricultural Credit	100.00	5.65
2612	1986	BANOBRAS	Low-Income Housing I	150.00	103.95
2658	1986	NAFIN	Proderith II	109.00	96.47
2665	1986	BANOBRAS	Earthquake Rehab.	400.00	118.92
2666	1986	BANOBRAS	Municipal Strengthening	40.00	37.88
2669	1986	BANOBRAS	Solid Waste Pilot	25.00	22.60
2745	1987	BANCOMEXT	Trade Policy Loan I	500.00	10.98
2746	1987	NAFIN	Industrial Recovery	150.00	117.78
2747	1987	NAFIN	Technology Development	48.00	39.37
2777	1987	BNCE	Export Development II	250.00	158.15
2824	1987	BANOBRAS	Urban Transport	125.00	125.00
2837	1987	NAFIN	Agricultural Credit	400.00	358.93
2858 3/	1987	NAFIN	Sm/Med Industries IV	185.00	185.00
2850	1987	NAFIN	Agricultural Extension	20.00	17.41
		TOTAL		9,700.01	
		Of which has been repaid to the Bank		2,421.25	
		Total now outstanding		7,288.86	
		Amount sold	92.34		
		Of which as been repaid	92.34	0.00	
		Total now held by Bank 2/		7,288.86	
		Total undisbursed			2,477.72

1/ The status of the projects listed in Part A is in a separated report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

2/ Prior to exchange adjustments.

3/ Not yet effective.

LocaStatus:BNK1MXC:A1...J78
EBA:revals:LA2CO
October 22, 1987

B. Statement of IFC Investments
As of September 30, 1987
(US$ million)

Fiscal Year	Obligor	Type of Business	Original Approvals: Equity	Loan	Total
1956/59	Industrial Perfect Circle, S.A. a/	Industrial Equipment	0.0	0.6	0.6
1958	Bristol de Mexico S.A. a/	A.C. Engine Overhaul	0.0	0.5	0.5
1961	Acero Solar, S.A. a/	Twist Drills	0.0	0.3	0.3
1962/5/6/8	Fundidora Monterrey, S.A. a/	Steel	21.4	2.3	23.7
1963	Tubos de Acero de Mexico	Stainless Steel Pipes	0.1	0.9	1.0
1963	Quimica del Rey, S.A. a/	Sodium Sulphate	0.0	0.7	0.7
1964/8	Industria del Hierro, S.A.	Construction Equipment	2.0	0.0	2.0
1970	Minera del Norte a/	Iron Ore Mining	0.0	1.5	1.5
1971	Celanese Mexicana, S.A. a/	Textiles	0.0	10.0	10.0
1972	Promotora de Papel Periodico, S.A. de C.V. a/	Pulp and Paper	b/	0.0	b/
1973/9	Cementos Veracruz, S.A.	Cement	0.0	15.0	15.0
1974/81	Cancun Aristos Hotel	Tourism	0.2	1.0	1.2
1975/78	Mexinox, S.A.	Stainless Steel	3.2	12.0	15.2
1976/81/82	Papeles Ponderosa, S.A.	Pulp and Paper	2.0	13.7	15.7
1978	Tereftalatos Mexicanos, S.A.	Petrochemicals	0.0	10.0	10.0
1979/81	Hotel Camino Real Ixtapa, S.A. de C.V.	Tourism	4.2	0.0	4.2
1979/83	Empresas Tolteca, S.A.	Cement	7.0	168.0	175.0
1979	Conductores Monterrey, S.A.	Electrical Wire & Cable	0.0	15.0	15.0
1980	Industrias Resistol, S.A.	Particle Board	0.0	25.0	25.0
1980	Vidrio Plano de Mexico, S.A.	Flat Glass	0.0	114.0	114.0
1980	Minera Real de Angeles, S.A. de C.V.	Mining	0.0	110.0	110.0
1981	Celulosicos Centauro, S.A. a/	Pulp and Paper	0.0	64.0	64.0
1981	Corporacion Agroindustrial S.A. de C.V.	Agri-Business	3.0	11.3	14.3
1983	Capital Goods Facility c/	Capital Goods Financing	0.0	100.0	100.0
1984	Metalsa, S.A.	Auto Chassis	1.4	3.0	4.4
1984	Protalsa, S.A. de C.V.	Agri-Business	0.0	2.0	2.0
1985	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemicals	0.0	16.4	16.4
1986	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and Paper	1.0	10.0	11.0
1986	Agromex Phase I (AESA)	Veg. & Fruit Processing	0.5	1.5	2.0
1986	Sulfamex	Chemical & petrochemical	0.5	2.0	2.5
1986	Apasco	Cement	0.0	40.0	40.0
1987	Spimex	Auto Assembly	0.0	9.0	9.0
	Total Gross Commitments		52.2	779.5	831.7
	Less Cancellations, Terminations, Repayment, and Sales		23.5	627.4	650.9
	Total Commitments Now Held by IFC		28.7	152.1	180.8
	Total Undisbursed (including participants)		5.9	12.7	18.6

a/ Investments which have been fully cancelled, terminated, written off, sold, redeemed or repaid.
b/ US$625,000.
c/ Excludes US$5.200 capitalized interest.

LoanStatus:IFC1MXC:A1...H75
ESArevalo:LA2C0
October 27, 1987

MEXICO

AGRICULTURAL SECTOR ADJUSTMENT LOAN

Supplementary Loan Data Sheet

Section I - Timetable of Key Processing Events

(a)	Time taken by country to prepare loan:	About two years
(b)	Loan prepared by:	Government with Bank assistance
(c)	First Bank mission:	September 1986
(d)	Departure of appraisal mission:	April 1987
(e)	Negotiations completed:	February 1988
(f)	Planned date of effectiveness:	March 1988

Section II - Special Conditions

(a) Conditions of effectiveness:

(i) Provision to the Bank of evidence that macro-economic policy framework is consistent with the program of agricultural sector adjustment program (para 96).

(b) Conditions of first tranche disbursements exceeding US$25 million:

(i) Provision to the Bank of terms of reference for studies acceptable to the Bank (paras 55, 76).

(ii) Removal of export controls on quality cuts of beef and high quality rice (para 76).

(iii) Preparation of disbursement procedure to coordinate disbursements with transactions covered by Trade Policy Loan II and Fertilizer Sector Loan (para 94).

(c) Conditions for second tranche release:

1. Food Security (paras 37-41)

- Implementation in 1988 of a satisfactory targetted program of food stamps or other well-targetted food subsidy program at adequate levels of funding sufficient to compensate poor for elimination of global food subsidies between 1983 and 1986 (about US$250 million or about 0.1% of GDP), using mechanisms to minimize diversion of stamps from the target population. Linkage of price of tortibonos to price of tortillas to maintain subsidy per recipient at constant real levels. Pilot introduction of targetted food assistance in rural areas. Revision of criteria for eligibility. Study of expansion of other programs (e.g., school feeding) to buffer impact of adjustment program. Preparation of a satisfactory action plan for expansion of nutritional monitoring program for urban and rural areas.

2. Reduction of role of parastatals (paras 57-68)

- Limitation of transfers to CONASUPO to less than US$85 million in 1988 Public Budget.

- No introduction of global food subsidies through institutions other than CONASUPO.

- Satisfactory progress on compliance with timetable for 500 DICONSA outlets being closed or moved to poor neighborhoods.

- Liquidation of CONASUPO's wheat-processing affiliate, TRICONSA.

- Satisfactory progress in sale or closure of 15 parastatals in the agricultural sector.

- Satisfactory progress in closure or sale of 2 sugar mills (four mills have been closed already).

- Discussion of study on sugar pricing policy, including cane, fob mill, and consumer prices so as to reduce subsidies and to promote greater efficiency.

3. Trade Liberalization (paras 69-76)

- Satisfactory completion of a study of variable tariffs and discussion of its results with the Bank.

- No imposition of export controls on fruits and vegetables.

- Encourage farmer organizations to establish and control export quality for vegetables and fruits while eliminating Government-imposed quantitative restrictions.

- Reduction of QR coverage of import licensing on agricultural and agro-industrial products by 5 percent of national production coverage.

4. Liberalization of Agricultural and Food Pricing (paras 42-56)

   - All guarantee prices administered by CONASUPO maintained at least at real 1987 levels in 1988. Guarantee prices for all crops except maize and beans maintained in 1989 within a range of 90% to 125% of comparable international prices, adjusted for processing margins, transport costs and quality differentials according to an agreed upon methodology. (Upper limit of 125% may be revised pursuant to results of study described below if agreed by both parties.)

   - Review and discussion with the Bank of the results of a study on the guarantee price system, including issues of pan-territorial and pan-seasonal prices.

5. Revision of Input Pricing (paras 77-81)

   - Provision of a plan of action satisfactory to the Bank to implement a system of charges for water used in agriculture that will achieve recovery of O&M costs except under specific circumstances estalished by Mexican law.

6. Sound Public Investment Budget (paras 82-86)

   - Establish procedures to encourage and facilitate disbursement of loans from international agencies in support of the investment budget of SARH. Submission of 1989 budget request to Congress that increases investment budget of SARH by at least US$200 million in real terms. Budgetted funds will be made available to SARH as needed for timely implementation of agricultural investments.

Characteristics of Production and Land Distribution

1. A wide range of crops can be grown in Mexico as a result of the considerable variety in agro-ecological conditions. Agricultural productivity varies considerably depending on the extent of commercially-oriented farming, public sector investment, and the use of inputs. In the irrigated and intensively farmed northwest, yields are twice and labor productivity three times the national average, whereas in the rainfed plateau states, both measures of productivity are well below national averages, reflecting the lack of investment in infrastructure as well as certain intrinsically poor characteristics of the environment.

2. The most important domestic crops, in terms of area planted, are maize (42.5% of the area planted to the 37 most important crops in 1984), beans (10.9%), and sorghum (10.0%). These crops represent 24.4%, 2.6%, and 6.8% of the total value of agricultural production. Fruits and vegetables occupy 8.8% of area planted but exceed all other crops in value of production and account value. Of the basic grains, Mexico is self-sufficient in wheat and rice but imports significant amounts of maize and sorghum. Soybeans and milk powder are other products that are heavily imported.

3. In 1985, some 5.4 million ha of irrigated land were harvested, representing 25% of the cropped area. Expansion of irrigated areas, at one time the most significant factor in the increase in agricultural production, has slowed in recent years, as the supply of land suitable for irrigation has run low. The scope for new schemes is becoming smaller and development more costly. Government policy therefore has tended to favor rainfed (temporal) agriculture in recent years, where the scope for productivity increases using available technology is high. Investment costs in rainfed agriculture are lower than in large-scale irrigation, and social benefits are higher.

4. After a half-century of land reform, about 3 million people own or have rights to land according to the 1970 census (the 1980 census has not been released as yet). About 4.5 million people remain landless. Collectively organized "ejidos" farm over 40% of the land area and constitute what the Government calls the social sector. The remaining individually-owned private farms are relatively small with 65% under 5 hectares and 80% under 10 hectares. Large parcels over 100 hectares are mainly in range land in the northern states. About 7% of the farms covering 19% of the cropland use modern technologies; about half the farms covering 34% of the cropland produce mainly for subsistence. The remaining are classified as traditional farms, producing for the market, but using antiquated technology. Although the Mexican Administration has reformed land policies to allow more consolidated use of ejido land, and reduced the threat of expropriation of larger land holdings, reportedly little has changed as a consequence. The threat of expropriation, whether real or implied, continues to constrain land use in some parts of Mexico.

POLICY MATRIX

Policy Objective	Actions Prior to Board Presentation Achieved	Conditions for Disbursement of Second Tranche (estimated date of disbursement March 31, 1989)
Elimination of global subsidies and establishment of a satisfactory targetted food subsidy program with adequate funding. (paras. 32-36)	- Reduction of global food subsidies except for sugar. Global subsidies, previously 1% of GDP, virtually eliminated in 1987 except sugar (0.05% of GDP). - Introduction of food stamps for tortillas (about 0.02% of GDP in 1987).	- Implementation in 1988 of a satisfactory targetted program of food stamps or other well-targatted food subsidy program at adequate levels of funding sufficient to compensate poor for reduction of global food subsidies between 1983 and 1986, using mechanisms to minimize diversion of stamps from the target population. About US$250 million or 0.1% of GDP would be considered an adequate level. Linkage of price of tortibonos to price of tortillas by adjusting tortibono prices, taking into consideration the price of tortillas and the rate of inflation, so as not to increase the subsidy in real terms per recipient to levels greater than those existing as of the Effective Date of the loan. Pilot introduction of targetted food assistance in rural areas. Revision of criteria for eligibility. Study of expansion of nutritional programs to buffer impact of adjustment program. Presentation of a satisfactory action plan for expansion of nutritional monitoring program to rural and urban areas.
Reduction of role of parastatals. (paras. 50-61)	- Agreement on reorganization and decentralization of CONASUPO and affiliates. - De facto limitation of CONASUPO purchases to 6 commodities for purposes of price support. - Closure of 31 defunct parastatals under SARH.	- Limitation of transfers for operating losses to CONASUPO in 1988 to about US$85 million. - No introduction of global food subsidies through institutions other than CONASUPO. - Satisfactory progress on compliance with timetable for 500 DICONSA outlets being closed or moved to poor neighborhoods. - Liquidation of CONASUPO's wheat-processing affiliate, TRICONSA. - Satisfactory compliance with timetable for sale or closure of 15 parastatals in agricultural sector. - Submission to Congress of a 1989 budget with transfers for operating losses to CONASUPO at levels below or equal to those currently budgetted for the 1988 in real terms.

POLICY MATRIX

Policy Objective	Actions Prior to Board Presentation Achieved	Conditions for Disbursement of Second Tranche (estimated date of disbursement March 31, 1989)
Reduction of role of parastatals (cont.)	- Agreement on sugar reforms. - Closure of 2 sugar mills.	- Satisfactory compliance with timetable for closure or sale of 6 mills. - Discussion of results of a study on sugar pricing policy including cane, fob mill and consumer prices so as to reduce subsidies and to promote greater efficiency in the sector.
Trade liberalization. (paras. 62-69)	- Removal of import licensing requirements for agricultural and agro-industrial products covering 2.8% of national production. - Reduction of tariffs on 66 categories and compliance with TPL timetables on removal of non-tariff barriers. - Elimination of monopoly import position of CONASUPO for basic foods except beans and milk powder. - Removal of export controls on wheat and some other agricultural commodities (about 0.8% of national production).	- Satisfactory completion of a study of variable tariffs and discussion of its results with the Bank. - Removal of export controls on high quality rice and cuts of beef except as justified by hygienic or other non-protectionist considerations as a condition of first tranche release. The Government shall not have imposed export controls on fruit & vegetables except for hygienic reasons and shall have encouraged farmer organizations to establish and control export quality standards for vegetables and fruits. The Government shall not have imposed quantitative restrictions on exports for the purpose of controlling domestic supply. - Reduction of QR coverage of import licensing on agricultural and agro-industrial products by 5 percent of national production coverage.

POLICY MATRIX

Policy Objective	Actions Prior to Board Presentation Achieved	Conditions for Disbursement of Second Tranche (estimated date of disbursement March 31, 1989)
Liberalization of agricultural prices. (paras. 37-49)	- Reduction of number of commodities under strict consumer price controls from 121 in 1983 to 21.	- All guarantee producer prices maintained at least at real 1987 levels in 1988. Guarantee prices for all crops except corn and beans maintained in 1989 within a range of 90% to 125% of comparable international prices, adjusted for processing margins, transport costs and quality differentials according to an agreed upon methodology. (Upper limit of 125% may be revised pursuant to results of study described below if agreed by both parties.) - Review and discussion with the Bank of the results of a study on the guarantee price system, including issues of pan-territorial and pan-seasonal prices.
More rational input pricing policy and reduction of input subsidies. (paras. 70-74)	- Increase in fertilizer prices, interest rates, water charges and power rates, but these remain highly subsidized. - Agreement to reduce subsidies to FERTIMEX, raise input prices to FERTIMEX, and privatize fertilizer distribution (conditions of proposed Fertilizer Sector Adjustment Loan).	- Provision of a plan of action satisfactory to the Bank to implement a system of charges for water used in agriculture that will achieve recovery of O&M costs except under specific circumstances established by Mexican law.
Sound Public Investment Budget. (paras. 75-79)	- Satisfactory 1988 public investment program for SARH.	- Establish procedures to encourage and facilitate disbursement of loans from internationl agencies in support of the investment budget of SARH. Submission of a 1989 budget request to Congress that increases investment budget of SARH by at least US$200 million in real terms. Bugetted funds will be made available to SARH as needed for timely implementation of agricultural investments.
Rationalization of Ministry of Agriculture. (paras. 80-82)	- Decentralization of SARH by moving staff from urban to rural areas. Restructuring to improve responsiveness to farmers. Streamlining by staff reductions of about 20%.	- Objectives achieved.

Annex 6
Table 1

CONASUPO'S FOOD SUBSIDIES*
(Direct and Indirect)
(million pesos)

	Current	Constant 1982	% GDP
1982	58,737.9	58,737.9	.62
1983	173,205.1	95,799.2	1.01
1984	271,656.6	94,390.8	.94
1985	205,089.6	43,524.9	.45
1986**	143,795.6	17,438.2	.18

* Does not include sugar subsidies, which are not administered by CONASUPO.

** Budgeted amount.

Source: CONASUPO estimates

Production Coverage of Price Controls, 1982 and 1986 1/

Implementing Agency/ Type of Control	December 1982	September 1986
SECOFI		
Strict Controls	23.29% 2/	10.98%
Registered Controls	N.A.	6.30%
Registered	6.59%	4.86%
CONASUPO 3/		
Grains	3.02%	3.02%
Oilseeds	.54%	.54%
AZUCAR SA		
Sugar	.93%	.93%
Molasses	.09%	.09%
PEMEX		
Crude Oil	15.93%	15.93%
Refined Oil	4.62%	4.62%
Basic Petrochemicals	.98%	.98%
TOTAL	55.09%	48.25%

1/ Production coverage is based on the methodology employed in the Trade Policy Loan 2745-ME. Only 3 of the products subject to controls are not in the sample of products used by the methodology.

2/ This does not include basic pharmaceuticals which were not included in the list provided by SECOFI. This is estimated to lead to an additional .5% of production under price controls.

3/ Maize and wheat are no longer under SECOFI controls in 1986, but still within CONASUPO controls.

Average Nominal Protection Coefficients for Major Crops a/

Price Ratio a/	1970/75	1975/79	1979/82	1983/86	Net Trade Position-1985
Maize					
Guarantee/CIF (landed) b/	1.01	1.04	1.44	1.28	Net importer
Guarantee/FOB b/	1.13	1.14	1.59	1.39	
Wheat					
Guarantee/CIF (landed)	0.77	0.78	0.83	0.88	Self-sufficient; large surplus in 1985
Guarantee/FOB	0.85	0.84	0.89	0.95	
Rice					
Guarantee/CIF (landed)	0.70	0.69	0.71	0.97	Net importer
Guarantee/FOB	0.79	0.75	0.78	1.10	
Beans					
Guarantee/CIF (landed)	n.a.	n.a.	0.78c/	1.13d/	Self-sufficient to net importer
Sorghum					
Guarantee/CIF (landed)	0.80	0.87	0.91	0.89	Net importer
Guarantee/FOB	0.90	0.96	1.01	0.97	
Soybeans					
Guarantee/CIF (landed)	0.96	0.96	1.18	1.08	Net importer
Guarantee/FOB	1.04	1.01	1.25	1.15	

a/ Nominal Protection Coefficients (basically the ratio of domestic to international prices) are unadjusted for under and over valuation of the exchange rate. Adjusting for exchange rates would lower the protection up until about 1982/83. In the mid-years of the 1980s, it would raise the coefficients of protection.

b/ Ratio of support or guarantee price to CIF or FOB price.

c/ 1980-82.

d/ 1985.

Annex 6
Table 4

Recent Nominal Protection Coefficients for Major Crops [a]
Price Ratio

	1983-86	April 86	Nov. 1986	April 1987	Net Trade Position
Maize Guarantee/CIF (landed)	1.28	1.37	1.05	1.01	Net importer
Wheat Guarantee/FOB	0.95	0.88	0.58	0.83	Large surplus in 1985
Rice Guarantee/CIF (landed)	0.97	0.66	0.74	0.75	Net Importer
Beans Guarantee/CIF (landed)	1.13 [b]	n.a.	n.a.	n.a.	Self sufficient to net importer
Sorghum Guarantee/CIF (landed)	0.89	0.92	0.71	0.57	Net importer
Soybeans Guarantee/CIF (landed)	1.08	0.81	0.85	0.75	Net importer

a/ Ratio of domestic (Guarantee) prices to international prices, at current exchange rate.
b/ 1985.

Industry Department
January 1987

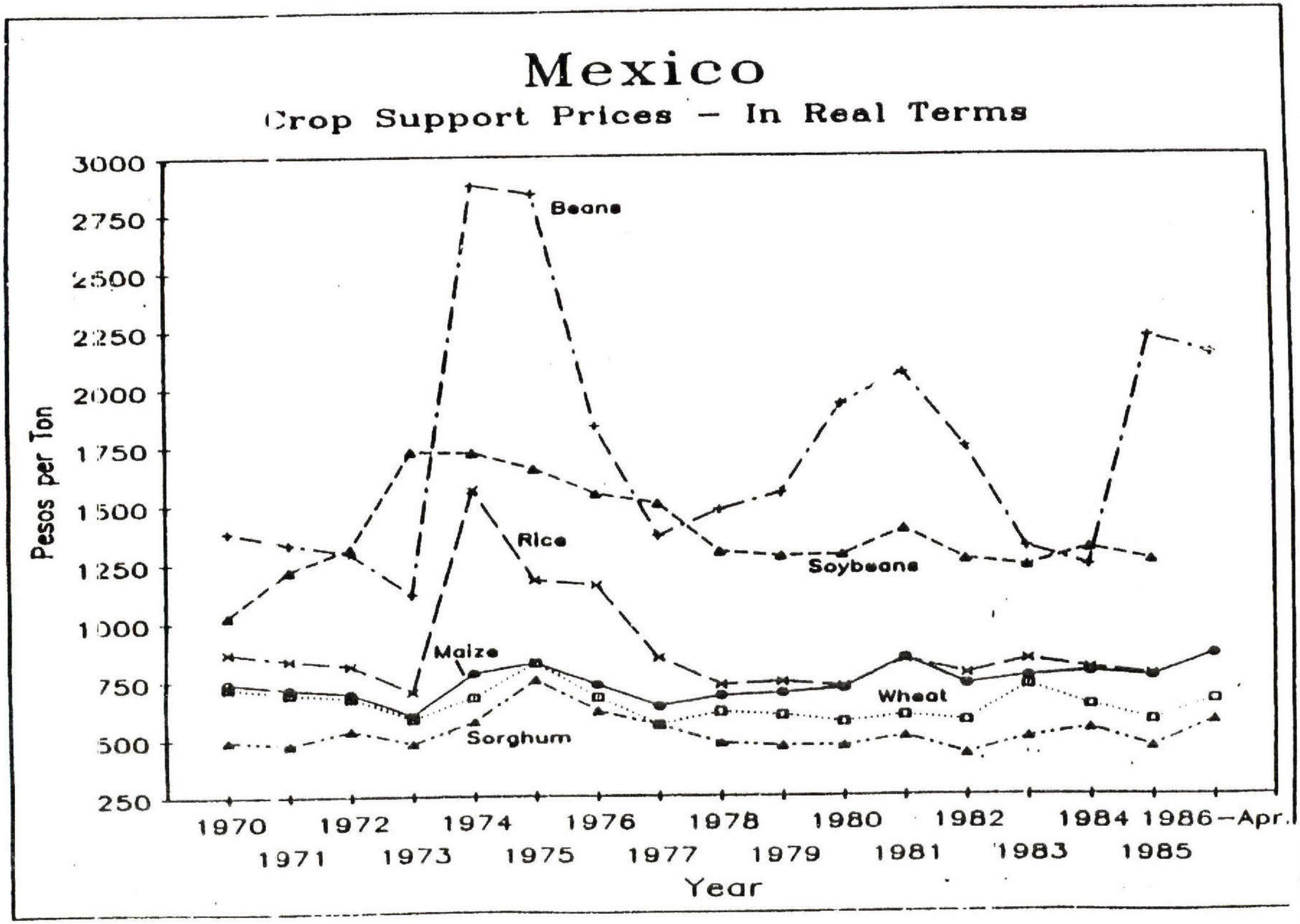
Percentage of Production Under Licensing
(as of March 31, 1986)

Sector		% Share of Sector in Non oil Production	% Share of Sector Under Licensing	% of Total National Prodn. Under Licensing
I.	Agriculture	10.2	87.4	7.0
II.	Agro-industry	23.9	65.0	12.3
III.	Livestock, Forestry, and Marine	7.8	25.8	1.6
IV.	Minerals	3.5	2.9	0.1
V.	Manufacturing	7.7	56.4	3.45
VI.	Other Manufacturing	46.8	26.9	9.96
VII	Petroleum and Derivatives	-	-	-

LIST OF AGRICULTURAL, AGRO-INDUSTRY, LIVESTOCK, FORESTRY AND MARINE PRODUCTS INCLUDED BY SECOFI IN DISCUSSIONS OF POSSIBLE LIBERALIZATION UNDER TPL II
(Numbers represent % of production)

RAMA		SCENARIO 1 8.3% REDUCTION OF QRS	SCENARIO 2 3.1% REDUCTION OF QRS
1 Agriculture		1.34	0.04
0603a001	Flores Frescos	x	x
0603a999	Los Demas	x	x
0604a003	Arboles de Navidad	x	x
0701a001	Papas (patatas except. fraccion 0701a002	x	
0701a005	Cebollas	x	
0701a008	Ajo para Siembra	x	x
0705a002	Frijoles (porotos) exc. fraccion 0705a004		
0705a004	Frijol para siembra	x	
0801a999	Los Demas	x	
0806a003	Membrillos	x	
0807a999	Los Demas	x	
0808a001	Fresas Frescas	x	
0809a001	Las Demas Frutas Frescas	x	
1001a999	Los Demas	x	
1002a001	Centeno	x	x
1003a999	Los Demas	x	
1004a001	Avena Excepto la fraccion 1003a002	x	
1005a004	Maiz para siembra	x	
1007a002	Sorgo para siembra	x	
1201a003	Semillas de Soya exc. frac. 1201a007		x
1201a006	De Nabo		x
1201a007	Semillas de Soya (soja) para siembra		x
1201a008	De Girasol para siembra		x
1201a009	De Cartamo para siembra		x
2 Livestock		0.10	0.10
0104a004	Caprinos para Abastos	x	x
0104a999	Los Demas	x	x
0106a004	Abejas	x	x
4 Fish and Seafood		0.68	0.0
0302a999	Los Demas	x	
0303a999	Los Demas	x	
11 Meat and Milk Products		0.56	0.0
0205a001	Tocino con exclusion del que tenga parte	x	

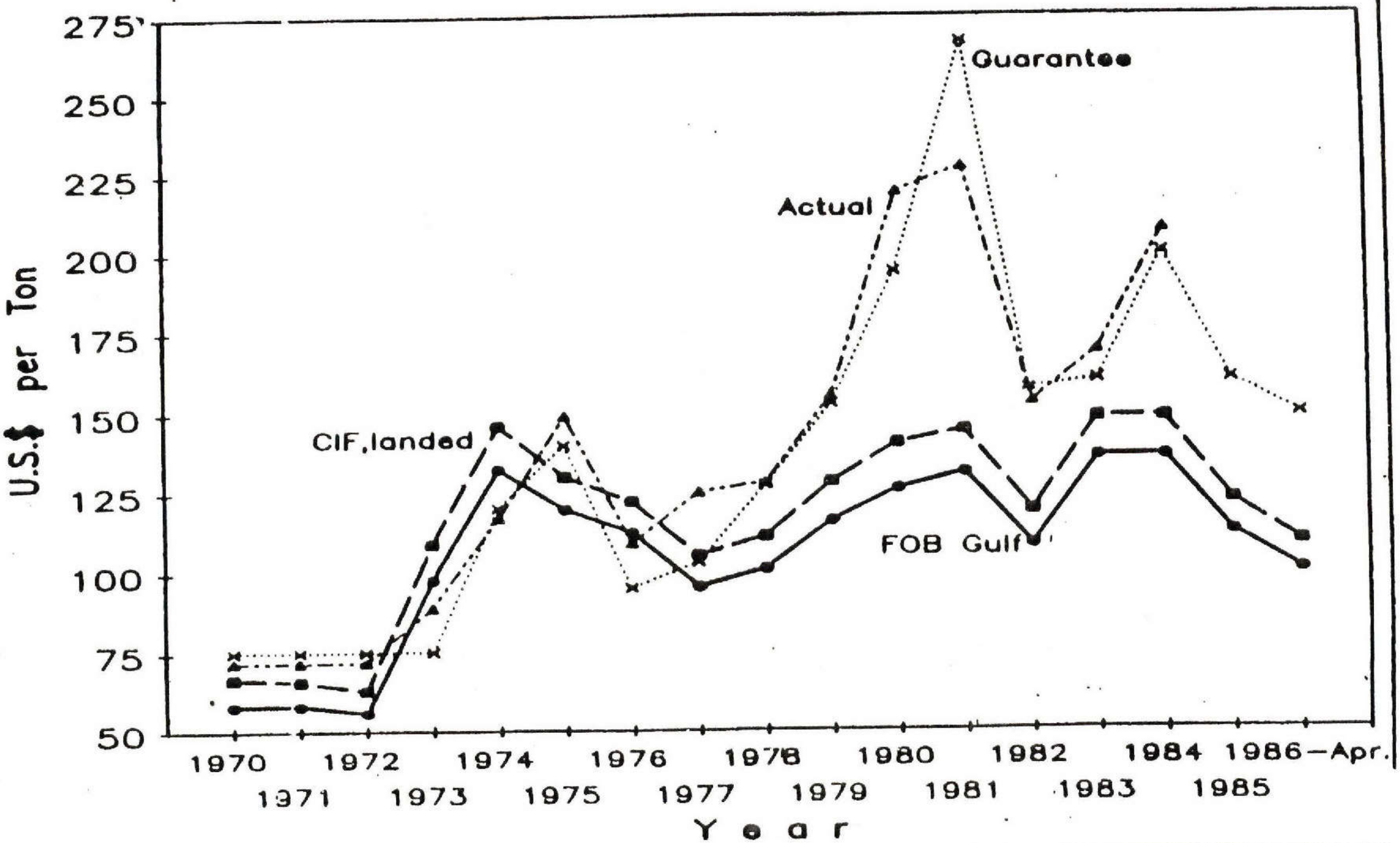
1601a001	Embutidos de carnes d'despojos compestibl.	x	
19 Miscellaneous Food		0.57	0.27
1006a001	Arroz entero descascarillado Pulido/Abri.	x	
1006a002	Arroz entero. Sin Descascarillar (wildrice)	x	x
1002a001	Avena sin cascara sin despuntar ni tritu.		
1203a014	De Calabaza	x	x
1604a002	Atunes	x	x
1604a004	Sardinas	x	x
1604a999	Los Demas	x	
1605a002	Centollas	x	
1605a003	Choros Cholgas Locos o Machas	x	
1605a004	Mejillones	x	
1605a005	Berbereches	x	
1605a006	Navajas	x	
1605a007	Zamburrinas	x	
1605a999	Los Demas	x	
1806a001	Dulces o Bombones	x	
2301a001	Harinas de Animales Marinos	x	x
17 Animal and Vegetable Oils		0.10	0.0
1507a001	Aceites de Ajonjoli	x	
21 Malt Beverages		0.06	0.06
1107a001	Malta, incluso tostada	x	x
12 Processed Fruits and Vegetables		0.03	0.03
0804a002	Pasa de Uvas	x	x
0808a001	Fresas Frescas	x	x
2007a001	D'Naranjas C/Densidad hasta d'1.20 a 15o		x
13 Milling Products		0.77	0.77
1908a999	Los Demas	x	x
23 Tobacco Products		0.6	0.0
2401a999	Los Demas	x	
2501a001	Sal (Crudos de Sodio)		
TOTAL		4.81 x	1.27



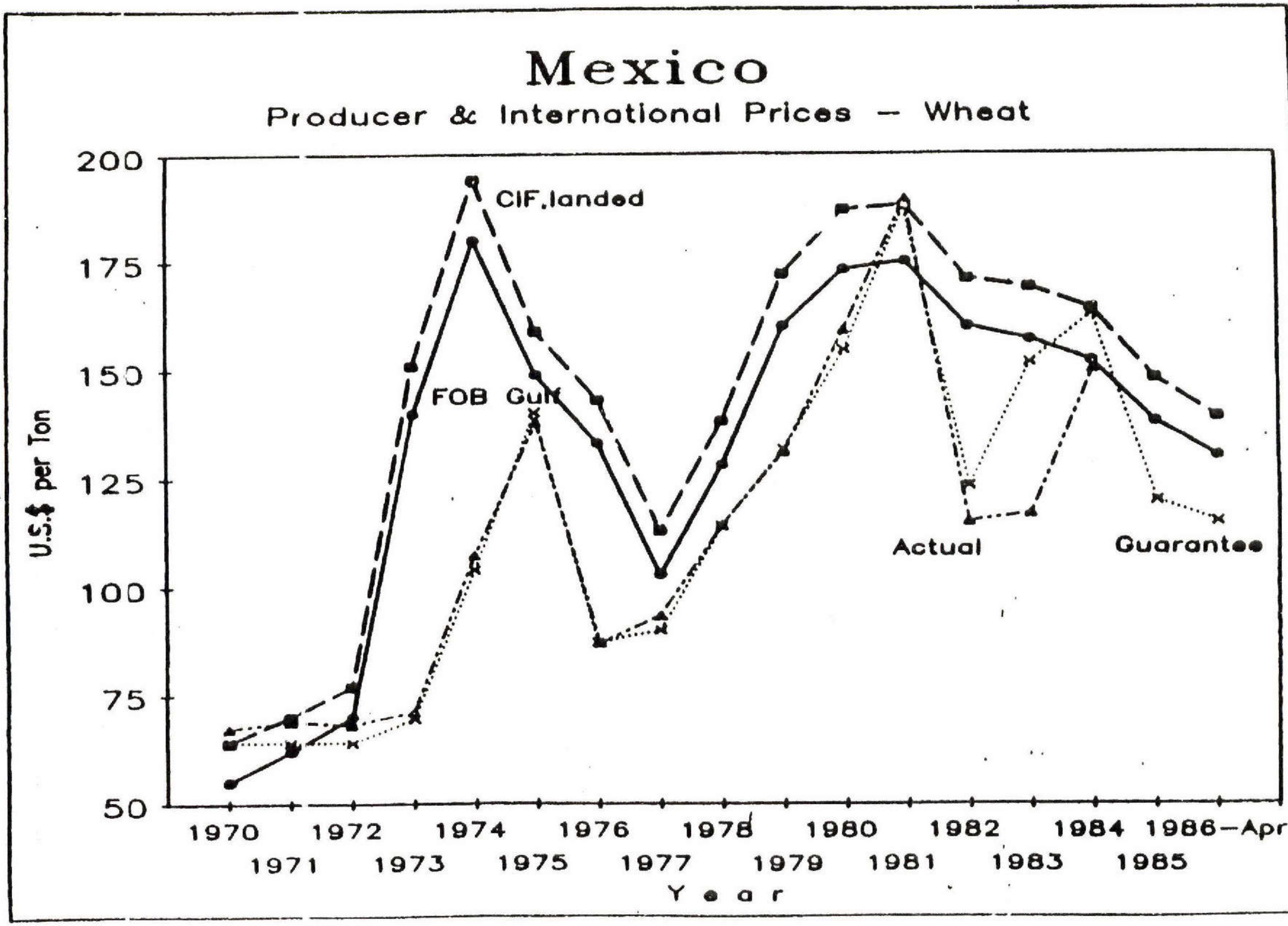
ANNEX 6
Graph 1

Mexico

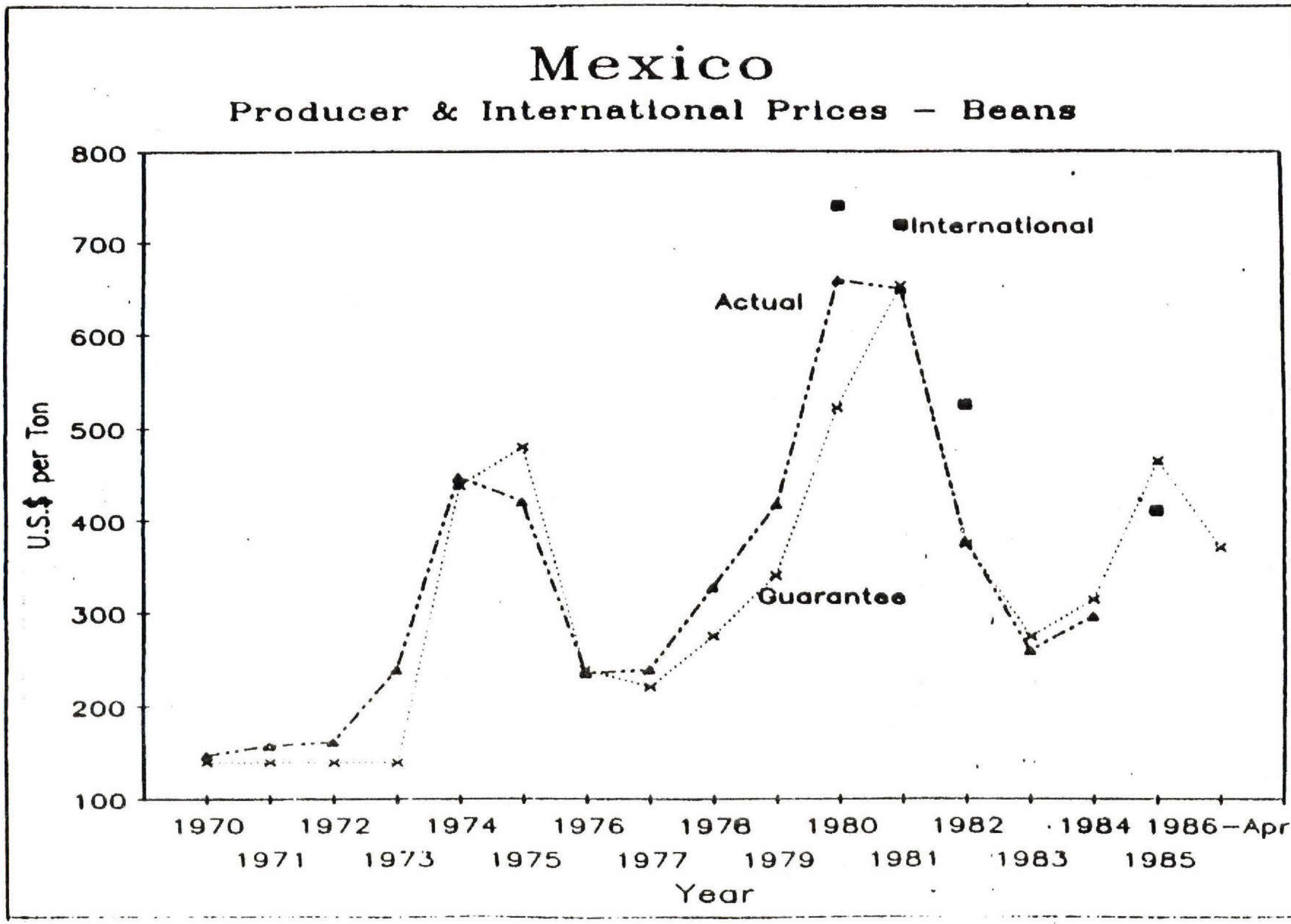
Producer & International Prices — Maize



ANNEX 6
Graph 2

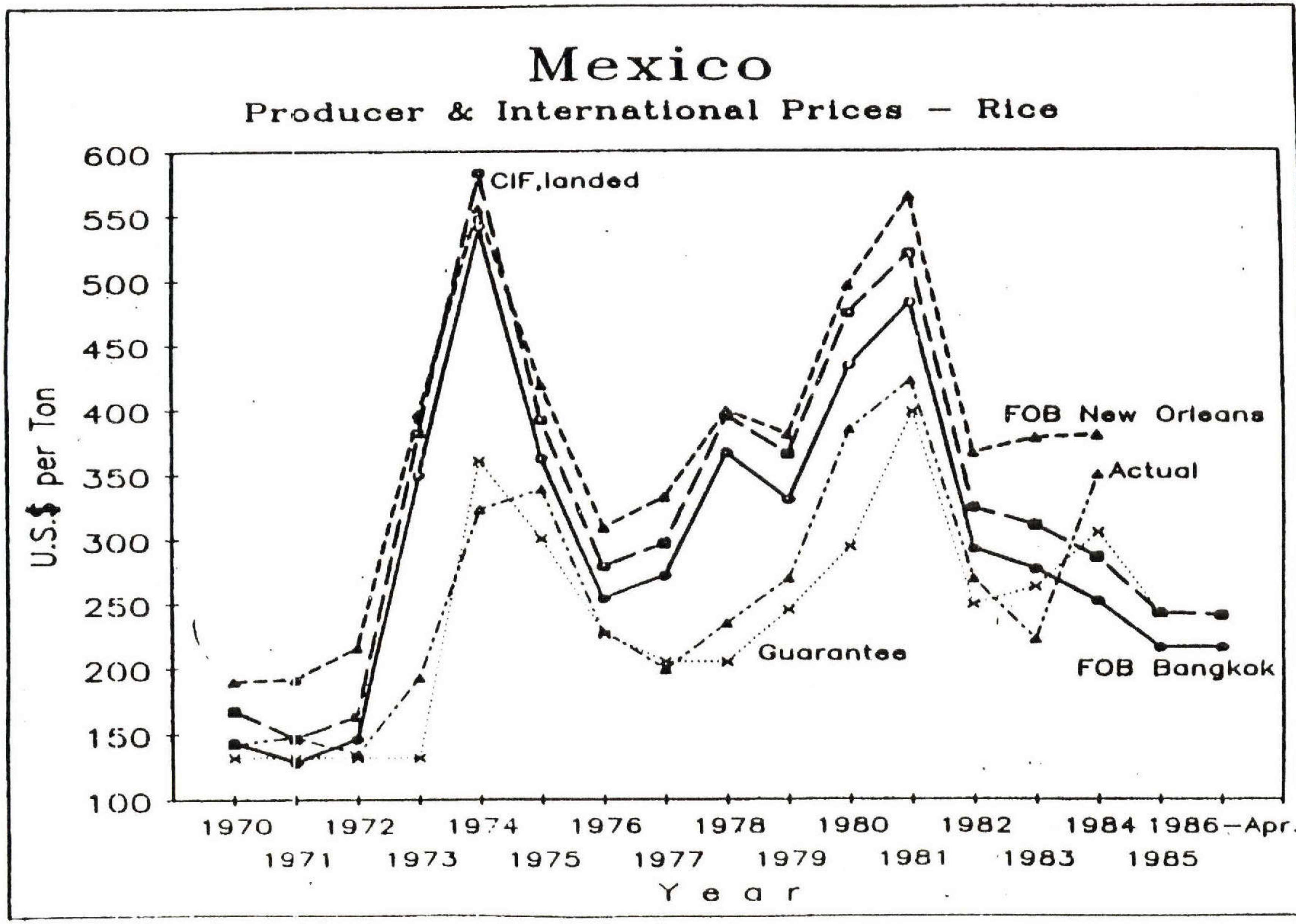


ANNEX 6
Graph 3

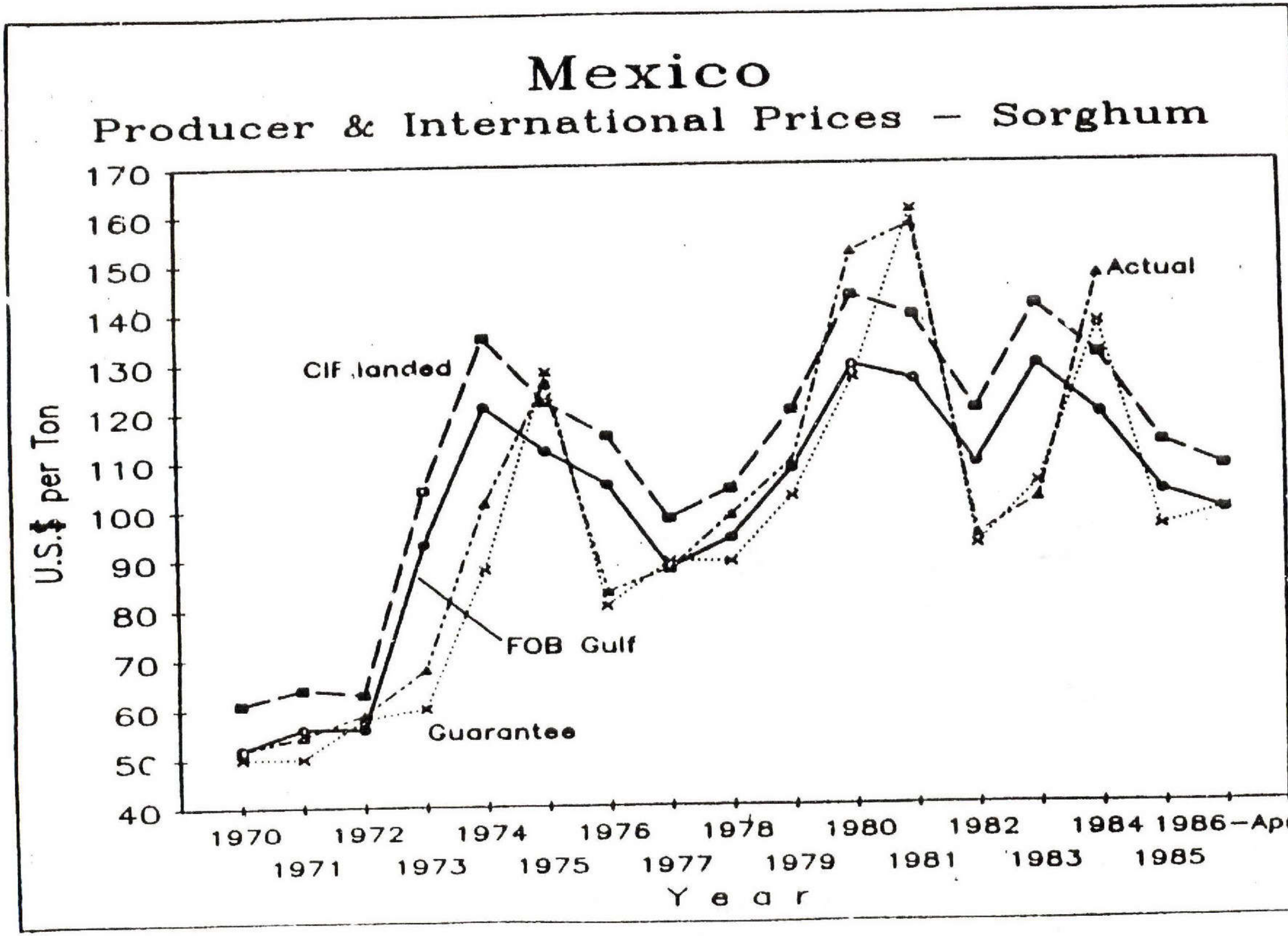


ANNEX 6
Graph 4

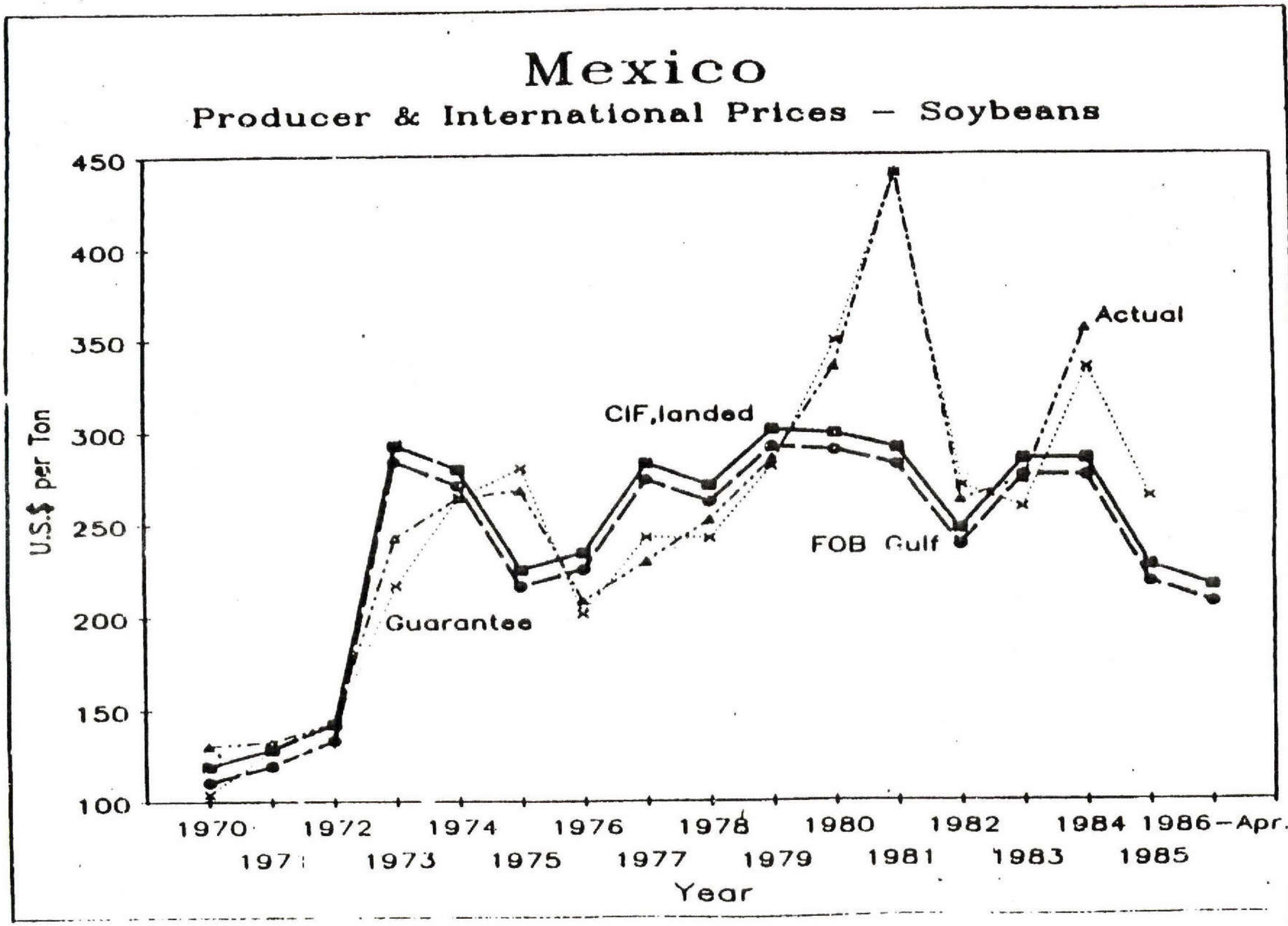
- 58 -



ANNEX 6
Graph 5



ANNEX 6
Graph 5



- 61 -

ANNEX 6
Graph 7

Social Impact of Agricultural Sector Adjustment Program

1. Impact on Farm Prices. As of end-1986 (the base year for the calculations below), domestic price of maize was 5% above world levels while the price of rice was 26% below, the price of wheat 12% below, the price of sorghum 8% and the price of soybeans 15% below equivalent world price levels. If the subsidy on fertilizer is removed and its price increased by approximately 143%, as initially projected in the Fertilizer Sector Loan, the costs of production of these crops would rise by 10% for maize, 13% for rice, 11% for wheat, 19% for sorghum, and 7% for soybeans. The resulting change in the share of fertilizer in the cost of production, assuming fertilizer use per unit of output stays constant, is displayed in the table below.

Share of Fertilizer in Cost of Production (%)

	Maize	Rice	Wheat	Sorghum	Soybeans	Beans	Winter Vegetables
1986	7	9	8	13	5	2	2
1991	9	12	11	16	7	3	3

However, world prices for these commodities other than wheat are projected to increase sufficiently such that if farmers received world prices, the fertilizer cost rises could be absorbed fully. That is, if farmers were paid at least world prices (a condition of the loan), the profitability of production of all crops would be enhanced. These calculations are summarized in the following table.

Effect of Fertilizer Cost Increases
On Profitability of Five Major Crops

	Maize	Rice	Wheat	Sorghum	Soybeans
1. Projected change in world price of crop, 1986-1991 (%)	28	16	1	27	12
2. Plus change in 1986 support price to reach 1986 world price (%)	-5	26	12	8	15
3. Minus change in cost of production coming from increased fertilizer price (%) 1/	10	13	11	19	7
Net Change in Producer Price Relative to Cost	+13	+29	+2	+16	+20

1/ Assumes increase in domestic fertilizer price of 143%, as initially projected in Fertilizer Sector Loan documents.

The five crops in the table account for about 91% of the 1985 harvested area and about 58% of 1985 production value in Mexico. A reasonable index of the net effect of these changes on the sector as a whole is the average of the net change in price relative to cost, with each crop weighted by its share in total production value of all 5 crops. (This approximates the change in the ratio of the sum of output value from all crops to the sum of cost of production of all crops, assuming that each crop has the same share in the total cost of production as it has in total output value, and that outputs do not change.) By this measure, the profitability of agriculture would improve by about 12.5%. By an alternative measure--an index with each crop weighted by its share in harvested area--profitability improves by 11%.

2. Fiscal Impact. The impact on fiscal outlays of the Government that would stem from adoption of the program proposed in the fertilizer sector and the agricultural sector reforms would come primarily from four sources. First, by raising fertilizer prices, Fertimex would realize major increases in revenue and would require much smaller transfers from the Treasury. Second, the direct and indirect subsidies given to food processors to maintain low consumer prices would be eliminated and replaced with less costly subsidies targetted directly to needy consumers. Third, CONASUPO's operating losses (exclusive of food subsidies and losses on foreign denominated debt that would come from exchange movements) would be reduced to a maximum of US$85 million per year. These operating losses result not only from inefficiency, but also from providing services such as transportation and storage for procured crops, without reflecting these costs in the margin between purchase and sales price. Fourth, the elimination of pricing policies that result in the subsidization of sugar consumption would curtail transfers to Azucar SA de CV. All of these fiscal effects are summarized by year in the table below. They indicate annual fiscal cost reductions ranging from US$1,053 million to US$1,226 million, depending on the year.

3. Consumption Impact and the Food Stamp Program. An integral part of the program set forth in the ASL is the substitution of food subsidies targetted to the poor in place of global food subsidies. The Sector Loan supports the expansion of the limited program of targetted subsidies now in progress (funded at a level of around US$60 million per year) to an eventual size of approximately 0.2% of GDP. The Sector Loan envisions that the current program of food stamps for tortillas would be expanded to other commodities and would be funded initially at around US$250 million, rising to eventually reach approximately 0.2% of GDP.

4. An important question about the program as a whole is whether this amount of targetted subsidies will be sufficient to off-set the impact of rising food prices as domestic restrictions and distortions have been and continue to be lifted, allowing domestic prices to reflect international levels. Between the end of 1983 and the end of 1986, as food subsidies declined, increases in the prices of the consumption staples of the poor steadily eroded their purchasing power. Based upon the purchasing patterns of the poorest 20%, an increase of approximately US$12.20 would be needed in the per capita incomes of this group to restore their purchasing power to its end-1983 level (see Table below).

Fiscal Savings from Adjustment in Agricultural and Fertilizer Sectors
(US$ Million)

	1987	1988	1989	1990	1991
1. Raising fertilizer prices over 5 years 1/	129	182	201	286	386
2. Replacing subsidies to processors with targetted consumer subsidies 2/	560	578	536	480	476
3. Reduce CONASUPO's operating losses 3/	248	248	248	248	248
4. Reform of Sugar Price Policy	116	116	116	116	116
5. Total	1,053	1,124	1,101	1,130	1,226

1/ Assumes that transfers to FERTIMEX will be decreased according to schedule in Fertilizer Sector Loan documents, whereas without the adjustment, the transfers would remain at 1986 levels (US$386 million per year).

2/ Assumes without-project subsidies at 1985 levels. With-project subsidies begin at US$250 million, then rise at approximately the rate required for lowest 2 deciles to maintain purchasing power as prices of staples increase. Because prices of some crops, notably maize, were projected to fall between 1986 and 1988, subsidies were projected to fall in 1988. (This causes the fiscal savings to increase in that year). Subsidies are then projected to rise, reaching US$334 million in 1991. Subsidies include 25% administrative cost and leakanges.

3/ Compared to 1985 levels.

Increase in Real Income Needed to Restore Purchasing Power of Poorest Two Deciles Lost by Increases in Real Prices of Staples Between October 1, 1983 and November 1, 1986

Food	Change in Price (%)	Share in Expenditure (%)	Increase in Income Needed (%)	Increase in Income Needed (US$)
Tortillas *	52	2.36	1.23	2.3
Bread	79	1.93	1.52	2.9
Beans	66	2.47	1.63	3.1
Milk	18	2.48	0.45	0.8
Eggs	73	1.98	1.45	2.7
Sugar	49	1.66	0.81	1.5
Vegetable Oil	20	1.43	0.29	0.5
Beef	-23	3.62	-0.83	-1.6
TOTAL	--	16.28	6.55	12.2

* Includes maize dough and flour.

In addition, if domestic prices are brought to the level of world prices and allowed to rise as world prices trend upward between 1986 and 1991, as they are projected to do, the purchasing power of the poor will erode still further. As displayed in Table below, projected increases in prices of maize, rice, wheat and vegetable oil will require compensatory per capita income increases of US$4.30.

Increase in Real Income Needed To Maintain Purchasing Power of Poorest Two Deciles after Projected Increases in Prices of Selected Food Crops, 1986-1991

	Maize *	Rice	Wheat **	Vegetable Oil	Total
% Total Expenditure Represented by Crop	6.2	0.7	2.7	1.4	11.0
% Rise in Price	20	57	7	32 ***	--
% Increase in Income Needed	1.2	0.4	0.2	0.4	2.2
Absolute Value of Increase in Income Needed (US$) ****	2.3	0.8	0.4	0.8	4.3

* Includes maize in grain, tortillas, maize flour, and maize dough.
** Includes breads, cookies, and noodles.
*** Projected price increase of soybeans.
**** Based on per capita expenditure of around US$188.

Source: Based on figures on expenditure from "Food Consumption and Expenditure in Mexico and the Income Effects of the Removal of Food Subsidies" by Cheryl W. Gray, December 12, 1986, mimeo; and per capita expenditure figure of US$225 for bottom 3 deciles, provided by Ms. Gray. Per capita expenditure of US$188 for poorest two deciles was computed by using this figure and the total expenditure figures by decile from Table 6 of the above-mentioned paper.

5. Allowing for administrative costs and leakages of 20%, an initial subsidy of about US$250 million, if targetted to the poorest 20% of the population, would raise per capita income in that group by slightly over US$12, sufficient to redress the loss in purchasing power since 1983 due to removal of global food subsidies and other factors influencing domestic prices. Over the subsequent 5 years, the subsidy would increase as a percentage of GDP, if the subsidies were linked to international prices. Again assuming costs and leakages of 20%, the eventual subsidy of 0.2% of GDP in 1991 would raise per capita incomes in the bottom 20% by approximately US$18 if both GDP and the target population remained at their current levels. This would more than compensate for the increases since 1983, as well as projected future increases in international prices. Realistically, while both GDP and the target population would grow, GDP would most likely grow faster, implying that a subsidy of 0.2% of GDP would provide some cushion for greater than expected leakages, administrative costs, and price increases.

Terms of Reference of a Study on Agricultural Pricing Issues

1. In accordance with the objectives, terms, and conditions of the Agricultural Sector Loan, it is agreed between the Government of Mexico and the World Bank that a study will be undertaken of the Government's pricing policies for crops that are included in the guaranteed price system. The purpose of the study will be to identify policy reforms that would minimize the distortionary effects of governmentally established agricultural prices while still meeting the legitimate goals of the pricing system.

2. This study will be carried out by private contractors under the supervision of an inter-ministerial group with representatives of SHCP, SARH, SPP, the Bank of Mexico, and CONASUPO. A representative of SEMIP will also be included in the supervision of the study of sugar pricing policies.

3. There will be four separate but related components of the study on agricultural pricing issues, which components will be defined as follows:

A. Crop by crop analysis of the benefits and costs of governmentally established guaranteed prices.

1. Benefits.

a) Original and current purpose of inclusion of each crop in guarantee program, and benefits (social and economic) derived from guarantee prices (stabilize prices, limit market power of oligopsonistic buyers, provide income support for poor regions or producers, etc.).

b) Historical performance of system in meeting its social and economic goals for each crop.

c) Current status of problematic situation that was the reason for including each crop under price supports (current market concentration of buyers, income levels of producers, etc.).

2. Costs.

a) Fiscal cost to Government.

b) Economic costs due to deviation of prices from economically efficient levels (i.e., border prices).

3. Distributional aspects - identification of the principal groups that would gain or lose from removal of each crop from the guarantee system, and quantification of gains or losses.

a) Geographical distribution of gains and losses (depending on geographical distribution of crop production).

b) Distribution of gains and losses by income level, farm size, irrigated-rainfed, etc.

4. Alternative means of achieving objectives of price guarantee system in cost-effective ways (variable levies to stabilize prices, anti-trust actions to make market more competitive, direct transfers to support incomes of poor producers, etc.).

B. Alternatives to quantitative import/export restrictions in stabilization of domestic producer prices of basic crops and off-setting "dumped" prices for agricultural commodities.

1. Effects of current system of quantitative restrictions.

a) Purpose and goals (stabilization, reinforce guarantee prices, off-set dumped prices, etc.).

b) Effectiveness in meeting goals.

c) Costs

(i) Total fiscal and economic
(ii) Distribution of costs by income level of consumer for goods with positive protection.

2. Variable tariffs.

a) Design and implementation in other countries (Chile, EEC).

b) Advantages and disadvantages relative to quantitative restrictions (more transparent protection, less susceptibility to political manipulation, etc.).

c) Suggested design for Mexico.

(i) Quantitative objectives (desired degree of stabilization, etc.).

(ii) Mechanism.

(iii) Simulation using historical data to determine tariff rates required to stabilize prices to the desired degree for each crop.

(iv) Consistency with GATT and other international obligations.

(v) Implications for variable tariff scheme of subsidized production in developed countries (producer subsidy equivalents).

3. Anti-dumping regulations.

a) Legal implications and feasibility under GATT rules for agricultural products.

b) Design and implementation in other countries.

c) Suggested design for Mexico.

(i) New legislation required.

(ii) Special attention to the issue of how the system can be made transparent and non-arbitrary.

C. Mechanism for and effects of establishing guarantee prices that would approximate market-determined prices.

1. Linkage of guarantee prices to world market by setting guarantee prices within a band around international prices.

a) Appropriateness of comparing domestic prices with international prices (appropriate comparators--including extent of substitutability between internationally traded and domestic varieties; geographic sources for comparable commodities; adjustments for international transport costs where relevant; adjustments for costs of internal transport, processing margins, and quality differences to make domestic and international prices comparable; and extent of Mexico's influence on international prices).

b) Appropriateness of establishing floor and/or ceiling for the band, and appropriate level for such floor and/or ceiling.

c) For the special cases of maize and beans, consistency of specific levels of price band ceilings with poverty alleviation of both producers and consumers, subsidy control and minimization of storage costs.

2. Adjustment of prices over time.

a) Description and effects of current system, including path of real guarantee price for each crop monthly since 1980, and monthly pattern of deliveries from producers to buyers.

b) Calculation of ex post economic rate of return to storing crops - monthly and yearly - for each crop since 1980.

c) Calculation of price adjustments for each crop that would have been necessary to make private storage viable (i.e., cover inflation and the cost of storage) - this will require estimates of storage costs.

d) Design of pricing adjustment mechanism that would encourage private storage (on-farm and off-farm); effects of implementing system, including the effect on production timing decisions and estimate of savings to Government if private sector assumes greater responsibility for storage.

3. Geographically differentiated pricing.

a) Principle of geographically differentiated pricing - difference between farmgate price and sales price to processor or consumer must be sufficient to cover transport and handling margins, so in areas from which transportation to processing or consumption centers is more costly, farmgate prices should be lower.

b) Calculation of transport cost from different production areas to processing or consumption centers; estimation of what farmgate prices should be to cover transport costs.

c) Comparison of economically efficient farmgate prices (as estimated in (b)) to actual prices; implicit subsidy or tax for each area (subsidy or tax would equal the product of the quantity produced in each area and the difference between the economically correct price and the actual price).

d) Distributional impact of subsidy and tax calculated in (c).

e) Design of system of geographically differentiated prices that would encourage:

(i) Private purchasers to become more involved in purchasing at farmgate.

(ii) Agro-industry to locate more plants in producing areas rather than near consumption centers.

f) Benefits of geographically differentiated pricing:

(i) Estimate of fiscal savings to CONASUPO if private sector assumes responsibility for purchasing more of the crop.

(ii) Economic efficiency.

D. Sugar pricing policy.

1. Analysis of the existing system

a) Prices at different parts of the production chain are determined by separate and unrelated criteria; the different procedures followed will be described in detail.

b) Disequilibria in the system are resolved by subsidies via credit, production and marketing costs; the transfer of fiscal resources to the sector will be analysed in detail.

c) Cane purchase by the mills is based on the provisions of the Decreto Canero of 1979; the existing practices would be analysed, and differences in practices between regions and mills detailed.

d) The interactions between decision-makers and interest groups in government, industry and agriculture would be analysed, their motives and objectives described, and an assessment made of the potential gainers/losers in a process of rationalisation and change.

2. Scope for change

a) The stated objective of the Convenio and the Programa de Reconversion is the achievement of financial self-sufficiency, and it is explicitly recognised that the design and implementation of an integrated price policy is essential. The range of options open will be analysed with detailed consideration of systems in operation in other major sugar producing and exporting countries.

b) The policy ultimately adopted should allow Mexico to exploit its comparative advantage in sugar production. The role to be played by the world sugar economy in the definition of domestic policy would be analysed in detail. The international market, in spite of major imperfections, represents the opportunity cost of acquiring or disposing of sugar and Mexico's long-term economic interests will be best served by explicitly recognising the signals generated in the world sugar economy. The study would consider how best to generate an appropriate border price based on long-run prices in international trade and establish a formula for maintaining it up-to-date.

c) The study would include an analysis of the world sugar economy and prospects for the medium and long-term (i.e., up to 2000).

d) Projections of domestic demand under different price assumptions would be made, and a comparison drawn with total supply (based on present process capacity and attainable output and productivity targets).

e) The study would consider the alternative schemes available for cane purchase by the mills based on sucrose content and cane quality, including premia/penalties, testing systems, the appropriateness of pan-territorial pricing and differences in technical capacities of factories to extract sucrose.

f) The study will consider the appropriateness of targetting subsidies to the poor and the implications of this for the sugar marketing system.

3. Recommendations

The study will make specific recommendations on the following:

a) The appropriate method for determining a border reference price, the translation of the price to ex-factory levels; the methods available to defend the price during periods of low world prices; and the degree of and mechanism for assistance (if any) to be given to producers exporting at low world prices;

b) The appropriate method of determining consumer and end-user prices, assuming the continued existence of the present monopsonistic marketing structure, which would avoid any transfer of fiscal resources;

c) The most effective and efficient means of targetting consumption subsidies for sugar to an identified section of the population and its estimated fiscal cost; and

d) The appropriate method or methods for purchasing cane based on quality and sucrose content.

ANNEX 9

Agriculture Sector Objectives of the Mexican Government, 1987 - 1988

The Mexican Government has assigned a high priority to rural areas. The Governmental Policy of Integrated Rural Development has as a fundamental purpose the improvement of social welfare of the rural population and increasing the levels of production, employment and income, through an increase in the efficiency of agricultural production, agroindustrial processing, and marketing. In addition, it established strengthening of food sovereignty of the country as one of the principle objectives.

To achieve this, the Mexican Government has enacted a group of actions oriented toward rationalizing the subsidies to food and agricultural inputs; toward liberalizing external trade for agriculture and agroindustry; toward rationalizing pricing policies for producers and consumers; and toward a selective participation of the public sector in the production, marketing, storage, and distribution of agriculture and livestock products.

During this year and the next, the Government intends to strengthen and consolidate the policy developed during the last years. In addition, it is proposed to maintain an adequate program of investment and to provide basic support services in an efficient and decentralized manner. Specifically, the program of the Government in this period is oriented toward achieving a solid program of public investments, based on economic and social criteria; toward making more efficient the basic services provided by government agencies, through their restructuring and decentralization so that a higher proportion of personnel will be in direct contact with farmers; increasing the efficiency of storage, processing, distribution, and marketing, considering if it is necessary to liquidate or privatize parastatal enterprises; giving a greater role to market mechanisms in the formation of agricultural product prices at the producer and consumer levels; expanding the opportunities of farmers to export their products and import inputs; giving the private sector better access to importing; diminishing the subsidies to agricultural inputs, such as water and fertilizer, and to interest rates for agricultural and livestock sector credit; and eliminating global consumer subsidies, maintaining selective subsidies for the population of lower income in rural and urban areas, with the purpose of protecting their purchasing power.

The Mexican Government has made important advances toward the achievement of the objectives indicated. What has been done to date and the actions that will be carried out in the rest of the current sexenio are presented in the attached table (Annex 5).

Steps Recommended to Strengthen Food Subsidy Programs

I. Tortibono food distribution program - For Urban Areas.

A. CONASUPO/DISCONSA unit in charge of the distribution and monitoring be strengthened to do the following:

1) reassess eligibility of current participants, and
2) reassess eligibility every 6 months.

B. Criteria for eligibility of participants be reduced to 1.5 minimum wages in urban areas.

1) More rigorous criteria of economic well-being be developed to eventually replace definitions of eligibility in terms of of only wage income.
2) Review eligibility criteria with respect to budgetary allocations.

C. Impact of program be re-assessed.

1) Household level surveys be conducted to assess impact of program on food consumption and real incomes (see attached outline for study).

D. Price of Tortibonos be linked to price of tortillas so as to maintain constant subsidy per beneficiary.

E. Study be conducted to examine whether certain basic food stuffs should be nutritionally fortified.

II. Food Subsidies for the Rural Poor

A. DICONSA rural stores be center for rural food subsidies through price discounts given from ration cards or introduction of system of food stamps.

(i) Local DICONSA committee and/or IMSS/Coplamar committees screen applicants (basic eligibility criteria based upon socio-economic and when possible anthropometric indicators).

(ii) Availability be for 5 to 8 months when food and employment are the most scarce (generally April through September are the most critical).

(iii) Eligibility be reassessed each year.

(iv) Nutrition and health education be included in the program for eligible participants.

B. Rural network be upgraded.

(i) Transportation, storage and working capital requirements of rural network be reviewed and supplemented as needed.

III. Monitoring Food Security and Nutrition

A. Plan for a continuous food consumption program be finalized for both urban and rural areas.

(i) INCO in collaboration with other relevant agencies be given responsibility for designing and implementing the program.

Proposed Outline of Study of the Existing Food Stamp ("Tortibono") Program

Justification: There is no reliable information on the impact of the program on real incomes, food consumption and nutrition among the various population groups. Such information would be useful for decision-making on future program modifications and implementation. Decisions on coverage, size of subsidy per household, distribution channels, commodities to be covered and related issues would benefit from information on who is currently benefitting and the impact of current and alternative program formulations. The program has now operated for more than a year and enough exprience has been gained for such a study to be successful.

Objectives: The objectives of the study would be: (1) to evaluate the impact of the existing program by stamp distribution channel (DICONSA, LICONSA, Labor Unions, Coabastos, community associations) on real incomes, food consumption and nutritional status of each of a predetermined number of households groups, (2) to assess the magnitude of leakage to households with incomes above two minimum wages, and (3) to explore how alternative programs or program formulation might affect impact, leakage, and cost-effectiveness.

Methodology: The study should be based on data collected by household surveys and surveys of agencies which issue stamps. The household surveys should cover random samples of households for each of the stamp distribution channels and samples of similar households not participating, e.g. households on waiting lists. Data should be collected on dietary patterns, food acquisition, total expenditures, incomes, household demography, weight and height of preschoolers, and other variables to be determined. Data analysis should be based on multiple regression. The survey of stamp issuing agencies should cover a random sample of each of the four major types (DICONSA, LICONSA, Labor Unions, community associations). Data should be collected on procedures and criteria used to determine household eligibility, controls, and other process variables.

MEXICO: SUMMARY OF TERMS AND STATUS OF 1986-87 FINANCIAL PACKAGE BY MAJOR CREDITOR GROUP
(In U.S. billions)

Type of Flow/Source	Amount	Drawings/Current Status	Terms: Maturity/Grace (Years)	Terms: Interest Rate (%)
New Money	10.7			
Commercial Banks	6.0 [1/]	4.4		
(Parallel New Money Facility - I	(5.0) [2/]	3.4 [2/]	12/5	LIBOR + 13/16
(Cofinancing New Money Facility - II	(1.0) [3/]	1.0	15/9	LIBOR + 13/16
Multilateral Development Banks	2.7			
(IBRD)	(2.3) [4/]	1.2 [4/]		
(IDB)	(0.4)	0.3		
IMF Stand-by	0.4 [5/]	0.8		
Japan	1.0 [6/]	0.2 [6/]		
CCC	0.6	0.8 (as of 6/30/87)		
Contingent Money	2.3			
Commercial Banks	1.7			
(Investment Support Facility - IV)	(1.2)	Cancelled (12/10/87)	8/4	LIBOR + 13/16
(Growth Cofinancing Facility - III)	(0.5) [7/]	—	12/7	LIBOR + 13/16
IMF Oil Contingency Mechanism	0.6 [8/]	—		
Debt Restructuring	76.5			
Commercial Banks	68.7			
(Pre-1983 Debt)	(43.7)		20/7	LIBOR + 13/16
(1983-84 Debt)	(8.6)		14/5	LIBOR + 13/16
(Private FICORCA Debt)	(11.2)	Terms comparable to those covering renegotiated public debt.		
(Interbank Credit Lines)	(5.2)	Level to be maintained until 6/30/89.		
Paris Club	1.8 [9/]	10/5 Appropriate market rates.		

1/ Disbursements contingent upon compliance with IMF stand-by and processing specific World Bank loans, closing date is June 30, 1988.

2/ Sum to be reduced quarterly by the amount Mexico saves as a result of the shift from a prime rate to a LIBOR reference rate and lower spreads on restructured debt during 1987. Reduction through 12/31/87 amounts to US$1.0 -1.1 billion, leaving a balance of about US$0.6 billion.

3/ B-loan cofinancing with World Bank transport sector loans. A non-accelerable World Bank loan guarantee for US$500 million is also provided.

4/ Includes an estimated present value of US$200 million for two World Bank guarantees totalling US$750 million. Drawings shown represent net disbursements both for IBRD and IDB.

5/ The IMF stand-by would provide SDR 1.4 billion in gross financing over the period of October 1, 1986 to March 31, 1988. At current SDR-U.S. dollar conversion rates, this would amount to approximately US$1.7 billion; the net transfer has been estimated at US$0.4 billion.

6/ Includes cofinancing of US$250 million (10/8/87) with the World Bank Second Export Development Policy Loan, US$250 million (7/27/87) for steel projects, and US$500 million (3/6/87) for the the Pacific Petroleum Project; these dollar equivalents for the Y200 billion facility are based on Y200.0=US$1.00 fixed in the ExIm Japan/Mexico agreement.

7/ Covered by a US$250 million non-accelerable loan guarantee of the World Bank, none drawn to date, with closing date of March 31, 1988.

8/ The IMF commitment is for the lesser of SDR600 million or US$600 million, but conditions for drawing have not been met and it is unlikely that any would be drawn.

9/ Rescheduling of 100% of the principal and 60% of the interest falling due on debt outstanding as of the end of 1985 during the period of October 1, 1986 to March 31, 1988.

Source: IBRD staff estimates.

January 13, 1988

Stu, Your copy. CST

cc Secretaria John

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

DATE: 27-Nov-1991 10:07am

TO: See Distribution Below

FROM: Edmund Mangan, EMTIE (EDMUND MANGAN)

EXT.: 32429

SUBJECT: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)

Attached is a brief EM from the Mexico Resident Rep office giving some of the details of the recent privatization of the Mexico public sector steel industry holdings, formally SIDERMEX. Included were three major operating steel plants, one mothballed facility and raw materials, mining and service and support operations. Overall this represents about 60% of Mexico's steel capacity and about 7 million tonnes of anual production.

The Bank has long been involved with the steel industry in Mexico in both the public and private sectors. The privatization step is the final culmination of recent involvement in the industry's restructuring process started first with the Public Investment Review carried out by the Bank in 1985, the Steel Sector Strategy Study done by the Bank in 1986 and finally the Steel Sector restructuring Loan in 1987. This loan and project are under active supervision and have provided the vehicle for the Bank to assist in developing the overall strategy for the sector and objective third party advise to SHCP as the privatization process developed.

It is interesting to note that in the final bids for these companies there is significent participation by Mexico private sector entrepreneurs who were not formally steel producers. The Alpha Group which owns HYLSA, the second largest steel company in Mexico behind SIDERMEX, bid on all of the facilities. Apparently they were not able to mobilize enough resources or were not willing to make the longer term committments to completing the current project and the further investment programs needed to develope and maintain a healthy steel industry.

This restructuring and privatization program is rich with experience and it may be worthwhile for the Bank to study it in some detail. This study if undertaken might also review other programs in the steel sector, for example, the recent privatization by Brasil of Usiminos, the largest and probably the most modern facility in Latin America. Public sector steel industry restructuring and privatization is actively being pursued throughout the world and this may be the opportunity for the Bank to contribute significantly to the effort by sharing the results and publishing the broad lessons learned here that are applicable in other countries and other industries.

DISTRIBUTION:

TO:	Carl Dahlman	(CARL DAHLMAN)
TO:	Mary Shirley	(MARY SHIRLEY)
TO:	Ibrahim I. Elwan	(IBRAHIM I. ELWAN)
TO:	Xavier Simon	(XAVIER SIMON)
TO:	Harold E. Wackman	(HAROLD E. WACKMAN)
TO:	Vivek Talvadkar	(VIVEK TALVADKAR)
TO:	Varel Freeman	(VAREL FREEMAN)
TO:	Stephen Ettinger	(STEPHEN ETTINGER)
TO:	Malcolm D. Rowat	(MALCOLM D. ROWAT)
TO:	Paul Meo	(PAUL MEO)
TO:	Rest of Distribution Suppressed	

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

DATE: 26-Nov-1991 05:29pm EST

TO: See Distribution Below

FROM: Joost Draaisma, 31480   (JOOST DRAAISMA AT A1 AT MEXICO)

EXT.: 550-7238

SUBJECT: Sale of Steel Industry.

Last Friday, the sale of the steel industry was announced by SHCP. A total amount of US$ 1,512.5 million was announced to be involved in the sale, made up of 340 million dollar in cash, 195 million dollar in nominal government debt titles, 585 million dollar in promised investments, 350 million dollar in long term debat take over, 42.5 million dollar in minority government participation.

The steel industry complex is split up between 3 private investment groups, both national and international.

A mexican group called Grupo Acerero del Norte, headed by Javier Autrey and Alonso Ancira took over the plant equipment of AHMSA, 29% of the Pena Colorada mine, Aceros Planos and the equipment of the Colada Continua Numero Tres. GAN will run this new operations in an association with the US company Southern California and the Dutch Hoogovens. Their offer consisted of 145 million dollar cash, 535 million dollar new investment and take over of 350 million dollar long term debt obligations.

A second mexican group called Villacero, headed by Julio Villareal and Enrique Sinente, will take over an 80% stake in Siderurgica Lazaro Cardenas-Las Truchas (Sicartsa-1st. fase) for an amount of 170 million dollar. The remaining 20% government minority participation is valued at 42.5 million dollar.

Finally, a group called Caribbean Ispat from India acquired a 29% stake in the Pena Colorada mine and Sibalsa. Their offer consisted of 25 million dollar cash, 195 million dollar nominal gobernment debt titles and 50 million dollar of promised new investment. This group owns 2 steel mills in India, 2 in Indonesia and one in Trinidad and Tobago.

The first conclusion to be drawn from this deal, is that although the resources obtained by the federal government are not very substantial, the authorities are assuring the necessary modernization of the steel industruy through participation of foreign firms, as well as the work of approximately 15,000 AHMSA workers. The new owners have announced that the workers can maintain their contract and that problems of overstaffing can be resolved by relocation.

DISTRIBUTION:

TO:	EUGENE MCCARTHY	(EUGENE MCCARTHY @A1@VAX12)
TO:	DANIEL OKS	(DANIEL OKS @A1@VAX12)
TO:	SWEDER VAN WIJNBERGEN	(SWEDER VAN WIJNBERGEN @A1@VAX12)
TO:	LYN SQUIRE	(LYN SQUIRE @A1@VAX12)
TO:	PAUL KNOTTER	(PAUL KNOTTER @A1@VAX12)
TO:	RAINER STECKHAN	(RAINER STECKHAN @A1@VAX12)
TO:	RICARDO A. HALPERIN	(RICARDO A. HALPERIN @A1@VAX12)
TO:	EDMUND MANGAN	(EDMUND MANGAN @A1@VAX12)

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

DATE: 27-Nov-1991 01:00pm

TO: Edmund Mangan (EDMUND MANGAN)

FROM: Xavier Simon, EDIFI (XAVIER SIMON)

EXT.: 36377

SUBJECT: RE: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)

Ed, I agree it is a case worth documenting--by far the richest in experiences that I have ever come across. Let's discuss how this might be done. How about lunch next Wednesday, Thursday or Friday--your convenience, let me know. Xavier

CC: VENKATESWARAN (VENKATESWARAN @A1@CHINA)
CC: Marko Voljc (MARKO VOLJC)
CC: Ricardo A. Halperin (RICARDO A. HALPERIN)
CC: Paul Knotter (PAUL KNOTTER)
CC: Rainer Steckhan (RAINER STECKHAN)
CC: Paul Meo (PAUL MEO)
CC: Malcolm D. Rowat (MALCOLM D. ROWAT)
CC: Stephen Ettinger (STEPHEN ETTINGER)
CC: Varel Freeman (VAREL FREEMAN)
CC: Rest of Distribution Suppressed

Table X: Trading in A's and L's

(Closing Price of A shares A share ADRs = $2.75)

	Price Per A Share ADR (NASDAQ)	Price Per L ADS (NYSE)	US$ Dollar-Equivalent Price Per A Share (BOLSA)	US$ Dollar-Equivalent Price Per L Share (BOLSA)
T	$2.75	[NO TRADES]	$2.75	[NO TRADES]
T + 1	2.75	$22.00	2.75	[NO TRADES]
T + 2	2.75	22.00	2.75	$1.10*
•	•	•	•	•
•	•	•	•	•
•	•	•	•	•
T + 5	$2.75	$22.00	$2.75	$1.10
T + 6	1.10	22.00	2.75	1.10

* No trading prior to 11:00 am Mexico time.

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Background Files for Privatization - Lessons of Experience, Prepared by Kikeri - Mexico - Volume 2	30451138

Document Date	Document Type
15 April, 1991	Facsimile

Correspondents / Participants

From: Goldman Sachs & Co

Subject / Title

Offering structure

Exception(s)

Information Provided by Member Countries or Third Parties in Confidence

Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

Withdrawn by	Date
Ann May	March 07, 2023

Document of
The World Bank

FOR OFFICIAL USE ONLY

DRAFT
CONFIDENTIAL

Report No. 7525-ME

Nothing on
Divestiture

MEXICO

TOWARDS GROWTH, STRUCTURAL REFORM AND MACROECONOMIC STABILITY IN MEXICO

(in two volumes)

VOLUME I - MAIN REPORT

December 6, 1988

Country Department II
Country Operations Division
Latin America and the Caribbean Regional Office

TOWARDS GROWTH, STRUCTURAL REFORM AND MACROECONOMIC STABILITY IN MEXICO

VOLUME I: MAIN REPORT

TABLE OF CONTENTS

This report has been prepared under the general direction of Miguel E. Martinez, Division Chief LA2CO by a team led by Sweder van Wijnbergen, Lead Economist for Mexico, (LA2CO) and comprising Enzo Croce, Julius Varallyay, Jaime Vasquez, John Johnson, Santiago Friedmann, Ijaz Nabi, Ricardo Martin, Neil Roger, Rafael Herz, Mauricio Larrain, Sreenivasa Ramachandran, Reuben Lamdany, Hans Binswanger, Jorge Garcia, and Sergio Pena. The report is based on the findings of a sector mission which visited Mexico from October 20 to November 4, 1988.

CHAPTER I

GROWTH, DECLINE AND THE CHALLENGES AHEAD

I.1 Introduction

Mexico's growth rate averaged 6.6% between 1950 and 1974. Between 1982 and 1987, Mexico did not grow at all. This stark contrast sets the agenda for the next six years. Restoration of growth to rates that offer some hope of improvement in per capita income should be the predominant economic concern of the incoming administration.

Of course, Mexico has recently done even better than 6.6%. Between 1978 and 1982 the economy grew at no less than 8.7% per year on average. However, over the same period external debt tripled, from 29 to 86 billion US dollar. Thus the ratio of external debt to GDP jumped from 28 to 52 percent, the high growth rate notwithstanding. This period was brought to a crashing halt during the debt crisis of mid-1982. The 78-82 episode highlights the constraints under which the economy should operate even if they would not be externally imposed; growth accompanied by unsustainable debt accumulation could very well lead to later losses that more than offset the earlier gains. The agenda is therefore not just restoration of economic growth, but renewed growth within the limits set by creditworthiness.

Recent economic history has taught another lesson. The outburst of spending in the late seventies, and the subsequent decline in oil prices and increases in real interest rates payable on the external debt caused serious public finance problems. These public finance problems in turn triggered an increase in inflation not seen earlier in Mexico's economic history. International evidence clearly demonstrates that high inflation rates go together with high relative price variability even when underlying supply and demand factors show no such variability. To this, high inflation will add fears of future recessionary stabilization programs. It should thus be clear that high inflation effectively precludes efficient private sector investment at levels necessary for satisfactory output growth. Economic stability is therefore a precondition for efficient economic growth. The agenda is thus further restricted: to the external constraint are added the fiscal constraints dictated by the requirement of low and predictable inflation rates.

Finally, economic growth is of little use if the additional resources are used so inefficiently that per capita welfare does not in fact increase. Restoration of a rational incentive structure is necessary if the benefits of these high growth rates are to lead to improved living standards.

Below we review the progress Mexico has achieved towards these objectives; we then discuss the obstacles that remain.

I.2 The Economy

A. Stability, Expansion and Collapse: a Brief Review of the Past

Between 1950 and 1974, Mexico enjoyed a remarkable period of high growth, low inflation and moderate external debt accumulation. Real growth averaged 6.4%, and inflation was in single digits throughout the period. This era of fiscal conservatism came to an abrupt end in the early seventies. Rapidly expanding government involvement in the economy pushed up the rate of economic growth. However, increasing government expenditure was not matched by rising public sector revenues. At the same time a decline in private savings incentives (real interest rates turned sharply downwards) prevented a matching increase in private savings. As a result, inflation tax and external debt became increasingly important sources of finance. The period of single digit inflation ended in 1973, the real exchange rate started to appreciate and external debt accelerated beyond the rate of growth in GDP from that year onwards.

Sharp adjustment measures in 1976 were not followed by a major crisis because major oil discoveries and subsequent oil price increases provided relief of both fiscal and external problems. In fact the subsequent period was characterized by both rapidly expanding government revenue and vastly increased public sector borrowing. On one measure (share in Value Added), the government sector increased by almost one third over this period. Government investment increased its share in total investment from 33.5% over the period 1970-75 to substantially over 40% in later years. Not surprisingly, the real exchange rate once again started to appreciate, eroding the gains of the 1976 devaluation. This expansion was largely fueled from abroad: Mexico's external debt increased from 16 bUS dollar to 86 bUS dollar between 1975 and 1982. A rapidly appreciating real exchange rate masks this increase when measured as a share of GDP however.

All this came to an end in 1982 when rising world interest rates and falling oil prices put an end to the increasingly expansionary policies of the Lopez-Portillo administration. The subsequent cut off from external capital markets left no option but fiscal retrenchment. Mexico, which had run non-interest current account deficits in each of the preceding thirty years, suddenly needed to run surpluses on that account in every following year. The ratio of external debt to GDP shot up anyhow under the influence of rising interest rates and falling growth rates. The gap between real interest rates on external debt and real GDP growth went from -6.3 percent in 1980-1981 to a full +10.5 percent in 1983. Differences this high mean that, even without deficits on the non-interest current account, the burden of debt will increase rapidly, simply through the compounding effect of interest on debt inherited from the past. In addition came substantial capital losses on external debt due to the necessary real exchange rate depreciation. The real depreciation was unavoidable given the major decline in oil revenues and rise in real interest obligations, but it added no less than 30 percentage points to the ratio of external debt to GDP during the period 1982-1987.

The counterpart to the non-interest current account improvement was a fiscal adjustment effort that is probably unmatched on a sustained basis in any country. A primary fiscal deficit of 7.1 percent of GDP before the crisis was turned into an astounding surplus of 5.3 percent in 1987 and an estimated 7.6% in 1988. And this while revenues from oil exports declined by more than 7 percent percent of GDP between 1983 and 1988, and GDP growth declined dramatically. Non-interest government expenditure was reduced from the equivalent of 34% of GDP in 1982 to about 25% in 1987. The public enterprise divestiture program was successful in closing or selling roughly 600 smaller entities, out of a total of about 1200 at the beginning of the period, with negotiations initiated or scheduled to start on a few larger enterprises. In addition to all this, Mexico has undertaken structural reforms at an accelerating pace over this period.

1983 saw an IMF supported stabilization effort, during which the fiscal deficit was halved, international reserves recovered, and inflation came down. However in 1984 and 1985 there was some fiscal expansion and monetary relaxation. On top of that came the earthquake late 1985 and a major terms of trade deterioration in 1986 due to falling oil prices. In response, the authorities adopted a new stabilization program in July 1986. In return for renewed monetary and fiscal austerity, this program also called for a concerted financing effort on the part of Mexico's creditors.

The 1986 package included new elements of policy reforms designed to eliminate structural rigidities in the economy. The most significant change is a major reorientation towards exploiting the benefits of international trade. Exports of manufactures, spurred by a 42% real depreciation over the July 1985-December 1987 period, have overtaken oil exports and more than compensated for the 7 billion U.S. dollars oil revenue loss experienced over the same time span. The trade liberalization process gained momentum since 1985. QRs were more than halved, tariffs reduced sharply, and quantitative controls on non-oil exports almost eliminated.

The fiscal retrenchment was clearly unavoidable given the sudden lack of access to international capital markets and the series of adverse terms of trade shocks that took place over the period. As a byproduct, the severe fiscal cutbacks have greatly increased the efficiency of many of the remaining government operations. There is, for example, little doubt that few if any of the many dubious large projects of the late seventies remain in the public sector investment program. But cutting the public sector investment budget from almost 10% of GDP in 1982 down to an estimated 3.3% of GDP in 1988 clearly has its costs; government investment has a role to play in areas that heavily complement private investment and in the social sectors. Also, private investment has not made up for the decrease. In fact it is surprising that the volatile macroeconomic situation has not led to a larger decline in private investment. It now is more or less at its pre-oil-boom level of 11 to 12 percent of GDP.

With lower investment on the one hand, and restrictive demand management on the other, real growth again stopped. There has been no real growth between 1982 and 1988, and hence a severe decline in per capita income. Also, inflation, rather than slowing down, in fact accelerated towards the end of the period, partially in response to a sharp nominal devaluation. This devaluation had become necessary because of the abrupt oil price decline in 1986. The subsequent <u>de-facto</u> targeting of the real exchange rate, together with an increase in the frequency of wage and cost adjustments, introduced an element of inherent instability into the system. This latter became fully apparent towards the end of 1987. The stock market plunge and a temporary opportunity for private debt buy backs evolving from the 1987 debt rescheduling triggered a run on the peso. This resulted in reserve losses and eventually a 37% depreciation, fueling inflation and expectations of further exchange rate depreciations. Mexico responded with the Pacto de Solidaridad, a concerted effort to bring down inflation that was now running well into triple digits.

B. Recent Economic Developments

The Pacto was negotiated in December 1987 between Government, labor, farming, and industry representatives. The program consisted of further tightening of fiscal and monetary policy, and renewed structural reform efforts. Trade liberalization was accelerated, credit subsidies substantially reduced, and the program of public enterprise divestiture reinforced. These measures were supplemented by a freeze of minimum wages, public sector prices and tariffs, and, a corner stone of the Pacto, pegging of the exchange rate against the U.S. dollar. This partial freeze was originally intended for a couple of months only but it has been extended at three months intervals.

On almost every target that is under direct or indirect control of the government, performance under the Pacto has been exemplary and often went beyond what was initially planned. Trade reform has been accelerated, partly because of the potential efficiency gains, partly because of a hoped for restraining effect on price increases. Total government expenditure net of interest expenses has fallen by about ten percent of GDP over the past few years, from 28% in 1982 down to an estimated 18% in 1988. The fiscal deficit is now much more closely in line with the low inflation targets embedded in the Pacto. This effort is the more noteworthy given the negative budgetary impact of further drops in oil prices and increasingly high real interest rates on foreign debt towards the end of the year.

Moreover, this has been achieved in spite of the current extreme level of domestic real interest rates. These have been at around thirty percent in real terms most of the year, and have crept up to a compounded real rate in excess of 40% towards the end of this year. And this while real interest rates on government debt were negative (-3 percent) last year. With the internal debt now at around 20 percent of GDP, such a turn around has caused a massive increase in real interest payments to service the domestic debt. This turnaround explains how a 2 percentage point improvement in the non-interest surplus was not enough to prevent a 5.1 percent deterioration in the operational deficit.

High real rates probably reflect anticipations of potential resurgence of inflation and exchange rate devaluation. Exchange rate uncertainty has forced the government to run very restrictive credit policies to avoid reserve losses given the fixed exchange rate; similarly, extraordinary high real rates on internal debt have become unavoidable to prevent capital flight. Clearly the transition of political power in December 1988 with the attendant announcement of a new economic team and its policies will reduce uncertainty. Also, the planned reduction in the frequency of Pacto renewals should reduce the volatility in financial markets. However, experience in other countries should caution against optimistic views of rapidly restored confidence and declining real interest rates on domestic debt. Israel, which applied a stabilization program rather similar to the Pacto in mid-1985, still has real interest rates at around 20 percent, roughly the level that obtained after the beginning of the program three years ago. The room for fiscal manoeuvre would increase substantially if real interest rates come down, output growth recovers and more external funding becomes available. However, it cannot be stressed enough that this additional room should not be used until it in fact emerges, i.e. only when real interest rates on domestic debt do in fact decline. Otherwise the potential of failure reflected in the current high level of real interest rates could become a self-fulfilling prophesy.

The fiscal measures, backed up by the exchange rate freeze and an array of formal and informal price controls, have had a dramatic success in reducing the rate of inflation. Inflation figures for August indicate a monthly rate of 0.9% for the CPI and 0.4% for the WPI. In September, the WPI actually declined. Also, the CPI inflation rate slowed down further in September to 0.7 percent. In October, CPI inflation was 1 percent, in spite of a series of substantial food price increses at the end of the month. This is a tenfold reduction compared with the beginning of the year; if the September and October rates can be sustained, Mexico's inflation rate would be at an annualized rate of approximately ten percent. This would not only be a dramatic change with respect to last year, but also not very far out of line with international inflation rates. The latter is important, of course, for an assessment of the sustainability of the fixed exchange rate policy.

Wage settlements for most of the year reportedly have exceeded inflation by a substantial margin, although reliable statistics are not available. The Central Bank has not been publishing wage data since the beginning of this year. Anyhow, this follows a prolonged period of decline in real wages in the preceding years and the initial months of this year. With the October contract settlements reportedly down to 10-15%, wage pressure is not yet a reason for concern but could become so if and when changes in controlled prices and the exchange rate increase the cost of living.

However, a word of caution is in order. About one third of the commodities covered by the CPI are still under fixed nominal price ceilings. Price controls cover mostly public sector utilities and agricultural products. With one third of the CPI basket under fixed nominal ceilings, a ten percent aggregate inflation rate probably translates in a 15% inflation rate without price controls once initial relative price realignments would have worked themselves out. That would clearly not be compatible with a fixed exchange rate against the US dollar: US inflation is at most 5 percent, making for a steady real appreciation of the Peso unless inflation comes down further.

Also, the price controls are coming under increasing pressure. In agricultural commodities the pressure manifests itself by increasing scarcity and under the table surcharges; in response, the government raised the prices of beef, eggs and milk by thirty percent at the end of October. Of course, fixed nominal price ceilings imply an inflation target of zero, which is clearly inconsistent with both actual inflation and the inflation target implied by the fixed exchange rate. The latter target implies an inflation target of around 5 percent. Sustainability of the controls at fixed nominal levels is thus increasingly becoming an issue.

The policy of a fixed Pesos-Dollar rate is coming under increasing pressure. The real exchange rate against the US has appreciated by 9.2% between January and August, and by 5.5% since March, the first month with low inflation. The real appreciation of the dollar between March and September 1988 has added to the pressure: on a trade weighted basis the real exchange rate has appreciated by 7.4% between March and August. This should be set against a sharp real depreciation of 42% on trade-weighted basis between July 1985 and December 1987. July 1985 was the month preceding a nominal devaluation of 17 percent and the beginning of a much more aggressive exchange rate policy. However, falling oil prices and rising foreign interest rates in the second half of 1987 have further added to pressure on the real exchange rate.

Doubts about the sustainability of the exchange rate may be behind the second striking feature of 1988, an extraordinary surge in imports. Between January and August, aggregate imports soared by 53.7 percent in dollar terms over the corresponding period last year. Price data are only available up to June but show only a six percent increase over the corresponding first 6 months of last year. Most of the increase is thus real rather than nominal. Moreover, this increase is largely a private sector phenomenon. Private sector imports rose no less than 63 percent over the period. The sharpest increase is registered by private consumer imports: 201 percent, although from a low base (their share in total imports almost doubled from 4 to 7 percent). Second are private capital goods imports, up by 74.6 percent (57.4 percent with government imports included). But the surge really is accross the board: intermediate imports are up too, by 52.3 percent for the private sector and 46.5 percent with the government included. It seems that a substantial part of the import boom is related to speculation against the exchange rate, and, possibly, a gamble on future trade reform rollback.

At the same time, non-oil exports are increasing at 20% in dollar terms, like in 1987 (the 1987 over 1986 increase was 23.7 percent). This has just been enough to offset falling revenues from oil revenues; total exports are up by 4.1 percent in January-August 1988 over the same period last year. The further decline in oil prices since August is likely to change this trend in the latter half of the year. In addition to this comes a strong increase in exports from the Maquiladoras, the import/export industries along the US border. While separate export and import data are not yet available for 88, value added is increasing at thirty percent over last year, adding a likely 2 billion US$ to the trade surplus this year (as opposed to 1.6 billion US$ last year). The increase in exports is due to improved competitiveness since mid-85; as mentioned before, the exchange rate depreciated in real terms by 42 percent between July 1985 and December 1987. Two qualifications, however. First, much of that gain has been eroded since the beginning of 1987. Second, since 1985 other exporters to Mexico's export markets have improved their competitiveness by almost ten percent, reducing the net gain for Mexico by that amount when measured against competing exporters to Mexico's export markets.

The net result is a projected deterioration in the trade balance of between six and seven billion dollars a year. Add to this rising interest payments on external debt and the projected current account deficit comes out 7.5 billion US$ below last year's admittedly large surplus: a deficit of 3.5 billion US$ in 1988 versus a surplus of 4 billion US$ in 1987. Also, most of the negative external developments took place towards the end of the year, so their full impact has yet to show in Mexico's external balance statistics. Still, this translates in a deficit of only slightly over 2 percent of GDP, and a non-interest current account surplus of close to 3 percent of GDP.

The need to effect a substantial resource transfer to foreign creditors clearly greatly complicates the fiscal measures necessary to reduce inflation on a sustainable basis. The need for some resolution of Mexico's external debt problems is thus not only essential for the renewal of growth, but would also contribute significantly to the Pacto's chances of success.

I.3 Consolidating the Recent Adjustments: Remaining Problems.

Mexico shows the credibility problems of a country that has implemented major reforms and stabilization efforts, but has yet to convince the private sector that the changes are there to stay. These problems have been compounded by an increasingly hostile external environment (although it is not known yet whether the new adverse external scenario is permanent or transitory) and substantial internal political uncertainty. They manifest themselves in three areas.

First, in a striking departure of the experience of countries like Israel and Brazil, monetary aggregates have failed to increase in real terms, the dramatic decline in inflation notwithstanding. In Brazil for example, base money almost tripled during the first year of the Cruzado plan. No such increase took place in Mexico. While some changes in financial structure may have contributed to this, the inescapable conclusion must be that fear of devaluation and renewed inflation keeps demand for real balances down. This clearly does not help either Central Bank reserve management or the funding of the public sector debt, more of which now needs to be financed at high cost Treasury paper (CETES).

The second manifestation of a credibility problem is the rapid surge in imports, in particular of consumer durables and capital goods. This increase is well beyond what could be expected given relative price developments and foreign aggregate import growth. Clearly, expectations of devaluation and future trade policy reversals play a role. In this context, it cannot be stressed enough how important a commitment to the past trade reforms is. Increases in tariffs, either for public finance reasons, or for purposes of realignment of the tariff structure, could easily be interpreted as a rollback of the reforms. This would further fuel expectations of slippage and should therefore probably be avoided at almost any cost.

The surge in imports has contributed to a substantial deterioration in the current account, by more than 4 percent of GDP (from a surplus of 3.8 bUS$ in 1987 to an estimated deficit of 3.5 bUS$ in 1988). What is the internal counterpart to this shift: an increased fiscal deficit, higher private consumption or more private investment? It clearly is not the impact of lower oil prices and higher foreign interest rates on public finances. These took place only towards the second half of the year, and anyhow have been offset by further fiscal tightening. The non-interest surplus in fact increased by almost 2 percent of GDP. Private investment has at most increased by one percentage point of GDP. An increase in private consumption and/or an increase in inventory accumulation must have taken place to close the remaining five percent (4+2-1..). Since GDP is estimated to increase by one percent, we are left with a gap of around six percent of GDP. The only explanation can be either increased private consumption, or a substantial increase in inventory accumulation compared to last year. Private consumption could have increased its share of GDP in the anticipation of renewed growth in the future, or in response to the income effect of the enormous real interest payments on internal debt. If these are high because of expectations of devaluation, they are not high in "ex-ante" terms and will thus not have negative substitution effects on consumption, just positive income effects. Alternatively, inventory accumulation is much higher than last year. No national accounts data on this are available either for 1987 or 1988, but Central Bank surveys suggest negative inventory accumulation in 1987 and positive accumulation in 1988 in manufacturing. The shift in inventory accumulation could thus be large.

Either explanation is bad news. High private consumption would need to be reduced to create room for investment within the constraint of a financeable current account deficit. A rapid increase in inventories, when unintended, signals that at current relative prices (i.e. at the current real exchange rate) the supply of Mexican goods exceeds demand for them. This of course implies that a real devaluation is called for. But how to achieve a real devaluation with the nominal exchange rate a corner stone of the Pacto and wages effectively indexed to it is not clear.

The third signal of low credibility is the extraordinary level of real interest rates. The excess of domestic real rates over foreign real rates (in the face of an appreciating real exchange rate!) has two components. Partially it covers expected real depreciation, thus lowering the "ex-ante" real interest rate below the "ex-post" one. In addition there is probably a risk premium, much like an insurance company charges a premium above the expected costs of its policies in return for its insurance services. In this case, the private sector is receiving such a premium from the government. The reduction in political uncertainty and changes in the frequency of Pacto renewals can be expected to lower the second element, but not the first. One should therefore continue to expect a high level of real interest rates for the foreseeable future. This is clearly confirmed by the experience of countries like Israel and Brazil with similar stabilization programs.

As to high real interest rates, there is probably no option other than assuming they are there to stay for several years and adjust fiscal policy accordingly. The risk of a self-fulfilling prophesy run on the Peso if fiscal policy were to be based on the assumption of substantially lower real rates is too great.

The proper response to the income losses caused by oil price and interest rate developments depends on whether these income losses are temporary or permanent. A temporary loss of income calls for neither fiscal nor external adjustment; instead it should be smoothed over by using reserves (this is after all the purpose of reserves) or by otherwise temporarily increasing net debt. Obviously this is not possible on a sustained basis in the case of permanent changes in oil prices or interest rates.

A permanent decline in public sector revenue calls for an equally permanent adjustment in public sector finances. This would create the room for increased private investment without further increasing the external deficit. Such a renewed private investment is necessary for growth, which in turn is necessary for sustainability of external debt accumulation at its current pace.

But it is here that Mexico finds itself in a difficult situation. Sustained access to external capital markets is clearly necessary to provide room for the additional investment needed for renewed growth. But fears of the consequences of no such future access to capital markets, with its implications for fiscal and exchange rate policy, are clearly among the factors holding this investment back. In turn, the resulting sluggish growth performance and public finance problems are among the factors causing the lack of access to external capital markets to begin with, thus closing the vicious circle.

To break out of this vicious circle, some external financing would be needed, thus relaxing the external constraint that is stiffling growth. But at the same time it would be necessary to give a signal that the increased external funds indeed will trigger the increased investment necessary for growth. In addition, a continuation of the structural reforms implemented over the past few years would likewise enhance the stability of incentives necessary to attract more foreign financing. Only then could complementary funds be expected on a voluntary basis.

The resulting increase in external debt does not really threaten Mexico's creditworthiness. Even a three percent of GDP (appr. 5 bUS$) increase in external debt would simply keep the external debt constant in real terms. Thus the debt-output ratio would in fact decline even at moderate rates of growth.

I.4 Towards Renewed Growth

The predominant long term problem in Mexico is the continued low growth rate of the Mexican economy. This is not only an issue of great social concern, but also presents a major inefficiency and a threat to the success of the short term stabilization program as well. An efficiency issue because it suggests that the rationalized incentive structure that is beginning to emerge because of the ongoing reform program is not sufficiently exploited; a threat to the Pacto because any fiscal deficit is much harder to finance at low than at high growth rates. Thus low growth rates increase the probability that recourse to reliance on the inflation tax is imminent. For all these reasons restoration of growth to the levels prevailing before the expansionary mid seventies is imperative.

In the short term, this would either require continued strong export performance, or renewed investment holding out the promise of future exports. The first avenue could become problematic if the current erosion of the real exchange rate continues. From this perspective too, restraining private wage settlements is essential. Exchange rate action would become unavoidable if non-oil exports start slowing down.

It is clear however, that because of the short-term problems fiscal efforts cannot be the main engine of growth. In the short run, BoP considerations leave no option but export led growth. Then however, supply bottlenecks will develop in time, with the consequent need for additional investment. At present, the latter stands at the equivalent of 16% of GDP, its lowest historical level. Some calculations put the required increase in the investment ratio required for sustainable 5% growth at 4% of GDP. With fiscal retrenchment necessary in the face of low inflation targets and the likely negative impact of external shocks on public finance, private investment will have to lead the way. This is also more in line with the structural reforms currently underway in Mexico; these reforms seek to reduce rather than increase the role of the public sector.

Where would the macroeconomic room for private investment based growth come from? If public sector revenue were to keep its ratio to GDP at the present level, public sector savings could only increase if further expenditure cuts could be secured. However, to do this on a large scale would be a very difficult task indeed, given the extent to which cuts have already taken place and the possible need for additional government investment. In addition, even in the event that, with renewed confidence in the economy, private savings recover the two percentage points of GDP lost between 1985 and 1987, a 2% of GDP shortfall in investment would remain. A starting point would therefore have to be the design of a policy-financing package that will provide the framework for the increase in private investment necessary for resumed growth. This raises the issue of Mexico's renewed access to international capital markets. A decline in the current account of two percentage points would still leave the non-interest current account in surplus by 2 percent of GDP. What would it do to Mexico's debt-output ratio? There are three factors influencing this ratio: (a) the non-interest current account; (b) a debt-dynamics term related to the excess of the real interest rate over the real growth rate; (c) capital losses due to depreciation of the real exchange rate. [1]/

The first term would reduce the debt-output ratio under this scenario. The second would, at 5 percent real growth, probably be in equilibrium since real interest rates on foreign debt are around that level too. This means that real interest payments add to the debt at the same rate that GDP is growing. The third term would also be zero if no further depreciation is necessary. The net impact of an extra 2 percentage points deficit on the current account, allowing 5% real growth, would thus be to reduce the debt-output ratio. After five such years, the debt output ratio would in fact have fallen by about ten percentage points. If macroeconomic policies are such that the extra leeway would indeed be used for investment, creditworthiness would likely be enhanced, the extra borrowing notwithstanding. Of course macroeconomic and tax policies that ensure that the private sector would indeed increase investment rather than consumption are imperative for this scenario to succeed.

The scenario would look even more favorable if the real rate of interest on Mexico's external debt could be reduced to say two percent, still a respectable return to foreign lenders. In that case the debt-dynamics term related to the difference between real interest rates and the real growth rate would also turn negative. With the same real growth rate and non-interest current account surplus, the debt-output ratio would fall by no less than twenty percentage points of GDP over the next five years!

These scenarios depend of course crucially on real growth in fact taking place and on the absence of any further real depreciation of the real exchange rate. Any percentage point real depreciation adds more than half a percent of

---

[1] The decomposition is based on accounting identities. Define the debt-output ratio b^* as:

$$b^* = (B^*/P^*).e/y; \quad e = E.P^*/P$$

e is the real exchange rate, B^* is the dollar value of foreign debt, P^* the dollar-based price index of foreign goods, and E the nominal exchange rate of the local currency against the dollar. P is the local price index. Increases in the debt-output ratio can be traced to the following components:

$$\dot{b}^* = nicad/y + (r^* - n)b^* + \hat{e}b^*$$

a " " indicates changes and a "^" percentage changes. nicad/y is the ratio of the non-interest current account deficit to GNP. r^* is the average real interest rate on foreign debt and n the real growth rate of GNP.

GDP to Mexico's debt output ratio. Similarly, each percentage point slow down in the growth rate of real GDP adds slightly in excess of half a percentage point to Mexico's ratio of external debt to GDP. In a "worst case" scenario, the current non-interest CA surplus of over 4% of GDP needs to be maintained, at the cost of zero percent real growth and 5% real depreciation to get export growth growing anyhow. Under this scenario, there would be an increase in the debt-output ratio of almost 40 percentage points in 5 years, the 4% of GDP Non-Interest current account surplus notwithstanding. Clearly, cutting back Mexico's access to foreign capital markets would in fact reduce Mexico's creditworthiness because of its likely impact on GDP growth. If this would materialise, further measures to create room for enough investment would become of the utmost importance. The dilemma is, of course, that those very measures may reduce private investment and thus growth even further.

But without such growth, the funding policies of the public sector will be complicated immensely. Also, with low growth and a high resource transfer to foreigners, the real exchange rate would need to be devalued much further than would be necessary with a smaller resource transfer out of Mexico. Low growth because of insufficient access to foreign capital markets would thus also jeopardize the short term stability sought under the Pacto. And the success of the Pacto itself is probably the most urgent precondition for renewed growth. There can be little doubt that a resurgence of inflation, abandonment of the exchange rate regime, possibly a forced reversal of the many trade and industrial reforms implemented over the past few years would prevent output growth for many years to come. The experience elsewhere in Latin America provides ample testimony to that. Any program for growth should therefore start with measures that allow the economy to emerge from the Pacto with the controls removed but its anti-inflation gains intact.

CHAPTER II

TOWARDS RENEWED GROWTH AND MACROECONOMIC STABILITY

II.1 Introduction

The government will have to operate under continuing fiscal constraints for the foreseeable future. Therefore public investment will only play a supportive role towards the target of renewed growth. The main impetus will have to come from a strong private sector investment performance. This is in fact also more in line with the structural reforms undertaken during the past few years; these reforms have been geared towards a reduction of the role of the public sector in the economy. Recovery of growth hinges crucially on the reduction of net external transfers to foreigners so as not to choke off investment in an attempt to service the external debt.

The resumption of growth requires action on three major areas. First of all macroeconomic stability. High inflation, fears of future recessionary policies, balance of payment crises, are all incompatible with the confidence necessary for renewed investment. To avoid these events from happening, fiscal policies and external financing plans that are consistent with other macroeconomic targets are necessary. Such consistency conditions are the focus of the first part of this chapter, together with a discussion on how to make the transition out of the Pacto. Consistency of fiscal policy not only requires consistency between fiscal deficits and available financing given macroeconomic targets, but also consistency between existing spending and revenue plans with those deficits targets. This too will be discussed, with particular attention to public sector pricing, investment requirements for growth and tax reform. Finally, with a sustainable fiscal policy in place, there is the issue of external requirements for sustainable growth. These are topics discussed in the final part of the first section.

But even within a stable macroeconomic environment, obstacles would remain holding investment down. Some have to do with the tax system, and these are discussed below (Section II.B.2.1). However, a different problem is that recently the banking system in Mexico has not been able to play a constructive intermediary role in the financing of private investment. Necessary measures for reform are discussed in the next Section.

Finally the benefits of increased resource availability through growth will only translate into increased living standards if incentives for private production and consumption are sufficiently in line with opportunity cost. The opening up of the economy towards external trade that has taken place over the past few years is an important step in that direction. This process will need to be complemented by internal price and regulatory reforms matching the new export orientation. This is such a comprehensive area that only part of it will be covered here. In particular, Chapter III deals with incentives, equity concerns and efficient government intervention in trade and the financial and agricultural sectors.

II.2 Macroeconomic Stability, External Balance and Growth: Can They Be Reconciled?

Even with external finance available for an increase in private investment, it is not automatical that private investment will in fact expand.

Continued uncertainty clearly encourages people to invest their wealth in more liquid assets than physical capital. Hence a strongly sustained stabilization effort is essential, its potential short term depressing effects notwithstanding. The first part of this section therefore discusses the outlook for the Pacto.

A fiscal stance that does not conflict with sustained low inflation, even in the event of unfavorable external developments and continued high real interest rates, is clearly necessary, although possibly not sufficient, to allay inflationary fears. Only if the inflation compatible with public finance requirements is compatible with the inflation rate implied by the fixed exchange rate regime, is the latter going to be sustainable. And this in turn is the cornerstone of the Pacto. Thus medium term consistency requirements, when violated, give a signal that will greatly complicate short term macromanagement. This will require restrictions on both the overall deficit and its mode of financing. Finally, even if all policy measures are at the desired levels, the sustainability of the implied policy changes themselves will be an important issue for the credibility of the package as a whole. This is especially important for the expenditure cuts undertaken in the past few years. All this is discussed in the second part of this section.

A final issue is the most fundamental one. For given deficit targets, is the private sector's savings over investment surplus that can be expected at given real interest rates and growth rates consistent with the public deficit on the one hand and available external financing on the other? Should an attempt be made to borrow more? What does this imply for the future burden of the debt? To which extent do the answers to all these questions depend on external events such as oil price or interest rate shocks? This is the subject of the last section.

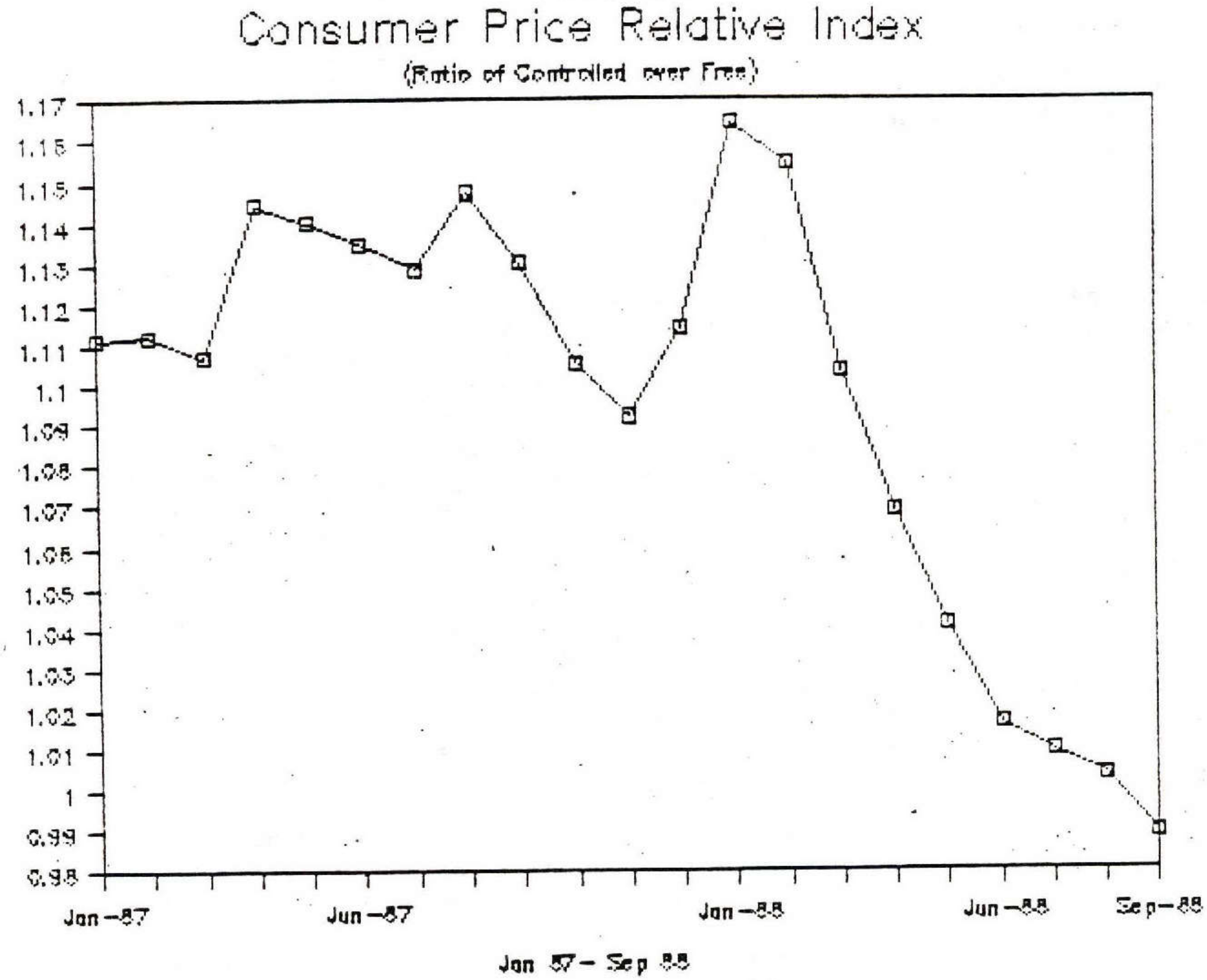
A Short term Stability: The Pacto de Solidaridad

The Pacto has been a success sofar. Inflation for both aggregate prices and the subset that are left free has been at or below 1 percent a month since August, and in continuous decline from the 15.5% monthly rate in January 88. However, signs of stress are increasingly becoming obvious. The exchange rate is appreciating in real terms as inflation, low as it is, still exceeds inflation in the USA, against whose currency the Peso is pegged. Moreover, the rise until recently of the dollar itself puts Mexico at a disadvantage against other exporters to the USA to the extent that they do not peg against the dollar. Moreover, relative prices in Mexico are becoming misaligned. An increasing number of commodities under control is not available anymore at official prices. The ratio of controlled over uncontrolled prices has fallen by almost 15 percentage points since January (Fig.1).

Fixed nominal price controls and a fixed exchange rate are incompatible as long as world inflation is positive; in addition, price controls do not allow any response to sectoral shifts that are bound to occur as time goes by. Decontrol thus becomes a necessity. At issue is, whether this should occur at once or gradually.

Instantaneous decontrol clearly resolves sectoral misalignment instantaneously; however, such a realignment will almost certainly involve substantial price increases (the controls are ceilings; so declines could always take place). This involves price level shifts rather than inflation, but such level shifts can be misinterpreted as a renewal of inflation in the current atmosphere of uncertainty about the Pacto's success. A policy of gradual decontrol would therefore seem more prudent.

FIGURE 1



Gradual decontrol can take two forms, and both can be applied at the same time. First accross the board; ceilings can be raised gradually (say by a percentage point a month). Controls on an individual commodity can then be abolished as soon as this process brings it within striking distance of international prices, in the case where traded commodities are involved. In the case of non-traded commodities, the Central Bank's surveys of scarcety could be used to decide when controls can be lifted.

A disadvantage of this method is that the announced rate of increase in the price ceilings could effectively establish a floor for inflation.

The second method is not accross the board, but would exploit individual windfalls as they occur. An example would be to release prices of agricultural goods at harvest time, possibly backed up by stockpile releases where possible. In this method in particular there could be a coordinated approach with further trade liberalization. There are several agricultural commodities where import quota put upward pressure on prices while controls are trying to keep them down. Simultaneous release of such quota together with price controls would clearly be advisable. Sugar is an example of such a situation.

A final issue concerns public sector utility pricing. Keeping public utility prices artificially down arithmetically lowers measured inflation. However, by putting increased pressure on the public sector deficit through the increased need to cover public utility losses, such a policy ends up increasing revenue needs and hence the likely recourse to inflation tax. It might thus in the end raise rather than lower inflation.

Price decontrol, like exchange rate policy, brings up an issue that is both the strength and the weakness of the Pacto, its concerted nature. Clearly, the fact that all the major actors in the Mexican economy were participants in the Pacto has been essential for its success. But the same concerted approach that made it work initially also makes it difficult to get out of it with anything less than a comprehensive package approach. The real wage is a particular stumbling block. The possibility to combine price decontrol or exchange rate realignment with for example improved targeted food assistance programs or lower payroll taxes deserves attention.

The most difficult issue involves the exchange rate. The peg against the dollar is the cornerstone of the Pacto and is widely perceived as such. There is little doubt that any significant exchange rate realignment would lead to matching wage claims and additional pressure on nominal price controls. Also, in a relatively open capital market like Mexico's, the money supply is not really under control of the government either under a fixed exchange rate regime, so the money supply could adjust quickly too. It is not clear that in such circumstances a nominal devaluation would in fact bring about a real devaluation on anything but a very short time horizon.

A prior issue is of course whether such a realignment is in fact called for. Current account imbalances are not necessarily an indicator of exchange rate misalignment; an unsustainable deficit calls for an aggregate expenditure shift from today to tomorrow, not for an expenditure switch between two current goods (foreign and domestic). Shifting expenditure over time is the proper realm of interest rates, and, where government expenditure is involved, fiscal policy.

The real exchange rate is the relative price of foreign goods in terms of domestic goods; factors influencing either could thus call for changes in the real exchange rate. Examples are declining transfers from foreigners because of reduced access to foreign capital markets, or lower oil prices. Each would reduce world demand for Mexican goods and thus call for a real devaluation. Similarly, a reduction in tariffs shifts domestic demand away from domestic goods without at the same time increasing foreign demand for home goods. If domestic suppliers are to find export markets for the goods they can no longer sell at home, a price realignment is called for. A nominal devaluation backed up by restrictive macroeconomic management is often the quickest way of bringing such a realignment about.

All these examples are in fact relevant for Mexico today. Oil prices did fall, foreign credit has dried up and tariffs have been lowered extensively. Does Mexico then need a real devaluation? The answer is not clear right now, but a realignment will most likely be needed in the future. The situation is not clear right now because Mexico went through an extensive, policy induced, real devaluation in the two years preceding the Pacto (to a cumulative effect of over 40 percent in real terms). Nobody knows whether that devaluation was more than was warranted by initial situation and subsequent external shocks and internal policy changes.

Two arguments support the view that it was. The first derives from the fact that manufacturing sales at home fell dramatically this year, just like in 1976 and 1982. However, in striking contrast to those two years, total sales did not slump. The difference is of course the continuing strong export performance. As long as that continues, a case can be made that there is no need to speed up a process of real devaluation through nominal exchange rate policy. The second argument is maybe more controversial. One way of interpreting continuing inflation above world rates in a fixed exchange rate regime is, as the economy's way to recover from excessive real devaluation due to nominal exchange rate policy. In that case, further nominal devaluation would simply speed up the process of subsequent appreciation through accelerated inflation in excess of foreign inflation.

There does not seem to be a strong case for a major realignment right now, although some correction could be defended. However, a fall or even a slowdown in exports or further substantial decreases in domestic demand for home goods threatening increasing excess capacity, would testify to increasing excess supply of Mexican made goods and a need for real depreciation. Moreover, continuing inflation in excess of world rates will clearly make any fixed nominal exchange rate unsustainable as time goes by.

B Macroeconomic Consistency and the Financing of Government Deficits

B.1 Consistency of Fiscal Policy.

There are three sources of financing public sector expenditure beyond what can be obtained from the regular tax system: external borrowing, monetization and issue of domestic interest-bearing debt. The amount that can be expected from each source will depend on other macroeconomic targets, such as inflation, output growth, interest rates and so on. The revenue from these three sources of financing can be combined into the calculation of a "financeable deficit". This is defined as the deficit that does not require more financing than is compatible with sustainable external borrowing, existing targets for inflation and output growth, and a sustainable internal debt policy. [2]/ If the actual deficit equals this "financeable" deficit, fiscal policy is consistent with the macroeconomic assumptions and targets underlying the calculation of the financeable deficit. [3]/

---

[2] A simple version of this framework was first used in Anand and van Wijnbergen (1987). The current version incorporates external debt considerations and implications of the financial structure for inflation tax revenues (van Wijnbergen and Anand (1988)).

[3] This should be interpreted with care. Consistency with macroeconomic targets does not guarantee that those macroeconomic targets can or will be achieved; only that the fiscal deficit is not inconsistent with them. To actually achieve the stated macroeconomic targets may require other measures, possibly

Underlying the framework suggested here to calculate the financeable deficit is a model describing private portfolio choice as a function of inflation, output and interest rates. This gives the amount of currency, demand deposits and time deposits the private sector is willing to hold given output, inflation and the level and structure of interest rates. This is coupled with a simple financial sector model incorporating reserve requirements and other bank regulatory policies to derive the demand for reserves by commercial banks. The demand for reserves is then added to the demand for currency already derived to get an estimate of the total demand for base money given inflation, interest rates, and so on. All this is used to derive total revenue from monetization, net of interest payments on reserves, for different output growth rates, interest and inflation rates and regulatory policies. To revenue from monetization must be added the revenue the government can expect from external and internal debt issue given its external borrowing policies and debt management approach. One can then calculate the financeable deficit.

The difference between the actual deficit in 1988 and this financeable deficit is called the required deficit reduction, RDR. A deficit cut equal to RDR will restore consistency with other macroeconomic targets. The results of such an exercise for Mexico are summarized in Table 1. The table lists the results for various assumptions on other macroeconomic variables.

In the calculations underlying the Table, it is assumed that issue of interest-bearing domestic debt is kept down to a rate that will maintain the real value of the domestic debt constant. The reason for not allowing a faster rate of domestic debt issue is the high interest rate it currently carries; at around 30% per year (almost 40% by year end!), it is well above the real growth rate of the economy. At this rate, debt-service will escalate as a percentage of GDP if more extensive use is made of debt-issue to finance the deficit; this is explored at greater length in the next Section. Also, on foreign financing different options are explored. The first row of the table assumes that the nominal value of the foreign debt stays constant (CAD=0). The second row looks at the consequences of changing that option to either a constant real value of the debt or to assuming a constant debt-output ratio.

With zero net foreign debt increase, the 1988 operational deficit (3.1 percent of GDP) is seriously out of line with inflation targets, as the first row demonstrates. The actual deficit in 1988 needs to be cut by 3.1 percent for compatibility with an inflation target of 15 percent, or the entire operational deficit needs to disappear. This reflects the fact that Mexico receives very little from the inflation tax and seigniorage, because of low growth and the practice of paying interest on reserves. Even for a 50% inflation target, the RDR still amounts to a hefty 2 percent of GDP.

---

including fiscal retrenchment beyond what is required for consistency as defined here.

TABLE 1: REQUIRED DEFICIT REDUCTION (RDR) FOR CONSISTENCY WITH VARIOUS MACROECONOMIC TARGETS (AS PERCENT OF GDP).

1. NO REAL EXCH.DEPRECIATION; CAD=0; OUTPUT GROWTH 1.5%

INFLATION TARGETS	p:	0	5	15	50
	RDR:	3.8	3.5	3.1	2.0

2. NO REAL EXCH. DEPRECIATION; INFLATION 15%; OUTPUT GROWTH 1.5%

FOR.BORROWING	CAD:	0	3.1 1/	4.0 2/
	RDR:	3.1	0.0	-0.9

3. NO REAL EXCH. DEPRECIATION; INFLATION 15%; CONST.B*/Y RATIO

OUTPUT GROWTH TARGETS	n:	0	1.5	4	5
	RDR:	2.8	1.7	0	-0.6

3. INFLATION 15%; OUTPUT GROWTH 1.5%; CONST. B*/Y RATIO

REAL EXCH.RATE	c:	0	5	10
DEPRECIATION	RDR:	-0.9	1.7	4.4

Notes: 1/ Constant real debt case
2/ Constant debt/GDP case

c :Rate of depreciation of the Real Exchange Rate
CAD :Current Account Deficit
n :Growth rate of real GDP
p :Inflation Rates
RDR :Required cut in fiscal deficit compared with 1988 (operational) deficit
B*,B :Foreign, Domestic Debt
Y :GDP

Of course more liberal access to foreign financing changes all that. The second row shows that the current deficit in fact is compatible with an inflation target of 15 percent if enough foreign financing is available to at least maintain the real value of the debt. This implies a 3 percent current account deficit, or refinancing of about half of interest payments. An even more liberal target would keep the debt-output ratio constant; at 1.5% real growth this implies a four percent current account deficit, with corresponding reduction in the need to cut back on the fiscal deficit.

The third row of the Table shows how, under a constant debt-output ratio target for foreign borrowing, fiscal leeway increases with output growth. The RDR falls from 2.8 percent of GDP at a zero growth rate to a zero RDR at a four percent real growth rate for GDP.

Another issue concerns exchange rate policy. If the debt-output ratio is the constraint on external borrowing, higher real depreciation will restrict the room for fiscal deficits. Table 1 demonstrates this effect for a constant foreign debt to output ratio as the restriction on foreign borrowing. The table clearly shows how, under such an external debt policy, capital losses on foreign debt due to real depreciation of the exchange rate severely restrict fiscal policy. A required fiscal deficit cut of -1 percent of GDP (i.e. room for expansion) at zero real exchange rate depreciation jumps to 1.7 percent [4] need for cutbacks at a five percent real depreciation. If the real exchange rate depreciates by 10 percent, the required deficit reduction (RDR) increases to no less than 4.4 percent of GDP. The main reason for this is reduced room for external financing.

Of course this analysis should not be interpreted as an argument to resist a real depreciation when commodity market equilibrium requires one. The proper interpretation is as an indication of the extent of necessary additional fiscal stringency if the real depreciation is not to result in an increasing ratio of external debt to GDP.

Fiscal Implications of Debt Management

With real interest rate differentials as large as they are now, debt management takes on a great fiscal importance. Take for example a debt-swap scheme where say 10bUS$ is used to buy back a corresponding amount of domestic debt (about 6 percent of GDP). With a staggering 25 percentage points real interest rate differential, this operation would reduce the real interest rate burden by no less than 1.5 percent of GDP, bringing down the required defict reduction for a given inflation target correspondingly. The impact on the operational deficit would be smaller, but still 1.2 percent. The smaller effect is because the operational deficit, somewhat inconsistently, counts payment of nominal interest rate charges on foreign debt, rather than just real foreign interest payments, like it does in the case of domestic debt.

A more serious exercise concerns the issue of domestic debt. At 1.5% real growth and no net increase in foreign nominal debt, the fiscal gap is 3.1 percent of GDP for 15 percent inflation. What if this gap is filled by issuing internal debt rather than foreign debt? Since interest rates on internal debt exceed the real growth rate by such a margin, this funding policy would solve today's fiscal problem at the cost of a substantially more serious one in the following year. This strategy would raise the required deficit reduction for a 15% inflation rate from 3.1 percent to 4 percent of GDP within one year. If continued for six years, the debt-output ratio would have risen from 19 percent to 52 percent of GDP! This clearly highlights the fact that internal debt issue should be avoided at almost any cost in the current situation in Mexico.

---

[4] This is the deficit reduction required (with respect to the 1988 fiscal deficit) for consistency with a 20% inflation target.

The final exercise demonstrates the extent to which high real interest rates are at the root of Mexico's current fiscal problems. Table 2 shows the equilibrium inflation rate, i.e. the inflation rate for which no fiscal adjustment is required, for various real interest rates on Mexico's internal debt. All this on the assumption that no net increase in the nominal value of the foreign debt is allowed (i.e a zero external current account deficit for the public sector).

Table 2: EQUILIBRIUM INFLATION AND THE REAL INTEREST RATE ON INTERNAL DEBT

NO REAL EXCH.DEPRECIATION; CAD=0; OUTPUT GROWTH 1.5%				
REAL INT.RATE ON DOM.DEBT R	30	15	10	
EQUILIBRIUM INFLATION p	150	22	0	

At the current interest rate, the required deficit reduction is 3.1 percent of GDP; alternatively, an inflation rate of 150 percent is needed to cover this amount through inflation tax. At a more reasonable 15 real interest rate, the erquilibrium inflation rate, for which no fiscal adjustment is required, falls to 22 percent! At a real interest rate of ten percent, the equilibrium inflation rate falls to zero. Note that as inflation rises, additional revenue from inflation tax falls, necessitating increasingly larger increases in inflation to cover a given increase in the operational deficit. This is because at higher inflation rates the elasticity of money demand increases, thus lowering the additional marginal revenue that a given increase in inflation rates yields as inflation rises.

There is probably no option other than assuming that high real rates on internal debt are there to stay for several years and adjust fiscal policy accordingly. The risk of a self-fulfilling prophesy run on the Peso if fiscal policy were to be based on the assumption of substantially lower real rates is too great.One option could help in the mean time and was tried with success in the UK a decade ago. The Thatcher government inherited an inflationary economy from its Labour predecessors, amid widespread doubts that the conservatives would be able to reduce inflation. After all a previous conservative government had failed to do so also. Faced with expectations of continued high inflation on the one hand and a stubborn determination to bring down inflation anyhow, the Thatcher government chose one obvious solution to the problem of high real rates during a stabilization program. It started to issue indexed debt, with principal repayments linked to the consumer price index. Since the return on such a debt instrument is not affected by surprize inflation, the component related to inflationary expectations and the inflation risk premium disappeared from the real rate. This greatly lowers the cost of funding the public sector internal debt.

There are problems with such a proposal, in particular if it would lead to further demands for indexation in the economy; on the other hand it could get the public sector out of the transitional stranglehold caused by fear of renewed inflation and devaluation and its suffocating effect on Mexico's public finances.

B.2 Sustainability of Current Policies

The analysis has until now focused on the revenue the government can expect from various sources of financing given its macroeconomic targets. Reducing the fiscal deficit to what is financeable given those macroeconomic targets makes sure that the fiscal policy is at least sustainable. If this adjustment is made, achieving the stated macroeconomic targets will not be jeopardized by fiscal crises, high inflation or escalating interest payments. However, it does not guarantee that those macroeconomic targets can or will be achieved; only that the fiscal deficit is not inconsistent with them. Whether the targets can be achieved depends on two major factors. First, are the fiscal measures themselves sustainable? Second, will the private sector in fact generate a sufficiently large surplus of private savings over private investment for the economy to achieve its external targets, given the fiscal deficit? Moreover, this surplus should be achieved at sufficiently high levels of investment to meet output growth targets given the public investment program. The remainder of this Section focuses on the sustainability of current levels and patterns of government expenditures and revenues. The second set of issues is addressed in the next Section, Section C.

B.2.1 Public Sector Revenues

The dominant factor on the public sector revenue side is of course the precipitous decline in oil revenues. Sales from oil exports fell from a peak of 10.8 percent in 1983 to 5.9 percent in 1987 and 3.5 percent of GDP in 1988. Moreover, the decline in oil prices towards the end of 1988 is likely to reduce that amount further to 3% of GDP if the average price of Mexican oil stays around its current value of $10 per barrel, down $5 dollar compared to expectations at the beginning of the year.

The decline in oil export revenue exactly equals the overall decline in public sector revenue, with a decline in sales by other state enterprises matched by a strong increase in tax revenues. There is of course little one can do about oil prices, and the other public enterprises will be covered below under expenditures and transfers. However a closer look at the tax system is useful, both for revenue reasons and from efficiency perspective (for a more detailed account than provided below, see ANNEX II.A).

Taxation in Mexico

By international standards, Mexico has had and still has a low ratio of tax revenue to GDP. In the fifties and sixties, this was supported by a stringent fiscal conservatism that kept the size of government low. During the strong expansion of the mid-seventies and early eighties, oil revenues and recourse to foreign borrowing made up for inadequate tax revenues. With both of these sources in steep decline, improving the tax system has taken on a new urgency.

Indirect taxes are in fact not low by international standards. Mexico has a well functioning VAT. VAT collection has improved over the past two years, mostly because of administrative changes that gave the states, who administer this tax, stronger incentives to enforce compliance and improve collection. This was done by reducing unconditional revenue sharing in return for a share in the VAT collected by the states themselves. The success of introducing incentive compatibility in tax collection strongly suggests that similar schemes should be tried elsewhere.

A prime candidate for such a scheme would be the property tax. There is an extensive system of property taxation in Mexico, covering both rural and urban areas. Revenues from it have declined precipitously over the last decade, however. This is one of the main reasons (the other being incomplete cost recovery on municipal services) that own sources of revenue of state and local government have fallen by no less than 60% in real terms over the last six years. At issue is not so much raising rates or coverage, but updating of cadastral records, reversal of the real erosion in assessment values and improvement in collection effort. As to the first, BANOBRAS has offered an update of the cadastral system; this has not been pursued by the municipalities that are by law responsible for this tax.

The reason for this is the second problem with the property tax, a serious incentive problem in the way collection has been organized. To have this tax handled by municipalities probably reduces the distance between taxing agency and tax payers too much for comfort of the collecting agency. A reform that would provide the states with incentives to collect this tax in the same manner the VAT collection was handled is worth studying. Detailed analysis is presented in the appendix dealing with taxation, but rough estimates suggest that at least 1 percent of GDP can be expected from this source. Moreover, while nation-wide implementation of the necessary reforms would necessarily be a time consuming process, an important component could be set in motion at short notice. The cadastral system for Mexico DF is in fact in good shape, so there property taxes could become an important source of revenue relatively quickly. From a social point of view, using property taxes as a major additional source of revenue would also soften the distributional impact of the fiscal retrenchment and fall in real wages of the last few years.

Of the remaining indirect taxes, excise taxes are up strongly, mostly because of a substantial increase in the price of gasoline, which is now sold approximately at world prices. Revenue from trade taxes has halved, however, from 0.8 percent of GDP in 1987 down to 0.4 percent in 1988 as a consequence of the accelerated pace of the trade liberalization. No increased revenue can be expected from this source without jeopardizing the trade reform.

In the area of direct taxation there is much more room for reducing efficiency costs and improving revenue collection. This is especially true for the personal income tax. Mexico derives only 2 percent of GDP from personal income tax, while countries like Chile or Turkey levy more than three times more as a share of GDP, without having higher rates. The personal tax system in Mexico is a bewildering array of exemptions, rates, administrative procedures and different rules for different types of income and different types of taxpayers. The system continuously changes under a barrage of ad hoc adjustments and rule changes. This has not only produced a patchwork tax structure, but also introduced an element of uncertainty in the tax structure. The resulting system is to complex to even attempt to summarize it here (see the annex covering taxation for a description). Problems involve exemption of a substantial part of labor income by not taxing fringe benefits; existence of extensive shelters for capital income; in general insufficient coverage of sources of income where witholding is not possible; and the existence of many deductions and exemptions. In addition, many administrative problems exist. These are covered extensively in the taxation annex.

Remaining problems involve the interaction with the corporate tax system. This is curious, since Mexico has an integrated tax system, with dividends paid out exempt from corporate taxation. This avoids double taxation of dividends and makes it unnecessary to pursue progressivity through the corporate tax, a virtually impossible task. In spite of this elegant set up, problems do exist. The first one involves the asymmetric taxation of capital gains on stock market transaction under corporate and personal income tax. Capital gains (and losses) are part of taxable income for the corporate tax when realized, but exempt from personal income taxation. This clearly opens up a wide loophole through which taxation of profit income can be avoided. A proper incorporation of inflation adjusted capital gains and losses into the definition of taxable income under the personal tax code is clearly advisable. This would reduce the discrepancy between the tax base under the two direct taxes and thus reduce the possibilities for tax avoidance.

Another problem is related to the level of the top marginal income tax rate. This rate is, at 50 percent, substantially above the corporate tax rate. The latter has, in line with recent tax reforms in the USA, be reduced to 35 percent. Large differences between top marginal income tax rates and the corporate tax rate always create problems of tax avoidance. An additional problem is related to the fact that the top marginal income tax rate is applied as a witholding tax rate on all dividend income paid to non-residents, independent of whether the dividend is transfered to individuals or corporations. For the latter, a problem arises because of the excess of the witholding tax rate over the corporate tax rate in the US. Because of this difference, corporations can not fully credit tax payments in Mexico against US tax liabilities over the same income when it is repatriated towards the US. Recent tax rules in the US have exacerbated this problem, which could by now become a serious obstacle to additional foreign investment.

Lowering the witholding tax on dividends paid to foreign firms below 50 percent would solve the problem, but has met with strong resistance in Mexico. An alternative would be to lower the top marginal income tax rate. This would, oddly enough, also improve the distributional impact of the basic income tax exemption; the steeper the progressivity, the more an income tax exemption becomes valuable to rich, high-marginal tax rate tax payers rather than to poor, low tax rate payers. The distributional impact of lower marginal top rates could in fact be softened by replacing a whole array of exemptions altogether by a tax credit. This has equal value to all tax payers with sufficiently large tax liabilities to use the credit. So as not to penalise tax payers with temporarely low income, a tax credit carry over facility is necessary, preferably with market interest rates paid on the credits carried over.

These two interaction problems are caused by flaws in the structure of personal income taxation, not in the corporate tax arrangements. The corporate tax system in Mexico is modern and well designed from an economic point of view. It was recently reformed, among other things to eliminate the distortionary effects inflation typically has on the choice of bond versus equity financing. There are two remaining problems, one structural, one more from a temporary nature. The structural one is the fact that agriculture, fisheries and transport are effectively not covered by the corporate tax. Bringing these sectors into the corporate tax net would bring in potentially substantial revenue gains. An argument can be made to exempt small farmers, for equity and administrative reasons; however now agriculture has become a tax shelter for the rich, clearly an unintended and undesirable situation.

The second remaining problem is temporary because it is linked to the transition regime between the old pre-87 regime and the new one established at that time. During the transition, firms have to calculate taxable income under both systems, apply the old 42% tax rate to the old base and the new 35% to the new tax base. Overall tax liabilities are a weighted average of these two liabilities, with the weight sliding by twenty percentage points each year in favor of the new system. Part of the new regime is a general, non-discriminatory very well designed investment incentive. Investors are allowed to deduct the discounted value of all future (indexed) depreciation deduction up front in lieu of these future claims. The real discount rate is consciously set below the market rae at 7.5% in real terms. As long as market rates are above 7.5% real, the scheme involves an investment tax credit. This credit rises and falls with rises and falls in market real interest rates; it also tends to automatically abolish itself as continued capital accumulation and growth push down the marginal productivity of capital and real interest rates. But the transition arrangement makes this scheme effectively inoperative, because the benefits of the discounted accelerated depreciation schedule will be scaled back by the weight on the new regime in that tax year.

Given the importance of renewed private investment growth for Mexico's growth potential, a strong argument can be made to accelerate the introduction of the new schedule. This would raise the effectiveness of the new accelerated depreciation scheme, which will have a considerable impact on private investment. The motivation for a gradual transition is anyhow weakened, since entrepreneurs have dramatically reduced their corporate debt in response to the tax reform and high real interest rates. Also inflation is now down substantially, reducing the implicit tax subsidy for debt finance embedded in the old system. Finally it would greatly reduce the administrative burden on the tax payer if a single set of books could be held.

Taxation: a Summing Up

In the long term, the potential for increased revenue from taxation is substantial in Mexico. If international comparisons are anything to go by, a comprehensive income tax reform could double or triple the revenue from personal income taxation. Such a reform should focus on increasing coverage, simplification, greatly reduced deductions and administrative improvements. However, in the short term only the revamping of the property tax offers possibility of significant revenue improvement. Some estimates put its potential at around one percent of GDP. Against that should be set the likelihood of reduced corporate tax revenues if the accelerated depreciation scheme becomes fully operative. Of course some of the cost of this scheme will be recovered through reduced depreciation deductions in the future, but by the very nature of the scheme, the discounted value of the changes is negative. This could lead to a first year revenue shortfall of close to half a percent of GDP, reducing the net gain in tax revenue to about half a percentage point of GDP. This is about the anticipated shortfall in oil export revenues if the oil price stays at $10 p/b. A cautious approach would therefore assume no net increase in total government revenues, with a possibility of a shortfall if the property tax does not get off the ground and oil prices stay low.

There seems substantial room for improvement in tax administration. Estimates about potential revenue gains from improved tax administration are hazardous at best. A cautious approach would be to discount any gains until the improvements are in place and can be seen to work. In fact the administrative changes suggested in the annex serve another purpose other than realizing revenue gains. Simplification, reducing the cost of compliance and reducing the cost of control, enforcement and administration are important objectives too, although they do not show directly in improved revenue figures.

B.2.1 Public Sector Expenditures

Since 1982, a major retrenchment of public expenditure has occurred of a dimension unprecedented in Mexican terms if not for most developing countries. Non-interest spending has declined by 45 percent in real terms, and, in relative terms, to 19% of GDP, a level last observed in the early 1970s. However, the composition of cutbacks was, perhaps, not ideal from the standpoint of growth. Real investment and maintenance expenditures, particularly in agriculture, oil, and basic infrastructure, were cut more deeply--by roughly 60% in real terms--whereas other current spending declined by roughly a third. As a result, infrastructural bottlenecks in areas such as roads, communications, urban services, and skilled manpower availability could impose severe constraints on the sustainability of growth as the economy seeks to recover the 4-5% per annum growth rates considered necessary to create enough jobs while permitting depressed living standards to recover. Moreover, considering the sharp real cuts in public wages, on the order of 46% over the past six years, and smaller, but still sizeable reductions in outlays on current goods and services, the adjustments in current spending have also had adverse effects on future growth potential, since capable civil servants are now beginning to abandon public service in growing numbers and the productivity of those who stay is being hampered by the scarcity of even basic materials needed to carry out their duties--paper, photocopiers, telephones, gasoline for rural extension vehicles, medical supplies, etc.

A detailed analysis is provided in ANNEX II.B, but the following sections discuss key issues surrounding public expenditure: (a) Government planning and budgeting procedures, (b) Public sector employment; (c) Satisfaction of social needs; (d) Parastatal finances; and (d) State and Local finances. Finally, some ideas for the 1989 budget are presented.

Goverment Planning and Budgeting

The deep and sustained cuts in public investment have meant that few new projects have been initiated over the past six years, with the result that a steady erosion of the institutional capacity to plan, prepare, monitor, and evaluate projects has taken place, both in the Secretariat for Programming and Budgeting (SPP) and in the line ministries managing sectoral investments. In addition, in the absence of a multi-year budgeting system, the government was lacking an essential instrument in the current "sexenio" for introducing efficient and balanced cut backs in public investment levels. As a result, it was difficult to protect ongoing programs in such a manner as to minimize the economic cost of postponing the completion of new investments initiated earlier and deferring maintenance expenditures.

The following actions are recommended to strengthen investment planning in three key areas: development of a project evaluation evaluation methodology for public sector projects; creation of a decentralized pre-investment fund and a central review unit charged with the tasks of enforcing the eligibility criteria for public investments, overseeing the preinvestment and budgeting activities of sectoral and line agencies; and greater involvement of the private consulting industry in preinvestment studies.

In the general area of budgetary procedures, it is advisable to develop and implement a system of multiyear investment budgeting separating qualifying projects into "core" priority investment which would be protected from fluctuations in budgetary availabilities, and secondary projects which could be subject to interruption.

In the area of project implementation, the main proposals are: changes in the implementation procedures for externally financed projects so as to accelerate the drawdown of foreign currency financing; and the posible creation of a Monitoring Unit for Externally Funded Projects to confirm physical implementation, the drawdown of external funds, and the timely release of required local counterpart.

Public Sector Employment

Between 1975 and 1982, public sector employment grew at an average annual rate of 8.1%, nearly three times faster than the rate of private sector job creation during that period. Since 1982, the expansion of public employment has slowed dramatically to 2.9% annually, although this was still significantly faster than the comparable rate of private sector job growth of 1.4% annually. Indeed, by 1988, about one in every five jobs in the economy was located in the public sector, up from one in seven jobs in 1975. And if the growth of temporary employment, now as much as one-quarter of total parastatal employment but not counted in official employment data, were taken into account, this ratio might be even higher. More to the point is that real non-interest public spending has contracted by 45% since 1982 while the size of the permanent public work force has expanded by nearly one-fifth. As a result, overall productivity appears to have suffered significantly, as the complementary spending on basic goods and services-- textbooks for teachers, transportation for extension and health workers, medical supplies, etc.--has had to be stretched over a larger number of employees. Similarly, a shrinking real public payroll, now about one-third smaller than in 1982, has also been diluted, resulting in an even sharper plunge in the average real public salary, in terms of the CPI, on the order of 46%. Adverse selection, meaning the voluntary departure of many public employees with the best skills and work habits precisely because they do have the best job options in the private sector, is now a serious problem. It has begun to affect many ministries and agencies in the Central Government and some of the autonomous agencies and parastatals, notably the nationalized commmercial banks. A graphic example has been the growing delays in issuing key economic and social statistics. The National Statistics Institute (INEGI) recently issued the first advance reports on the results of its 1983-84 income and consumption survey. The five-year delay was caused in part by the loss of computing facilities during the 1985 earthquake and by the decentralization of its staff to an outlying state, but also by the constant turnover of economists and computer specialists able to earn two to three times more in the private sector.

Clearly, there is a need to upgrade real public wages selectively to retain competitiveness with the private sector for vitally needed skills as well as to raise budgets for vitally needed equipment. But a real increase in non-interest current spending sufficient to fund significant near-term improvement in wages and working conditions seems unlikely. On the other hand, a significant improvement in labor productivity could be achieved through an orderly reduction in the size of the public work force accompanied by a reallocation of current spending toward complementary purchases of materiel and supporting services. Higher productivity would allow for gradually improved wages and benefits consistent with fiscal discipline.

The Government is currently promoting a number of new programs intended to address the humanitarian problem of the large number of employees who, for reasons of age, family situation, or other personal circumstances, wish to leave public service. The three principal programs are the voluntary early retirement program, the regular retirement with bonus program, and the reduction of job slots through attrition. Together, these three programs had resulted in the elimination of nearly 60,000 job slots during 1988, mainly in four secretariats of the Central Government (SPP, SHCP, SARH, AND SCT). This was offset by a roughly similar increase in hiring, mainly of new teachers, the sectors where the bulk of new hiring has taken place during the most recent sexenio. Next year, the Government expects to increase the early retirement program from roughly 40,000 to 60,000, so that, added to the bonus retirement and job attrition programs, the number of outgoing employees may slightly exceed new hires, thereby producing a small decline in the size of the public work force for the first time in many decades.

Satisfaction of Social Needs

As result of economic growth and sustained social commitment of the government, the Mexican population have enjoyed a continuous improvement of its well being over the last 50 years. During the sexenio 1983-88 further progress was made in expanding services to satisfy basic needs and in improving efficiency through better management and -in some cases- substitution of targetted for general subsidized welfare programs.

Achieving the Government's goal of eradicating extreme poverty involves dealing with two main issues: (a) To improve the efficiency and effectiveness of the existing infrastructure and resources of the social delivery systems to raise -at a reasonable cost - the quality of the services provided to the population already covered; and (b) To further expand the services. To deal with these issues a two-tier strategy could be consider. This strategy would simultaneously aim at: (a) Consolidating the sectoral delivery systems that already provide for the social welfare of the population in most of the states with a well developed infrastructure; and (b) Building the regional infrastructure and expanding services as needed to provide a minimum of welfare to the population in dispersed rural areas of the most backward states.

Strengthening Parastatal Finance

A review of public sector prices suggests the need to adopt different criteria to judge their appropriateness, depending on whether their outputs are internationally tradeable goods or not. Moreover, the impingement of the

Economic Solidarity Pact requires a separate discussion because of its strong simultaneous impact on parastatal costs as well as prices. During the period of January 1984 to July 1988, prices of public non-oil manufactured tradeables (coal, iron ore, sugar, fibers, petrochemicals, fertilizer, and steel) have fallen as much as 28% below prices of comparable international goods during the first quarter of 1987, when a rapid real depreciation of the exchange rate was taking place, but have moved much closer to international prices since the introduction of the Pact, reflecting up front domestic price adjustments of from 22-85% during December-February 1988, followed soon thereafter by a freeze of the nominal exchange rate. As of July 1988, the domestic prices of these tradeables were about 10% below international levels, a comparatively modest divergence. As for domestic prices of oil-based products, including excise taxes, these were set at approximately U.S. retail prices for gasoline and natural gas, and somewhat lower (by anywhere from 20-40%) for cooking gas and related oil by-products. However, on average, they were well under half of European oil prices, reflecting mainly a large difference in the size of applicable excise taxes.

On the other hand, the key question for non-tradeable parastatal prices is whether they are adequate to cover long run marginal social costs. While detailed case-by-case studies would be needed to determine these costs for different parastatals, comparisons with 1970 base real tariff levels suggest potentially serious shortfalls, ranging from 50-80%, for four key products--electricity, water, urban transport tariffs in the Federal District, and train passenger fares.

In fiscal terms, the parastatals as a group still absorb a proportionately excessive share of federal resources to cover operating costs. At first glance, this would appear not to be the case, since transfers earmarked to cover operating losses are estimated at only 0.11% of GDP in 1988, less than half the level recorded in 1985-86. However, much of the financing of overhead costs overhead was transferred to the books of the Central Government during 1986-87. Also, extensive credits have been provided by Public Sector Financing Fund (FFSP). Once this is taken into account, the drain of transfers to cover current parastatal losses has diminished modestly from 2.6% of GDP in 1985 to an estimated 2.1% in 1988. Furthermore, some recovery in real parastatal investment is likely to be needed in the future if they are to remain viable enterprises; moreover, the bulk of the investment that does take place is currently financed through a combination of borrowing and federal government capital grants. Considering all that, some upward adjustment of relative parastatal prices would appear to be required in the not-too-distant future.

State and Local Government Finances

States and municipalities have benefitted enormously from a sweeping tax reform in 1980 which consolidated a number of tax bases shared by local, state, and federal governments into a single revenue sharing system. The efficiencies of consolidation have resulted in a significant increase in revenue sharing, which rose from 1.5% of GDP in 1978 to an estimated 3.0% this year, constituting roughly 11% of federal revenues and over 60% of state and local income.

Unfortunately, as revenues from tax sharing increased, state and local governments' own tax-raising efforts have seriously deteriorated. For example, in the four years preceding the 1980 tax reform, real estate tax collections increased by roughly 29% in real terms, in line with a cumulative GDP increase of 27%, whereas during the four years following this reform, they declined by 61% even though GDP grew by a cumulative 5%. Although data on municipal and state finance beyond 1984 is not yet available, the prospects for future property tax collections may have worsened as a result of the decision to increase the share of real estate taxes transferred to local governments from 15% to 100%, while leaving the responsibility for collection in the hands of the states. In the first year of this new experiment, property tax collections declined by 40%, as the states appear to have largely lost interest in enforcing its collection. At present, the ratio of property tax collections to GDP in Mexico is by far the lowest among the larger Latin American countries at a mere 0.1%, compared to 0.3% in Brazil, 0.4% in Colombia, 0.7% in Peru, and 1.5% in Argentina.

The state of user fee collections tells a similar story. In the four years prior to the revenue sharing reform, collections remained approximately unchanged in real terms, whereas from 1979 to 1984, they declined by one quarter, with charges for water and sewerage declining by 40% in real terms. This was about one-third larger than the decline in real wages, and eight times larger than the fall in real per capita national consumption.

The deterioration in user charges and property taxes appears to have been most serious in the Federal District, where non-tax revenues declined by 7% annually , compared to 5.1% annually in the other municipalities. The situation with water and sewerage is illustrative. With tariffs ranging from 151 to 743 pesos/cu. mt. of water for various categories of residential and industrial consumers during early 1988, the theoretical average tariff of 317 pesos/cu.mt. was substantially below the estimated average cost, including sewage treatment, of 639 pesos/cu. mt., and farther still from the estimated marginal cost of around 1239 pesos/cu.mt. What made this dismal revenue picture even worse is that an estimated 94% of all users did not pay according to the tariff structure, but rather a fixed charge of around 5000 pesos monthly, the equivalent of only 16 gallons of water. This was because water service was metered in less than half of all locations served, and many of the existing meters were either inoperative or not read. As a result, it is estimated that users in the Federal District pay only about 6% of the true costs of supplying water, often from distant locales, distributing it, and treating it, with a cost to the Federation of well in excess of 1% of GDP. A similar situation exists with respect to charges for the District's urban transport system. Tariffs charged cover only about one-third of the marginal cost of a ride on the metro, and only about one-fifth of the marginal cost of a bus ride, and are substantially below the cost of urban transport services offered in major provincial cities. The District's overall deficit in 1988 is estimated at about .6% of GDP and it is likely to increase to about 1.6% of GDP in 1989 unless increases in real user charges and tariffs take place.

The following actions are recommended:

(a) Preparation of revisions to the revenue sharing formula so as to give added weight to efforts by states to increase property tax collections and user charges as well as efforts to introduce similar incentives for their municipal government

(b) Gradual elimination of non-matching grants for investment and regional development in those states and municipalities able to service Banobras credits on non- subsidized terms;

(c) Revisions to the Financial Restructuring Agreement with the Federal District requiring it to accelerate its new program of installing new water meters and privatizing the reading and collection of bills due, together with tariff increases (the Pact permitting) and tightened property tax collections sufficient to substantially raise real own resources.

Investment Requirements to Restore Growth and Meet Social Needs

The restoration of growth will require a minimum increase of about 1% of GDP in public sector investment in 1989. The major real investment increases are required in agriculture, ecology, transportation, energy and the social sectors in the 1989 budget. This would imply a 25% real increase in investment during 1989 and a roughly 74% real increase by 1994 vis-a-vis 1988 real levels. As a share of GDP, public investment would rise from 3.5% of GDP in 1988 to around 4.5% in 1989, and 6.2% by 1994, which in relative terms, would bring non-oil public investment back up to around 5% of GDP, i.e. back to the moderate levels of the late 1960s. Investments in petroleum, at little over 1% of GDP, would show little real growth over the sexenio, and would remain well below the real levels of the late 1970s and early 1980s. The needs of these sectors are sumarized below:

Agriculture: Real agricultural investment has fallen so far and so quickly that a number of high-return projects remain uncompleted for lack of comparatively small additional investments. Half of the suggested real investment would be devoted to completing these projects, and the bulk of the remainder to reducing a huge backlog of deferred maintenace, to carry forward drainage and other rainfed projects, and to advance urgently needed flood-control and related emergency programs. During the remainder of the sexenio, these programs would require an average of about 1.6 trillion pesos, or three times the real level of 1988, equivalent to about 0.4% of the 1988 GDP.

Ecology: The backlog of air pollution, sewerage treatment, and water supply problems were recently estimated at roughly $ 17 billion for water supply and treatment problems alone, with the costs of cleaning up the significant air pollution in Mexico's major cities and chemical contamination of the subsoil and ground water unknown, but likely to be at least as large. Presently, the public sector spends an estimated $ 260 million dollars annually for all ecology-related purposes, with the Federal Government responsible for over 80% of this amount. Although emergent environmental policy is expected to put growing emphasis on the contribution of private sector polluters to correcting the problem, the speed and size of this private sector response remains very much in doubt. Meanwhile, of the 200 or so existing water treatment facilities in urban areas, about 80% are in urgent need of rehabilitation and modernization. The proposed increase of 65% in Federal spending would represent about 0.1% of GDP, and would mainly permit some of the most critical water sanitation problems in the three major urban areas to be addressed.

Transportation: An increase of roughly one-fifth in transportation investment is recommended for 1989, to the equivalent of 0.9% of GDP (an increase of 0.1% of GDP with respect to 1988), chiefly to support the rehabilitation and deferred maintenance of the highway system and the modernization of the railways (The proposed budget assumes that the program for private sector involvement in toll roads is successfully implemented, otherwise the budgetary increase should be higher).

Energy: An increase of about 16% in public investment in power generation capacity is recomended. This should be complemented by the introduction of an adequated tariff structure which should induce a better utilization of the installed capacity (peak load pricing, etc)

Social Sectors: Increases in educational investment should be directed to the initiation of a primary school outreach program in four to six of Mexico's most educationally-deprived states. In health, there is a need of additional resources for medical supplies and the maintenace of buildings and equipments.

B.5 Budgetary Implications for 1989

The revenue implications of the recommendations discussed above are presented in the Table below. The estimates presented there indicate an improvement in the operational deficit of around 0.4 percent if the oil price stays at ten dollar, and an improvement of 1.0 percent if oil goes back to $12.-. At a two percent current account deficit, consistency requires a one percent improvement to support a 15% infation target. The proposed measures will bring this further one percentage point reduction in the deficit about if the average oil price reaches an average of $12.- in 1988. $12 would be down from a 1988 average of $12.3 but up from the $10 of October-November. In later years, the fiscal situation should improve: by that time more can be expected from the tax reform measures suggested in the report and under consideration in Mexico.

<u>Additional Public Expenditure Recommended in 1989</u>
(percentages of GDP)

Investment				+0.9
Infrastructure	+0.5			
Agriculture	+0.1			
Environmental	+0.2			
Energy		+0.1		
Current				-0.2
Targetted social services (basic education,health, community water supply and sanitation programs		+0.2		
Increase in public sector salaries (4% real)	+0.2			
Phasing out of Transfers to BANRURAL, ANAGSA		-0.6		
<u>Total Increase in Expenditures</u>			+0.7	
<u>Additional revenues in 1989</u>				
Oil Revenue Loss (assuming $10 p/b)		-0.6		
Increase in Federal Tax Revenue			+0.3	
inv.tax credit		-.45		
Bring agriculture and transport in the corporate tax	+0.75			
Increase in state and local cost recovery and tax revenue (watercharges, increases in property tax assessments, updating of cadastral system)			1.0	
Additional Non-Tax Revenues				
Increase in Federal District				
20% gasoline tax	+0.2			
20% incr. in water pr.	+0.1		+0.3	
Increase in average parastatal prices				+0.1
<u>Total Increase in Revenues</u>:		1.1 (1.7 with $12 p/b oil)		

C The Outlook for Growth

The central question to be answered in this section is whether external restraint and consistency requirements for fiscal deficits leave enough room for public and private investment and satisfactory output growth. Can external balance and output growth be reconciled, or is there an inherent conflict between the two? This section provides projections with an econometric model presented in Annex I that assist in answering this question.

The core question in devising an external debt strategy is whether to opt for a growth-oriented strategy within the constraints sustainability of foreign borrowing imposes, or to rely on high surpluses on the non-interest current account to keep the debt-output ratio in check. The record of the past six years in most of Latin America has shown that the second option inflicts tremendous social costs in terms of lost output growth without resolving the debt problems; gains due to trade surpluses are mostly eroded by the impact of high foreign real interest rates and low growth rates. The first strategy will therefore need to be at the basis of policy design for the next six years.

The key factor determining the success of such a growth-oriented strategy is an internal adjustment program that relies sufficiently on reduced consumption rather than reduced investment to generate the internal surplus that is required. If consumption does not fall, either external targets or output growth will need to be sacrificed; the former if investment is not reduced and the latter if it is.

The central question thus is whether external restraint and consistency requirements for fiscal deficits leave enough room for public and private investment and satisfactory output growth. Can external balance and output growth be reconciled, or is there an inherent conflict between these two objectives?

It is here that the interaction between private sector savings and investment decisions and fiscal policy becomes important. The way consistency between internal policies and external targets is brought about determines whether fiscal plans and external targets can both be met without jeopardizing output growth: does the private sector run a surplus at high levels of savings and investment or at low levels? If the surplus is achieved by increasing savings for sustained investment levels, output growth can be maintained. If however the adjustment comes mostly out of investment cutbacks for given private savings rates, external adjustment is bought at the cost of lower output growth.

This Section focuses on the role that fiscal policy and real interest rates can play in bringing about these developments. There are several channels through which fiscal policy influences the size of the private sector's net savings surplus, and the level of investment at which any given surplus is acchieved. First, fiscal policy may exert a direct influence on the net private savings surplus through real interest rate-based crowding-out. The overall fiscal deficit is important for this channel.

But if high real interest rates are maintained to create the room for higher fiscal deficits without a matching current account deterioration, how can output growth be maintained? High real interest rates presumably slow down at least private investment, thus slowing down output growth. Fiscal policy can play a role in avoiding such a slowdown in two different ways. The first one focuses on policy instruments that to some extent will focus the effect of high real interest rates towards consumption restraint while shielding private investment. Investment incentives, tax measures and credit policy all play a role here. Second, output growth depends on aggregate investment, not just on private investment. There is therefore a role for public investment in reconciling external balance and output growth. Government investment itself results in capital accumulation. So negative output effects of fiscal deficits through real interest-based crowding-out of private investment can be offset to some extent by shifting the composition of government expenditure away from consumption to investment. The composition of government expenditure, and not just the overall deficit, is an important part of a successful internal adjustment program.

In addition to this direct substitution effect there is a more indirect channel through which the composition of government expenditure influences private investment. Public sector investment, especially in infrastructure, often stimulates rather than replaces private investment expenditure. Public sector investment in, say, roads will make investment more attractive for the private sector in places that were inaccessible before. This effect is difficult to quantify; however it suggests that carefully targeted increases in public sector investment in areas of complementarity with the private sector should be part of the public sector's program.

C.1 Private Savings, Investment and the Current Account: Is There Room for Growth?

The base case starts from an assumption of moderate (2 percent of GDP) current account deficits over the next two years. This is a slight improvement over the likely outcome in 1988, and should not be impossible to finance (see Chapter IV, where this issue is taken up). It constitutes less than half of the interest due and would result in a fall in the real value of the debt at projected world inflation rates. From 1992 onwards, we presume slight widening of the CA deficit to three percent of GDP. This is roughly compatible with a constant real value of the external debt and a falling debt-output ratio, as by that time growth will be gathering steam.

It is also assumed that fiscal corrections necessary for consistency with inflation targets will in fact be implemented. The non-interest surplus will by assumption average around seven percent for most of the period, down from 7.6 percent in 1986. This is below consistency requirements in the first two years when real interest rates are likely to stay high, but above what is necessary towards the end of the sexennio when real rates, if all goes well, should drop to a more reasonable risk premium over foreign real rates. Real rates are assumed to stay at 30 percent in 1989, to fall to 20 percent in 1991 and 10 % from 92 onwards. The operational surplus will thus recover from its likely three percentage deficit in 1988 and a projected deterioration in 1989 to approximate balance by the end of the sexennio.

Private consumption is expected to slow down as a share of GDP somewhat next year, and recover the lost ground later in the sexennio. [5]/ As to public investment, it is assumed to slightly fall in 1989 due to budgetary restraint, but gradually recover thereafter. This yields public investment of 5 percent of GDP in 1990, climbing to 6.5 percent at the end of the sexennio. What happens to total investment and thus output growth depends on private investment behavior. This in turn depends on real interest rates and the tax policy followed. Without any tax credit, investment is projected to slow down under the impact of continuing high real interest rates, down by almost two percentage points of GDP in 1990 compared to 1988. As a consequence, total investment falls by a percentage point of GDP in 1989, but gradually recovers

---

[5] The projections discussed in this chapter have been generated with the help of an econometric model described in Annex I.

thereafter to reach 18.5 percent of GDP towards the end of the sexennio. This is up from 15.4 percent in 1988.

This investment behavior will lead to a resumption of growth, but in a rather unspectacular manner. After a projected growth of 1.5 percent in 1989, output growth slowly climbs from 2 percent in 1990 to 3.7 in 1993 and 3.9 percent in 1994. Private investment, after dropping initially, will by then have recovered its 1988 value of around 12 percent of GDP under the influence of lower real interest rates. This implies that the main impetus will in fact come from government investment, which goes up by between two and three percent of GDP over the sexennio.

An investment tax credit along the lines of the one that is in fact on the books since last year will have a significant impact, especially in the early years where real interest rates are high (remember that the scheme has been constructed so as to give bigger credits the higher the real interest rate is). Private investment, rather than dropping by a full percentage point in each of the first two years of the sexennio now hardly falls at all in 1989 (down to 11.9% from 12.1 percent of GDP in 1988). After that a strong recovery follows as the tax credit reaches its full impact. Private investment reaches a peak of 14.1 percent of GDP in 1992 after which it tapers off slightly as the declining value of the tax credit more than offsets the impact of falling real interest rates. The end result is still a respectable 13.5 percent of GDP by 1994.

Since public investment is not affected by the tax credit, total investment will increase in line with private investment, to reach around twenty percent in the last three years of the Sexennio. As a consequence, real growth accelerates; it reaches four percent a year two years earlier because of the tax credit, in 1992 rather than in 1994. In the last two years of the Sexennio, the economy is projected to grow at a healthy 4.7 percent a year under this scenario.

Stronger investment performance under the same current account target requires of course higher private and/or public sector savings. The econometric model runs suggest that under this high growth scenario, private consumption will grow faster, but less so than GDP. As a consequence, private savings goes up to provide between half and one percentage point of GDP extra leeway towards the end of the sexennio. The remaining difference will need to be made up by fiscal improvement. An initial improvement of between 1 and 1.5 percent of GDP in the non-interest surplus is necessary to accommodate the increased investment by the private sector. The suggested longer term reforms in tax administration and the structure of personal income and property taxation take on an added importance inm this context. International personal income tax comparisons suggest that the asked for improvement in public sector revenue is not infeasible, especially when supported by further public sector pricing reform (in particular fertilizer prices, water and electricity).

What about debt and the exchange rate under all these scenarios? Net external debt decreases under both scenarios as a percentage of GDP, but faster under the high growth scenario. Without the investment tax credit, net external debt falls from 67 percent of GDP in 1988 to 56 percent at the end of the Sexenio. Under the high growth scenario it actually goes down to 54 percent of GNP by 1994.

The model assumed a constant real exchange rate throughout both periods. It produces an indicator of exchange rate imbalance. The ratio is the ratio of total demand for (non-oil) Mexican goods by foreigners (export demand) and by domestic residents over aggregate supply of Mexican goods. A decline below one suggests exchange rate misalignment. The model run suggests that exchange rates may in fact be a problem early in the program. The ratio is projected to drop from 89% in 1988 to 86% in 1989. After that the situation improves as increasing investment increases demand for domestic goods. Under the no-tax-credit scenario, the ratio improves rapidly after 1989 and actually reaches one by 1993. This suggests that growth in 1989 could actually be restricted because of low aggregate demand for Mexican goods at the current relative price (i.e. real exchange rate). A real devaluation would help avoiding this by shifting domestic and foreign expenditure towards Mexican goods; an issue is, however, whether under the Pacto a real devaluation can in fact be achieved.

The tax-credit-scenario changes the picture somewhat, but not much. With public sector adjustments assumed on the tax and transfer side rather tan real expenditure, aggregate demand for Mexican goods rises early on in this scenario under the impact of high investment growth. The balance indicator still falls in 89, but only to 87 percent. This is reversed towards the end as growth accelerates, increasing domestic supply, and investment demand tapers off somewhat.

A final comment on employment. The real wage was assumed to rise at 4 percent per annum, which, according to the econometric analysis, just offsets the autonomous increase in demand for labor for given GDP. However, with an estimated labor demand elasticity with respect to GDP of only 0.64 (cf Annex I), employment growth is only .7 percent for the first two years, and then climbs up gradually to reach two percent at the end of the sexennio. It is not clear that with this growth and real wage outcomes, the projected increase in the labor force can be absorbed into productive employment.

Four caveats should be stressed at this point. First of all, the scenario depends heavily on the actual implementation of substantial fiscal correction. There is no accurate information on fiscal budgets in 1989 yet, so nothing can be said on how likely this is.

Second, the scenario assumes that the bulk of the fiscal correction will come from current expenditure, subsidy cuts or tax increases. If the fiscal adjustment comes from public sector investment, growth performance will fall short of the base case projections commensurately.

Third, no further real depreciation of the exchange rate is projected beyond 1988. Exports are predicted to grow at 6 percent in real terms in this case. If instead a policy of real exchange rate depreciation would be followed, the debt-output ratio would increase faster due to the capital losses incurred after a real depreciation. Alternatively, more fiscal adjustment will be needed to offset this effect. The size of the trade-offs involved is discussed in Section III.B.

Fourth, the scenario assumes that the foreign financing necessary to cover a current account deficit of between 2 and three percent of GDP will indeed be forthcoming. This will require additional financing, since Mexico has just entered a period of substantially increased repayment obligations. The implicit assumption is that these can be refinanced, and that additional funds will be available to allow a current account deficit of two percent of GDP initially and of three percent later on. The implications for gross financing needs are discussed in Section IV. Of course, in the current external environment it is conceivable that aditional funds cannot be raised.

The next Section therefore considers what will happen if this additional financing will in fact not materialise.

C.2 External Financing, Output Growth and the Public Sector

Consider now the case where no external financing will be forthcoming, and Mexico simply runs a zero current account balance. The macroeconomic consequences will clearly depend on how the internal adjustment to this external shock will take place. Does the fiscal sector adjust one for one? and if so, through cuts in government consumption or cuts in public sector investment? The consequences for growth will of course be different under the two cases. An alternative would see no public sector adjustment at all; the government could force the entire adjustment on the private sector by increasing real interest rates. This would reduce private investment and consumption, but at the cost of greatly increased debt service on the public sector's internal debt, with attendant financing needs. Consider the public sector adjustment through cuts in public investment scenario first.

The external shock amounts to two percent of GDP initially, and three percent from 1993 onwards. By assumption, the entire first round adjustment comes from cuts in public sector investment. Of course public sector investment is cut to the bone under this scenario. It falls to an absurdly low 0.9 percent of GDP in initially, and never regains the three percent level assumed for 1989 in the base case. It hovers around 2.7 percent of GDP for the rest of the sexennio.

This clearly has a major impact on growth. Output growth slows down by one percentage point initially; as time goes by the fall in growth deepens to almost two percent by the end of the sexennio. On average over the next six years, growth declines by 1.5 percent of GDP, to reach only two percent at the end of the sexennio and less than that before. The slowdown in growth has a perverse multiplier effect on the need for public sectore adjustment. Slower growth leads to a fall in private sector savings, which requires a larger fiscal adjustment than would otherwise have been necessary. This explains why public sector investment falls not just by three but by four percentage points of GDP by the end of the sexennio, although the external shock never exceeds three percent. This of course also compounds the slow growth scenario.

Not surprizingly employment grows slows down too and never exceeds one percent in any year of the sexennio. Finally the exchange rate misalignment indicator drops too, on average by three percentage points. Without access to external funds a real devaluation becomes clearly unavoidable.

II.3 Conclusions

Without renewed access to foreign capital markets, Mexico faces a grim fiscal situation in 1989. Without a net nominal increase in foreign debt, a 15 percent inflation target requires no less than a three percent increase in the non-interest surplus for fiscal consistency. This is up from the already extraordinarily high 7.6 percent primary surplus in 1988. To put this in perspective, this would amount to a wholesale scrapping of the entire public sector investment program. In fact, the fiscal effort should be even larger than that; at unchanged policies the operational deficit is likely to worsen in 1989 unless there is a substantial turn-around in the international price of oil. Measures to offset this increase would come in addition to the three percent.

An adjustment this large would clearly be an almost infeasible task after the massive fiscal retrenchment of the past few years. Issue of indexed domestic debt could alleviate the fiscal problem caused by high domestic real interest rates; but another conclusion seems inevitable. As long as internal internal rates remain as high as they are, Mexico's fiscal problems are intractable without renewed access to foreign capital markets. But rollover of half or two thirds of foreign interest payments would bring a solution within reach.

But without such access, output growth would almost certainly be compromised, as the simulations have shown. With low growth, the funding policies of the public sector will be complicated immensely. Also, with low growth and a high resource transfer to foreigners, the real exchange rate would need to be devalued much further than would be necessary with a smaller resource transfer out of Mexico. Low growth because of insufficient access to foreign capital markets would thus also jeopardise the short term stability sought under the Pacto. Renewed access to foreign capital markets is thus not only imperative for restoration of medium term growth, but also essential for the chances of success of the current short term stabilization effort.

And the success of the Pacto itself is probably the most urgent precondition for renewed growth. There can be little doubt that a resuregence of inflation, abandonment of the exchange rate regime, possibly a forced reversal of the many trade and industrial reforms implemented over the past few years would prevent output growth for many years to come. The experience elsewhere in Latin America provides ample testimony to that. Any program for growth should therefore start with measures that allow the economy to emerge from the Pacto with the controls removed but its anti-inflation gains intact.

Price decontrol, like exchange rate policy, brings up an issue that is both the strength and the weakness of the Pacto, its concerted nature. Clearly, the fact that all the major actors in the Mexican economy were participants in the Pacto has been essential for its success. But the same concerted approach that made it work initially also makes it difficult to get out of it with anything less than a comprehensive package approach. The real wage is a particular stumbling block. The possibility to combine price decontrol or exchange rate realignment with for example improved targeted food assistance programs or lower payroll taxes deserves attention.

The increase in external debt implied by renewed access to international capital markets does not really threaten Mexico's creditworthiness. Even a three percent of GDP (appr. 5 bUS$) current account deficit per annum, with a corresponding increase in external debt, would simply keep the external debt constant in real terms. Thus the debt-output ratio would in fact decline even at moderate rates of growth. On the other hand, a cut-off from external capital markets, with the attendant short term stabilization problems and likely medium term slow down in output growth, would compromise Mexico's ability to service even its current debt. Thus, paradoxically, lending to Mexico would very likely increase the expected net repayment, in discounted value terms, rather than decrease it, the increased up front borrowing initially notwithstanding.

This conclusion depends of course very much on a continuation of Mexico's current reform program. The analysis has shown that continued fiscal stringency is necessary, even with allowable current account deficits of between two and three percent of GDP. The proposed TFL would support the implementation of a budget, and further monetary and fiscal policies, that would be consistent with these restrictions. Moreover, a policy package that will channel the additional spending such deficits allow towards investment rather than consumption is equally imperative. This would involve restoration of public sector investment towards levels compatible with a supportive role of the public sector in the growth process. The analysis has shown that this is feasible only if the drain on the Treasury from state enterprises is stemmed and certain tax measures, spelled out below, are taken. In addition, measures to facilitate private investment are advisable. These measures would involve changes in tax treatment for both domestic and foreign investment; the preceding analysis mentioned specific measures to reduce the marginal rate of capital taxation and harmonize the tax treatment of foreign investment with the US corporate tax system. In addition, changes in the current regulatory approach to foreign investment so as to establish general guidelines instead of the current case-by-case approach, would be advisable.

Two major issues remain: increased private investment is only possible on a sustained basis if the financial sector increases its intermediary role. This requires both structural reforms and reduced reliance by the public sector on the banking system for the government's funding needs. This is the subject of Chapter III. Finally, little is gained if additional investment is misdirected because of a distorted incentive structure. Mexico has of course made major progress in this area in the past few years. Chapter III covers trade and agriculture; industry and public enterprises are discussed in the corresponding supporting reports.

With foreign financing in place, and the internal reform program continued and deepened beyond the considerable progress already made, a cautiously optimistic prognosis seems justified. The analysis presented suggests that with all this in place, a recovery of growth is likely to start by the end of 1989, with positive per capita growth to be expected thereafter. Moreover, while this would require additional funding from abroad, Mexico's debt indicators are projected to decline substantially nevertheless. With a continuation of the Government's reform program, investing in Mexico promises a high pay-off.

CHAPTER III

FURTHER STRUCTURAL REFORMS

III.1 The Financial Sector

An efficient financial system can help the government's restructuring efforts by ensuring that credit, and hence investments and other resources, are put to their most productive use. The government has taken several steps in recent years to improve the financial system's efficiency: many failing commercial banks were restored to solvency through mergers and their capital increased since 1984, a part of their equity has been sold to help competition, laws governing money markets have been enacted, and distorted credits have been reduced. Other significant problems remain however. Commercial banks, the financial sector's most important intermediaries, have been forced to divert a substantial part of their funds to the government. This results from the need to finance a substantial although declining fiscal deficit domestically.

But not only macroeconomic problems affect Mexico's financial system. Although uncontrolled subsidies through directed credit have been declining in recent years, they could be further reduced and better targeted. Over-regulation, including controls on interest rates and preferential lending to favored sectors, has caused the private sector to turn to less regulated markets. Unregulated intermediation has been taken place at an increasing scale in response to the overregulation of the regular banking system. The main instruments are brokerage firms, but commercial banks too are increasingly engaging in off-balance sheet transactions. The emergence of a large unregulated intermediary sector poses a threat to financial stability, as experience in countries like Turkey and Chile has shown. There is therefore a need to increase reulation on these brokerage firms, at the same time that regulation on banks is reduced. This will also put them on more equal footing.

A separate problem in the financial sector exists with development banks and Fideicomisos. There seems a poor match between objectives on the hand and number and focus of these institutions on the other. Mergers could clear up their structure to some degree. In addition, they have been encroaching on regular banks' territory, just as banks have been forced to engage in preferential lending. A better separation of the banking system and the development banks could usefully be pursued. Finally it is not clear that the development banks and Fideicomisos operate at maximum efficiency. Room for improvement will be indicvated below.

Improvements in the financial sector could be ensured by phasing out forced lending schemes, permitting banks to respond to market forces. The budget deficit should be financed by the voluntary purchase of government bonds. In accordance with the government's policy of having competitive commercial banks, banks should be allowed to set their own deposit rates enabling them to compete for funds. The more efficient institutions, whether banks or non-banks, would grow thereby reducing the costs of intermediation. Prudential regulations and supervision should be improved. Subsidies through low interest rate loans that the government deems necessary should be carefully targeted, tightly controlled, and distributed through development banks and trust funds which should be made more efficient.

Background

Mexico's financial system consists of a central bank (Banco de Mexico), 20 commercial banks ("bancos multiples"), 8 development banks ("bancos de desarollo"), 21 government trust funds ("fideicomisos") and 25 privately owned brokerage firms ("casas de bolsas"). Other financial institutions like insurance companies ("aseguradoras"), factoring companies ("afianzadoras"), leasing companies ("arrendadoras"), credit unions ("uniones de credito") and currency exchanges ("casas de cambio") are less important.

Commercial banks have been universal since 1976, and can both lend and invest in equities. Many banks operated as part of industrial groups, lending to, and investing in the equity of, the related firms. Banks with net foreign currency liabilites lost part of their capital when the peso was sharply devalued in 1982. Inflation exacerbated the situation because bank interest rates were controlled and slow to change thus reducing their financial margins while their loan portfolio worsened. Many banks were insolvent when they were nationalised in September 1982.

The government merged and closed several of the 60 banks forming the present 18 (excluding the small foreign bank and the union-owned one) and sold bank holdings in related non-banking firms. The 6 national banks now account for 76.4% of total commercial banking assets (with 62.1% in the big three), the 8 multi-regional banks for 16.4% and the remaining 5 regional banks for 7.2%. Commercial bank capital is now 3.5% of assets, small by international standards but higher than the 1.6% in 1984. Banks' administrative costs are higher than those abroad but even within Mexico, the administrative costs of the multi-regional banks are almost twice as high as the three large banks. A fund financed by a 2/1000 annual levy on bank assets, Fondo de Apoyo Preventivo or FONAPRE, was instituted to restructure banks and help the less efficient ones adopt better technology. In 1988, 34% of the commercial banks' (non-voting, class "B") equity was sold to the private sector and the government reiterated its intention that commercial banks be run independently, responding to market forces. Of the 60 institutions, 35 were universal banks, 10 were deposit banks ("bancos de deposito"), 9 were finance companies ("sociedades financieras"), 5 were venture capital firms ("sociedades de capitalizacion") and a mortgage bank("banco hipotecario").

The 8 development banks together rival commercial banks in total assets. They focus more on lending than on deposit gathering (less than 9% of their assets are funded by deposits) because over two thirds of their funds are from abroad. The 4 largest development banks account for 91.2% of total development banking assets, with NAFIN alone accounting for 43%. The 21 government financial trust funds lend through commercial or development banks ("2nd tier" operations) but the 7 largest trusts total barely 5% of the assets of the banking system.

Many of the 25 privately owned brokerage firms are run by former bankers who moved after nationalisation. Brokers trade equities, bonds, and commercial paper. Brokers are allowed to underwrite securities but lack the capital of commercial banks who therefore dominate this business. Brokers have become extremely active, especially after 1976 when the government began borrowing through treasury bills (CETES) which accounts for 68.6% of government securities outstanding in August 1988. Brokers manage several of the 90 mutual funds ("sociedades de inversion"). There are now 300,000 investors in these funds, up from 19,000 in 1982, but below its peak of 390,603 in 1987. The stock market crash of 1987 caused investors to flee and several brokers insolvencies. The larger non-financial firms also lend surplus funds to each other but little is known about this active intercompany market.

The Issues

The main issues now affecting Mexico's financial system are: (1) extremely limited access by the private sector to commercial banking funds; (2) misallocation of credit through forced loans at different interest rates; (3) deposit rate controls that reduce commercial bank competition and deposit mobilisation; (4) inefficient financial intermediation; (5) unclear roles for development banks and trust funds and an inadequate control of subsidies; and (6) inadequate supervision and prudential regulations of banks and brokers.

Commercial bank lending to the private sector has been severely restricted. In addition to the usual reserve requirement (10% of deposits or "captacion"), commercial banks have been forced to lend a large part of their funds to the government (31%), to development banks (10%), to housing and other favoured segments of the economy (7.8%), and to development activities (16.2%) at different but below market interest rates. Lending at different interest rates could misallocate credit. In addition, lending to the private sector has been limited to 85% of its December 1987 nominal value. Any excess has to be lent to the government at less than market interest rates. Consequently, direct commercial bank lending to the public sector, excluding reserve requirements, has grown from less than 3.6% of assets in 1980 to over 35.3% in July 1988. Lending to the private sector, meanwhile, has fallen from 43.5% in 1980 to about 30% now. Commercial banks' total deposits declined from 25.7% of GDP in 1982 to 20.5% in 1985 but has since risen to 23.3% in 1987 while their total assets have fluctuated around 40%.

Brokers, unlike commercial banks, are free of such controls and can therefore offer a lower spread, channelling more of the funds remaining for the private sector. Brokers cannot accept deposits but they manage trusts and mutual funds. Investors can also have discretionary brokerage accounts and although brokers are supposed to guarantee investment returns, many do. These funds are lent to the private sector through commercial paper and to the government through treasury bills. Brokers are now important intermediaries, and this has given rise to three concerns. First, credit could be misallocated if the paper of smaller firms, even if profitable, is harder to place. Even so, brokers have alleviated the harmful effects on the economy of the controls on banks. A second concern is that implicit promises to investors cannot be kept if returns are low and their capital is impaired. This too is because the controls on banks have forced those who would normally be bank depositors to invest with brokers. The third concern is that trading on margin (i.e. borrowing against securities) has become increasingly common and delayed settlements or postdated cheques for payment allow margin limits to be evaded. This flaw was exposed in the aftermath of the 1987 stock market crash and better supervision is therefore warranted.

Commercial banks have sought to retain private sector business by circumventing the forced lendings through "non-traditional" activities. Excess funds from many bank deposits (e.g. "cuenta maestra") are swept daily into trusts or investment funds, reducing the amount subject to controls. Prudential regulations are undermined when commercial banks move their business off their books through such instruments as non-traditional bankers acceptances. Not all bank borrowers could obtain funds in this fashion, and those that cannot are implicitly penalised. To re-establish prudence, the authorities now tacitly acknowledge the harm of such controls by including the off-balance sheet activities only for capital requirements and not for forced lending. Thus, the controls on lending are ineffective but nevertherless impede efficient banking intermediation.

The central bank sets the deposit rates for all banks, preventing price competition. Although time deposit rates are now being set to reflect market rates, other deposit rates are less flexible. This has altered the composition of deposits. Chequeing accounts, on which no interest may be paid, have fallen from over 18.1% of total commercial banking assets to 6.4% in mid 1988; savings accounts from 14.9% of assets to 4.5%. Time deposits, predominantly under 3 months maturity, have risen from about 37.5% of assets in 1980 to over 50.5% now. The low rates on savings deposits are regressive because savings depositors are generally poor and unsophisticated.

Commercial banking spreads and operating costs are high by international standards partly because of the various restrictions described but also because not all banks use modern technology in processing accounts. Brokers also use obsolete technology.

Development banks and trust funds lend heavily to the government raising doubts about their role. Some 84.4% of their loans, or 63% of their assets, are to the public sector with 58% of their loans going directly to the Federal government. It is therefore difficult to defend the forced loans from commercial banks which were ostensibly to finance activities that development banks lacked the funds to foster. The multiplicity of trust funds with overlapping roles needlessly increases administrative and monitoring costs.

Until recently, development banks and trust funds lent at fixed nominal interest rates allowing the subsidies to vary uncontrollably with market conditions. Furthermore, these rates were lower than even the deposit rates of commercial banks, allowing arbitrage. The situation has improved, as noted in the reports relating to the General Interest Rate Agreement between the government and the World Bank, and such subsidies are a declining proportion of GDP. While the rates are now above the commercial banks' average costs of funds, they remain lower than the government's marginal borrowing costs.

Several development banks have made many bad loans, some to public enterprises. Subsidies far greater than that implicit in low interest rates are involved when loans are not repaid. Eventually, the losses have to be recognised and bank capital is reduced. Periodic infusions of capital by the government could therefore be an implicit, non-transperant subsidy.

While the institutional framework for supervising banks is in place, certain regulations and their enforcement should be improved. In particular, the ability to assess credit risks is inadequate. Supervisors cannot therefore ensure that banks provision adequately for potential loan losses and prevent interest accrual on risky loans that may never be repaid. The four supervisory agencies, namely the Ministry of Finance (SHCP), Banco de Mexico, Comision Nacional de Bancos y Seguros and the Comision Nacional de Valores, should better co-ordinate their activities.

The Proposed Reforms

The proposed reforms seek to free commercial banks to compete in the market and respond to market forces while simultaneously strengthening the government's role in supervision, prudential regulations and the pursuit of its social goals through an efficient development bank and trust fund system.

Commercial banks should not be compelled to lend to the government or to any sector. Except for the capital requirements and prudential supervision to reduce moral hazard and safeguard the payments mechanism, and the reserve requirements to finance the central bank, all other restrictions should be phased out.

Allowing each bank to set its own interest rates would help reduce the costs of bank intermediation. While rates on unrestricted lending to the private sector are not controlled, the central bank's setting deposit interest rates inhibits competition for deposits and thus restricts the growth of the more efficient banks. Commercial banks should not only compete with brokers but also with each other.

Brokers should be allowed to expand the scope of their operations and develop into more efficient institutions. They should be allowed to import readily available specialised financial services technology and brokers could cement such links through joint ventures with foreign institutions that supply this expertise. The more efficient brokers would grow and intermediation costs would decline; but the aggregate market share of brokers and bankers cannot be predicted.

Changes in the development bank and trust fund complex would depend on the purpose of these institutions and the government would have to define this carefully. Many trust funds have overlapping functions. The role of each development bank and trust fund should be clearly defined and this would reduce their number and improve their organisation. There is a conflict of interest when development banks manage trust funds and the role of one or the other could be distorted. Some functions, like channeling foreign funds, providing funds at terms the market does not (e.g. long term credit), or subsidising carefully targeted groups, could be performed through trust funds and commercial banks making retail operations by development banks unnecessary.

The role of subsidies should also be clarified. Subsidies could ostensibly be to (a) promote investment in particular sectors or (b) to redistribute income. Subsidised loans are generally not a good vehicle to increase investment in a sector when funds are fungible. Subsidies could be tied to loans if other means are not available, but the criterea must be well defined. For example, it is difficult to justify subsidised loans to municipalities or other public enterprises because they could be given direct transfers. Any subsidies, however, should be tightly controlled and properly targeted. To ensure this when market interest rates vary, the government should charge the trust funds and (transformed) development banks its cost of funds (perhaps CETES, in the absence of market instruments of comparable maturity) and the subsidy allocated from the budget. This appears to be the government's new policy under the Pact and it should be supported. Equity in development banks and trust funds should be kept low as it is all too easy to treat it as a zero interest rate loan. Periodic infusions of equity are non-transparent subsidies and could encourage financial laxity. When trust funds are controlled by development banks, there is a conflict of interest and subsidies could be redirected. Transactions between trust funds, development banks and public enterprises should therefore be re-examined.

Simultaneously, supervision should be improved. With the incentive for off-balance sheet activities removed, banks would behave more prudently. However, some procedures should be improved. Banking supervisors should classify loans by default risks and not permit interest accrual or the roll over of bad loans. The four supervisory agencies should be better co-ordinated and share information. Public disclosure of the financial state of each bank will also help ensure prudence.

The changes suggested for the development banks and trust funds are likely to reduce the budget deficit to the extent subsidies are better controlled. It would be difficult to estimate the effect on the government budget of allowing commercial banks to fund the government and its preferred sectors voluntarily. The suggested changes reduce the effective marginal "tax" on commercial bank intermediation but, as this would increase commercial bank intermediation, the "tax" receipts gathered through the reserve requirements could rise. Reducing the marginal tax on commercial banks by eliminating the restrictions, however, is the only way to restore efficient intermediation in the private sector. If, however, the budget deficit increases excessively, the (flat) tax on commercial banks could be effectively increased by reducing the interest paid on reserve requirements. Fixing the nominal interest on reserve requirements sufficiently low (perhaps even zero) would ensure that the tax would fall with the inflation rate. Even if the reforms were made revenue neutral, however, greater operating efficiency could reduce the burden on commercial banks. With greater transparency and without the incentive to circumvent
controls, supervision would be improved.

III.2 The Agricultural Sector

Agricultural growth and food consumption policy present some of the most complicated tradeoffs between the goal of controlling inflation, favor consumers and increase real wages and estimulate production. Policy in this area must therefore be approached as a single coherent package within which all major issues are addressed at the same time. This section therefore addresses four issues which remain at the center of agriculture and food policy: (i) Agricultural trade policy reform. (ii) The conflict between protecting consumers and stimulating producers and at the same time keeping the fiscal impact of subsidies moderate. (iii) The high fiscal costs of untargeted subsidies to credit and agricultural inputs, and (iv) The inadequacy of public investment in agricultural infrastructure and technology development and diffusion.

From 1971 to 1981 Mexican agriculture grew at the healthy rate of 3.5 percent. Between 1982 and 1987 the growth rate has slowed down to a mere 1.6 percent. During 1988 the low water levels in the irrigation system resulted in sharp declines in output of irrigated wheat, soybeans and rice. Fortunately good rainfall resulted in a good summer crop of maize and other upland crops. Nevertheless the aggregate crop output in 1988 will be at its lowest level in the 1980s, declining by 16 percent relative to its 1987 level. While full irrigation dams make for a better outlook for 1989 the question remains: Why did the growth rate decline?

Up to 1985 domestic terms of trade for agriculture continued to follow the adverse trend associated with industrial protection, overvalued exchange rates and adverse producer price policies. As a result, private agricultural investment declined. Between 1982 and 1988 the public investment budget for agriculture declined from 4000 mmp in 1988 prices to approximately 558 mmp (257 million US$ or only about one percent of agricultural GDP). In addition yield growth has been disappointing, which is not surprising given the extraordinarily low research budgets, the poor state of agricultural extension and the inadequate quantity and quality of seed production. During the early 1980s government policy made unsuccessful attempts to maintain the agricultural growth rates of the 1970s by providing enormous subsidies to credit, crop insurance, fertilizers, electricity and and irrigation water. These subsidies failed to stem the adverse effects of inadequate private and public investment and of slow technology advances.

Agricultural trade policy reform: The policy reforms initiated since 1985, and especially since October 1987 have substantially reduced direct and indirect price discrimination against agriculture. Exchange rate policy has become more favorable to all tradeable sectors. Import barriers have been sharply reduced for major agricultural inputs such as machines, pesticides), and other high technology inputs. Export restrictions on fruits and vegetables, which represent 25 percent of crop output, have been substantially reduced. And most producer prices have been moved into a band of between 90 percent and 125 percent of international prices.

Progress has therefore been substantial. Nevertheless, within the trade regime the following issues remain unresolved: For the 12 crops under the guarantee price system domestic prices are regulated via direct state trading or quantitative restrictions on imports and exports. It is not clear that this is the most cost-effective way of providing agriculture with the same degree of protection as other traded commodities and/or to stabilize domestic prices of basic staples. Price and trade policy for sugar remains in disarray. Milk powder is a monopoly import of the parastatal LICONSA. Coffee is traded by a state monopoly INMECAFE which regulates the sales to the quota markets of the international coffee agreement. And tobacco trade to the various quota and state regulated markets of the USA, the EEC and the socialist countries is the prerogative of the parastatal TABAMEX. While most beef exports are now unregulated, live animals up to 280 kg are subject to a 20 percent export tariff while the export of larger animals (a small proportion of total beef exports) are subject to a tax of 60 US$ per head and export controls. For selected fruits (tomato, watermelon, melon, mangoes, and strawberries), SECOFI still has to provide export permits. Exports of fresh and canned fish and of fishmeal are subject to a variety of formal and informal export restrictions. Solving these remaining producer pricing and trade issues will remain high on the the policy agenda.

The major objective should be to maintain the progress already achieved and to prevent the possibility of backsliding by gradually eliminating consumer price controls. For producer prices the objective should be to accord agricultural producers the same protection accorded other tradeable commodities by keeping guarantee prices within 100 and 120 percent of international prices. Under the agricultural sector loan, the government has already agreed to move guarantee prices into a band of 90% to 125% of international prices prior to second tranche release (except for maize and beans). It has also agreed to conduct a study of the entire guarantee price system and of the mechanisms to be used to maintain prices within the agreed band.

For the few commodities which still suffer from export restrictions, it is recommended to abolish all remaining export tariffs, reference prices and export permits (licensias de exportation other than for technical reasons) for all agriculture, fruits, livestock and fisheries products (except for sugar, coffee, tobacco and milk).

Commodities with quotas in international markets: International sugar and tobacco markets are characterized by quota restrictions or state trading in most importing countries. Particularly important are the quota restrictions in the United States which are allocated to individual countries and the restrictions in the EEC. Producing nations have to control the access to these quota markets as unlimited competition among individual exporters of the same country would result in the loss of the quota rents to the individual importers of the consuming nations. Control over exports to quota markets can be achieved by either state trading as is now done by TABAMEX and AZUCAR, or by auctioning these quotas off to individual producers. The auction system would result in additional government revenues and produce a more transparent and efficient allocation of resources. The possible auction system require further study. In the case of sugar such a study is already being carried out as a condition of second tranche release of the agricultural sector loan.

Consumer Prices and General Food Subsidies: The conflict between providing producers adequate price incentives and ensuring low food prices for consumers has been a central theme of Mexican policy for a long time. Substantial progress has recently been made in reducing untargeted food subsidies, which at their peak in 1980 had represented approximately 983 million US$. Untargeted food subsidies have declined to less than 90 million dollars in 1987.

Three targeted food subsidy programs have been developed: TORTIBONOS (provides maize tortillas at preferential prices to 4.5 million persons); Social Mlk Supply (provides low cost reconstituted milk to 1.8 million urban and 40000 rural families in 211 municipios and it is the largest targeted program); Rural Stores (provides basic commodities at a discount over private shops in rural areas).The total amount of purchasing power transferred to the beneficiaries of these three targeted programs is about US$ 372 million. The recurrent fiscal cost of the program is however substantially less, because a substantial proportion of the administrative cost is borne by the groups which target the beneficiaries or run the stores.

The key issues surrounding these targeted programs are: less than 15 percent of the income transfers effected by these programs reaches the rural areas where most of the serious malnutrition occurs. Targeting rules of the individual programs may have to be revised and the cost recovery percentages from the beneficiaries may be excessively low. For example TORTIBONOS are sold for 32 pesos per kg while the (subsidized) controlled price of tortillas is 283 pesos. The Comision Nacional de Alimentos (CONAL) is currently studying the targeting, the cost effectiveness and the nutritional impact of these and other nutrition programs. The study will be completed before the release of the second tranche of the agricultural sector loan (AGSAL). In addition the governement has agreed to revise the cost recovery percentages of the TORTIBONO program upwards prior to second tranche release of the AGSAL.

While the CONAL studies of the food and nutrition programs will undoubtedly lead to changes in these programs, their very broad development over the past few years provides an administrative and implementation capacity which would allow the complete replacement of untargeted food subsidies via subsidies which are clearly targeted to the low income groups. Moreover the beneficiaries of the TORTIBONO program are already protected against rises in maize prices, the commodity with the most serious differential between producer and consumer prices.

With the existence of targeted programs the justification for general food subsidies is rapidly disappearing. Moreover, once the low income groups are afforded substantial protection from rises in the prices of basic staples, consumer price policy and minimum wage policy can be separated, although settlements of wage rates above the minimum wage will undoubtedly continue to take into account rises in basic staple prices.

Consumer price controls have recently led to shortages in products whose supply is entirely in the private sector such as meat, eggs, fresh milk and sometimes beans. Price controls are also a serious impediment to the fisheries sector, where for example, large quantities of sardines are converted to fishmeal rather than the canning industry, as fishmeal is sold at uncontrlled prices. For these reasons the issue of the speed of adjustment of controlled prices to producer prices and how to eliminate the system of consumer price controls is emerging as one of the major budget and inflation control problems of the new administration. We estimate that the elimination of all consumer price controls on food products and the alignment of consumer prices with producer prices and international prices will lead to an increase in the Canasta Basica of about twenty percent. However these increases overestimate the real impact on purchasing power of consumers as price controls on a number of these commodities are already evaded. Finally for maize and milk the low income groups served by the TORTIBONO and the LICONSA milk program are already insulated from any rises in controlled market prices. The policy goal therefore should be the adjustment in the controlled prices to eliminate explicit and implicit subsidies and eliminate the consumer price control system entirely. Eliminating price controls should not be too difficult for commodities with very small weights in the Canasta Basica such as canned sardines and tuna, cookies and margarine.

<u>Targeted Food Subsidies</u>: In the short run the main action to protect low income urban consumers from food price rises is the extension of the TORTIBONO program to those urban low income consumers who are not yet reached by it. The Liconsa program already reaches almost all eligible beneficiaries. Both programs will be revising some or their targeting and operational procedures in light of the findings of the ongoing evaluations carried out by CONAL. In the longer run the governement may want to consider the transformation of these two programs into a genuine food entitlement program for low income groups, which would allow beneficiaries to purchase a broader range of commodities.

For the rural poor, who despite their rural location are mostly net buyers of basic staples, the short run solution is not as obvious. Programs which focus on maize may not attract sufficient demand and involve circular transport costs of raw product to processing locations and of processed product back to the rural areas. The creation of a genuine food entitlement program, which would allow the rural poor to choose among a range of commodities which are available in local shops and the CONASUPO/RURAL stores, is therefore a high priority. Transactions costs could be minimized by, for example, using the existing committees which manage the CONASUPO/RURAL stores to select the beneficiaries. Food entitlements are particularly important for the agricultural slack season and could be suspended during the agricultural growing season when employment opportunities are ample in the rural areas.

Untargeted credit and input subsidies

Untargeted credit and input subsidies remain a major problem for agricultural policy and the governement budget. BANRURAL, the agricultural development bank which serves primarily small farmers and ejidatarios remains the single most important recipient of governement transfers to the agricultural sector (about $ 1.3 billion in 1988).Large losses of about US$ 510 million also continue in ANAGSA, the public agricultural insurance company which insures agricultural yields of producers who use agricultural credit up to the amounts of credit taken. ANAGSA insures all crop production loans of BANRURAL on a compulsory and must be viewed as a part of the BANRURAL system, absorbing an additional share of its loan losses. The total fiscal transfers to the agricultural credit system therefore is about US$ 1893.

Fertilizer prices remain below international prices. In 1987 the subsidy to farmers which is implicit in this price difference has been estimated at 142 billion pesos or approximately 103 million dollars. How these subsidies affect the fertilizer parastatal Fertimex is discussed in the industrial sector loan. The other major subsidy arises from the special electricity tariffs charged farmers for operating irrigation pumps. In 1987 electricity subsidies amounted to US$353 million. Subsidies to the operating costs of irrigation districts still amounted to US$ 109 million in 1985.

Total input and credit subsidies therefore still amount to about $ 2.3 billion, almost ten times the public investment in agriculture. Compressing these subsidies should allow for a threefold increase in public agricultural investment while still sharply reducing public agricultural expenditures.

Substantial reductions in the transfers to BANRURAL are possible without jeopardizing the key role which it plays in providing credit to small farmers which are not reached by the commercial banks. The Bank can reduce the subsidies to those customers who are commercial farmers and whose incomes are well above the poverty line. It can also significantly reduce transactions costs, even for small farmers. And loan evaluation can be strengthened to reduce further loan losses in the future. Specific measures include: (i) further improvements in collection of overdues (ii) Reduction in the interest subsidies to commercial ejidatarios by classifying them as such and not as small farmers just because they legally belong to the ejidatario sector. (iii) Allow commercial ejidatarios to obtain individual credit rather than only group credit. (iv) Eliminate interest subsidies to commercial farmers and commercial ejidatarios. (v) Reduce transaction costs for credit by abandoning overly paternalistic practices such as the release of credit in kind and in numerous small installments. (vi) Reduce transactions costs by eliminating the number of different credit lines which differ only slightly in interest rates. (vii) Allow and encourage BANRURAL to retail credit through alternative credit channels such as well managed unions of ejidos or rural credit unions. By applying these and other means it will be possible to substantially reduce current and capital transfers in 1989 to BANRURAL.

ANAGSA losses can be curtailed in several ways: The only financially viable types of insurance against crop losses is insurance against specific natural acts such as hail, flooding, frost or hurricanes for which losses are fairly easy to estimate accurately. Individual crop insurance should therefore only be provided for specific natural disasters. In addition ANAGSA could provide reinsurance services to groups of producers who insure their crop yields on a mutual basis and tie ANAGSA reinsurance services to statistically measured area-wide yields of the regions within which the reinsured groups operate. By these and other administrative changes ANAGSA should be able to eliminate its losses completely within two years. The main policy recommendations are the implementation of the current reorganization plan, the elimination of compulsory insurance requirements to obtain agricultural credit and other actions to reduce ANAGSA's losses by at least 50% of their 1988 level by the end of 1989.

Public Investment in agricultural infrastructure and technology

The main components of agricultural infrastructure which cannot be executed by the private sector are rural roads, dams and canal irrigation programs and the draining of floodplains and other major waterlogged areas. These investments have been a major source of agricultural growth in Mexico and their expansion remains critical for future growth. Private provision of infrastructure is possible in minor irrigation schemes, especially groundwater development. However such development needs to be regulated in order to avoid depletion of the aquifersby competitive pumping from a common pool. However, in the recent past public policy has excessively constrained private development of minor irrigation, rather than simply assuming a regulatory function. A policy shift is in order here.

Rural road infrastructure is well developed except in the poor states of the South, with Chiapas and Oaxaca showing the greatest deficiency. Most major irrigation development will continue to be located in the North, where abundant sunshine and low rainfall clearly provide the highest return to these investments. Capital cost recovery from these relatively wealthy states must however be improved, and the existing water law provides a good basis for this. Minor irrigation investment will take place all over the nation and will be very important in improving agriculture in poverty regions. Investments in drainage will be concentrated on the gulf coast and in the coastal areas of Oaxaca and Chiapas, where large areas now used for pasture or extensive crop production can be converted to intensive crop production. Improved water control via irrigation and drainage is in many cases a precondition for the application of modern input intensive technology, although the potential for increased use of modern inputs in the upland areas of the higher rainfall regions is by no means exhausted. In the dryer upland regions improved soil and water conservation is the major critical investment, along with the full development of minor irrigation.

By 1987 and 1988 investment in the public agricultural infrastructure has ceased almost completely, with a total allocation of only 257 million US$, far less than the cost of a single fertilizer plant. This allocation is insufficient to maintain the existing infrastructure and has allowed only minimal progress in completing high priority projects under execution.

Public agricultural infrastructure needs to expand rapidly over the new sexenio. In irrigation, rehabilitating and completing irrigation projects which already exist or are under execution should add about 1.5 million ha to the existing irrigated area of 5.1 million hectars of irrigated lands. As deferred and normal maintenance will be done in the irrigation districts, maintenance and operation of the systems should be turned over to the users. For the unirrigated areas the public investment program foresees a substantial expansion of drainage investments and other land improvements, including soil and water conservation. And additional 2.4 million ha of uplands can be improved by the end of the sexenio.

Technology development and extension have also seriously suffered. A major structural reform in INIFAP has transformed the administrative structure of the organization so that it can effectively pursue basic research, national applied research themes such as maize improvement, as well as region -or state- specific projects. In order to be able to charge producer groups for commodity-specific applied research, INIFAP's legal status is being changed to an autonomous decentralized public entity. Within five years INIFAP should be able to recover 50 percent of its operational research costs from producers. The close farmer contact which cost recovery from producers implies that it will also improve the relevance of the research program for producers. For basic research, for applied research which is not crop specific, and in areas dominated by small farmers, cost recovery will, however, be unfeasible. A substantial expansion of research in the disadvantaged South is therefore not feasible without considerable increases in both the investment budget and the operational budget of INIFAP.

Public agricultural extension has come to a virtual standstill. While the creation of the Distritos de Desarollo Rural Integral have advanced the decentralization of the functions of the ministry or agriculture, the extension service still suffers from many structural problems: Apart from technology transfer the extension agent has to gather the primary data for the agricultural statistical system, a function absorbing up to 50 percent of his time. He has to put pressure on farmers to implement district- specific production goals which are handed down by the Center, and execute national priority programs which may have little to do with district priorities. Finally extension agents are the most poorly paid staff of the public agricultural service. It is therefore not possible to attract qualified technical specialists to the service. The reform of the agricultural extension service is therefore a high priority task for SARH. Particularly important is the redefinition of the tasks of the extension agent to exclude all function not strictly related to technology transfer. Part of the current extension staff should be shifted to a new agricultural statistical service which will gather data on a sample basis rather than the current attempt to gather data from all farmers. Salary reform and the hiring of more qualified technicians are also very urgent. Finally decentralization needs to be strengthened by abandoning the system of centrally imposed district specific production goal.

Proposed reforms involve the transformation of INIFAP into a decentralized public organization,a substantial increase in its budget in real terms and that a higher proportion of the budget be spent on expanding the research program in the neglected South.In extension the PROCATI project already provides a model how to improve the extension program. Also, a reform of the extension service is recommended. This would include: (i) the redifinition of the role of extension agents to exclude all functions which are not strictly related to technology transfer (which implies the creation of a separate agricultural statistical service with own staff who would collect data on a sample basis); and (ii)a substantial expansion of the agricultural investment budget.

III.3 Trade Policy

Background

Industrialization through import substitution has been the dominant development strategy in the Latin American region since the 1950s and Mexico has been no exception. Trade policies, particularly tariffs and quantitative restrictions on competing imports, have been used to promote manufacturing production for the domestic market at the expense of agricultural and export activities. At the same time, trade restrictions have been used to support extensive control of pricing and marketing of agricultural goods. Trade policies have also been directed at macroeconomic goals--periodic balance of payments crises have led to tightening of import restrictions; inflationary pressures have led to loosening of trade restrictions.

The onset of the payments crisis in 1982 saw quantitative control of all imports, and thus protection of all domestic production of tradables. Since mid-1985, Mexico has undertaken a fast and far-reaching liberalization of the trading regime, aimed at expanding the tradables sector, opening it to international competition, and encouraging efficiency in both exporting and import-substitution activities. Mexico acceded to the GATT in 1986. The pace of liberalization was quickened in 1987 and early 1988, as part of the ESP. The trade liberalization process has been supported by World Bank lending. While the full impact will take some time to appear, the initial results are promising--incentives have been redirected and restructuring toward more efficient activity begun.

The key reforms included more flexible management of the nominal exchange rate to promote the tradables sector, and reductions in licensing and official reference prices for imports and exports, and tariffs. Some quantitative indicators of liberalization are reflected in Table 1.

The progress has been impressive. Import licensing coverage is now one-quarter of what it was in June 1985, official reference prices for imports have been completely abolished, and the maximum tariff is now one-fifth and the average tariff one-half of what they were in June 1985. Progress as of mid-1988 has gone beyond the Government's original schedule, GATT commitments, and the targets in the TPL II and ASLI.

The progress on trade reform was complemented by other reforms, particularly in the areas of macroeconomic stabilization, reducing domestic price controls, and aligning of administered agricultural prices more closely with international prices. Most agricultural producer prices have been moved into a band of between 90 and 125 percent of international prices (as defined).

Table 1: TRADE LIBERALIZATION 1985-1988

	6-85	12-85	6-86	12-86	6-87	12-87	5-88
Import Licensing a/	92.2	47.1	46.9	39.8	35.8	25.4	23.2
Reference Prices a/	18.7	25.4	19.6	18.7	13.4	0.6	0.0
Tariffs-Maximum	100	100	45	45	40	20	20
-Average b/	23.5	28.5	24.0	24.5	22.7	11.8	11.0
Real Exchange Rate c/	100	127.1	144	157.4	155	147.2	124.8

a/ Percentage coverage of production of tradables using 1986 weights.
b/ Weighted by production of tradables in 1986; excludes 5 percent surcharge.
c/ Increase represents a depreciation in real terms.

This substantial opening up of the economy was achieved quickly during a period of considerable macroeconomic instability and uncertainty. The priority now is for a period of consolidation of the impressive improvements in the neutrality, transparency and simplicity of the trading régime, and deepening of reform in areas where there has been lesser progress so far.

The Current Trade Regime

The main features of the key measures--NTBs, tariffs, export controls, and anti-dumping--are briefly discussed below, further details are provided in Annexes V.A and V.B.

NTBs on Imports

As of August 1988, less than one quarter of domestic production of tradables was protected by quantitative restrictions on competing imports (on the basis of 1986 weights). No official reference prices remain for imports. Three hundred and twenty five items (under the newly introduced Harmonized Tariff system) are still controlled, accounting for less than 3 percent of all items and about 16 percent of imports (1987 values).

This position represents an improvement of some 10 percentage points in production coverage of QRs over the targets in TPL II. Table 2 shows the August 1988 and TPL I and II target positions on the basis of both 1983 and 1986 weights. The original targets were expressed in terms of 1983 production weights. The reweighting is approximate.

Table 2: QR COVERAGE a/

	8-1988		TPL II end 1987		TPL I end 1986	6-1985
Weights:	86	83	86	83	83	86
All tradables	23.2	33.1	32.8	43.1	63.1	92.0
Oil & Derivatives	5.5	20.5	5.5	20.5	20.5	5.5
Other	17.7	12.6	27.1	22.6	42.6	86.5

a/ Coverage of domestic production of tradables: 1983 or 1986 production weights, as indicated.

As part of the reform program, the Government retained the option of applying temporary surcharges on liberalized items, but none have been used. The remaining QRs are concentrated as follows:

Table 3: REMAINING QRs ON IMPORTS, MAY 1988

Coverage:	Sectoral	Total
Oil and Derivatives	95.3	5.5
Agriculture, Livestock & Fishery	44.3	7.8
Agroindustry	24.9	6.1
Industry programs	41.3	3.3
Other Industry		0.5
All tradables		23.2

The protective incidence of the remaining QRs is likely to be quite variable. Clearly the QRs on oil and derivatives have little impact, since Mexico is a major exporter of these products. In agriculture and agroindustry the QRs support price controls, guaranteed prices and international marketing agreements. Again many of the products are exportables. In industry, the QRs support the "Programas de Ramas" for autos and auto-parts, and pharmaceuticals. Mexico has significant exports of autos and auto parts, so unless extensive cross-subsisization takes place, the QRs are probably less important than when the program started.

Tariffs

With the halving of almost all non-zero tariff rates in late 1987 and elimination of the 5 percent temporary import surcharge, the tariff range was reduced to 0 to 20 percent with only five rate categories. The tariff shows the typical escalation by stage of processing; most raw materials and intermediates attract rates of 0 or 5 percent, most capital goods 5, 10 or 15 percent, and most consumer goods 15 or 20 percent. Nearly two-thirds of imports enter under the 0 and 5 percent rates.

Table 4: TARIFF DETAILS a/

	percent:
Range	0-20
Simple average	9.8
Production Weighted Average b/	11.0
Import Weighted Average c/	6.5

a/ May 1988, NCAA Tariff Classification.
b/ 1986 production of tradables.
c/ 1987 imports values.

As of July 1988 Mexico introduced the Harmonized System of tariff classification. Mexico has signed the GATT Customs Valuation Code.

Import duties and a few export taxes accounted for 7.2 percent of total tax revenue in 1987, and about 0.8 percent of GDP. Trade taxes in the first half of 1988, when imports were 60 percent higher, accounted for about 3.5 percent of tax revenue, and about 0.4 percent of GDP.

Export Taxes and Controls

Export regulations traditionally have been less binding than import regulation (and information is scarcer). Export regulations have also been significantly liberalized during the 1980s, again particularly after 1985. At the end of 1987, about 240 items were subject to export licensing, accounting far some 25 percent of non-oil exports and covering about 25 percent of domestic production of tradables (less than one half the coverage of the early 1980s). Some 60 items are subject to export tariffs, the only significant one being coffee. There are only 12 remaining official reference prices for exports.

The remaining export controls are concentrated as follows:

Table 5: EXPORT CONTROLS, DECEMBER 1987

Coverage:	Sectoral	Total a/
Oils & Derivatives	32.4	1.9
Agriculture, livestock & Fishery	59.2	10.3
Agroindustry	31.0	7.6
Industry (Petrochemicals, Steel, Metal Products)	64.1	4.2
All tradables		24.8

a/ Percentage coverage of production of tradables using 1986 weights.

During 1988 there has been further progress on reducing export controls on agricultural and agroindustrial products, particularly fruits and vegetables (which account for 25 percent of crop output). However, an export tariff has been introduced on some beef.

The controls support the monopoly trading positions (e.g., CONASUPO), domestic price controls (e.g., agriculture), administration of the supply of goods under international trade agreements (e.g., coffee, textiles and steel).

Some agroindustry activities have controls on both exports and imports (e.g., coffee and sugar).

Anti-Dumping System

Anti-Dumping law and regulations were introduced in 1985 and 1986. In 1988 Mexico signed the GATT Anti-Dumping and Countervailing Code. While the experience with the new system is limited and conclusions are therefore tentative, there is some evidence of protectionist tendencies inconsistent with the opening-up of the economy to international trade:

(i) the number of cases has increased rapidly;
(ii) the "injury test" is not playing a strong role in evaluation of dumping;
(iii) high anti-dumping duties have been imposed;
(iv) in 1988 the first "ex-officio" case was initiated covering 12 countries and a wide range of products.

Annex V.B contains a review of recent anti-dumping experience.

Temporary Import and Duty Drawback Schemes

Mexico uses several approaches to allowing exporters access to duty free imported inputs: (i) a scheme for the maquila enclave industry; (ii) a temporary import scheme based on three year export agreements and providing duty free imported inputs and machinery and reimbursement of indirect taxes; (iii) a duty drawback scheme which reimburses duties paid; (iv) an in-bond system; and (v) customs temporary import system for infrequent exporters. The schemes have been improved since 1985 to expand coverage and improve benefits. The schemes have expanded rapidly in recent years with strong growth in exports.

Some 600 firms use temporary import and duty drawback systems, accounting for roughly one third of manufactured exports. There is little information on usage of other schemes. Many other exporting firms may already import inputs at zero or low duties. The schemes reportedly work reasonably well. They suffer the typical difficulties of all such schemes-- it is very hard to cover indirect, distant and small exporters; high administrative costs; leakage to the domestic market and so on.

The lowering and simplification of tariffs reduces the need for such schemes, but at the same time makes their implementation easier.

Further Areas of Progress:

Overall Program and Macroeconomic Consistency

The credibility and sustainability of the trade liberalization program will be enhanced by a strong confirmation early in the new administration of the Government's intention to maintain existing progress and make further advances over time to enhance the neutrality, transparency and simplicity of the trading regime. Proposed further policy improvements and medium term goals will be clearly announced to condition new investment in efficient activities.

Further trade reform will be grounded in a consistent macroeconomic framework, with particular emphasis on continued fiscal restraint and management of the nominal exchange rate to promote trade. The performance of non-oil exports will be an important signal for exchange rate management.

QRs on Imports

Further reductions in remaining QRs on imports will need to be carefully sequenced with proposed decontrol of pricing and activity in the agricultural and industrial sectors. Regard will be had for macroeconomic consequences, distributional implications and existing agreements. A firm action plan will require further studies-- such as those currently underway on agricultural pricing and marketing.

Tariffs

By the standards of most developing countries, both nominal and effective rates of protection stemming from tariffs are not very high anymore in Mexico. But the variability of protection (even from the narrow range of tariffs) can still be marked. Further progress could be made on reducing tariffs and thus reducing the variability of protection but this is not an urgent task. More important is the consolidation of existing progress and reduction of uncertainty about the continuation of the trade reform. Any roll back of past reforms must be avoided. Consistent with multilateral trade negotiations, the maximum tariff will be bound in the GATT. Some issues in future tariff reform are discussed in Annex V.C.

In line with the objective of providing similar protection to all tradable activities, agricultural producer guarantee prices will be moved gradually into the range of 100 to 120 percent of international prices (as defined). The Government is undertaking a study of the guarantee price system which will inform this process.

Anti-dumping System

The Government will continue to monitor and review the experience of the anti-dumping system with regard to consistency with the trade liberalization process, transparency of procedures, and the national costs and benefits of protection provided.
It is recommended that the Government will:

-create a fully independent Tariff Commission in charge of final "resoluciones" located in a Department with economy-wide responsibilities; the Tariff Commission provide an annual report on the national costs & benefits of anti-dumping actions.
-strengthen the role of the "material injury" test;
-introduce a "sunset" clause for anti-dumping measures (say three years) with no reopening of a case for another three years;
-publish information concerning market structures in the "resoluciones".

Temporary Imports and Duty Drawback

The Government will monitor experience with the schemes and modify them as appropriate to improve access, automaticity and transparency.

Export controls

Further reductions in export licensing will also have to be carefully sequenced with decontrol of agricultural pricing and marketing. Where export licensing remains, say in support of international marketing arrangements, consideration will be given to auctioning of quotas. Auctioning of quotas would add to transparency and neutrality of protection provided, as well as enhance Government revenues. Implementation of auctioning will require consideration of particular cases. In this regard the Government is undertaking a study of the sugar industry, and will undertake studies of tobacco and coffee.

Institution building

Customs procedures for both importing and exporting should be reviewed with a view to simplification and modernization. Consideration could be given to the establishment of a trade transparency agency to advise Government on trade policy matters along the lines of similar agencies in Australia, New Zealand, and Sri Lanka.

CHAPTER IV
EXTERNAL FINANCING FOR GROWTH

The current account of the balance of payments is projected in the range of 2.0-3.0% of GDP over 1989-94, requiring significant amounts of additional external finance. In addition to financing the current account deficit, net reserves will have to be built up every year and will reach around US$ 6.5 billion by the end of 1994. Mexico's net external financing requirements have been estimated as the sum of the current account balance and the build-up in reserves in 1989-94 under the base case economic scenario.

Base Case Scenario. The current account balance is projected to change from a surplus of 2.9% in 1987 to a deficit of 2.0% of GDP in 1988. Oil prices are projected to decline on average 8.9% in real terms in 1989 from 1988 levels and increase by an average of 2.4% in the remainder of the "sexenio". Fiscal policy is designed such that the current account remains at 2% of GDP initially, but increases to 3% from 1992 onwards. The base scenario shows that a growth rate of 5% p.a. can be achieved towards the end of the Sexenio.

Mexico's debt indicators would gradually improve in 1989-94. The stock of debt as a percentage of GNP would decline from around 59% in 1988 to 52% by 1994, while debt service as a percentage of exports would taper off from 58.2% to 29.7% in the same period. Interest payments as a portion of current GNP would be reduced from 5.3% in 1988 to 4.0% in 1994.

Net flows are available from the existing pipeline, but some of the sources imply net outflows, while others taper off over time (see Table 1). Considering Mexico's current prospects, it has been assumed that the IMF would make available an US$600 million compensatory facility in 1989. Since no stand-by program is currently under negotiation, none has been assumed. This implies a cumulative resourse transfer to the IMF of US$5.1b. Any possible stand-by program should thus be netted out against the financing requirements listed below. New Bank commitments are tentatively projected at US$2 billion per year; Bank's exposure would increase by US$4.7 billion over the next six years and its country share may slightly exceed 10% and remain there through 1994. The IDB is projected to lend at very modest levels, resulting in a small net outflow of capital. Bilaterals would also expand, their lines, which contributes a net inflow of US$2.5 billion over the "sexenio". On the other hand, bond holders, commercial banks, private non-guaranteed creditors, the IMF and --to a lesser extent-- suppliers are expected to take out a net US$20.8 billion over the next "sexenio". Direct foreign investments would, on the other hand, add a next flow of US$11.9 billion over 1989-1994, which can be justified on the basis of historical rates and, of course expected further relaxation of existing legal impediments and fiscal disincentives to foreign investments. The net effect of the existing pipeline and the above assumptions is that the country will be faced with a financial gap of US$36.5 billion in 1989-94 (US$ 6.1 billion per year), which has to be financed to cover the current account balance and the required build up in net reserves (see Table on p.61).

Mexico's Financing Needs 1989-1994 (bUS$)

Needs (cumulative)			Sources		
Current Account Def.		27.6	DFI	11.9	
Net Scheduled Amort.		22.7	IBRD	4.7 [6]	
of which			Bilaterals	2.5	
Bonds	1.5		IMF CFF	0.6	
Comm.Banks	13.5				
Priv.Non-Guar. Debt	7.5		Subtotal		19.7
Suppliers	0.2				
IMF		5.6	FINANCING GAP		36.5
Total		56.2	Total		56.2

Note: Totals may not add up due to rounding error

Sensitivity of Financing Requirements to External Variables

Lower Oil Prices. In this scenario, oil prices drop by 24.7% in real terms in 1989, down to US$10 pbb, instead of US$12 pbb in the base scenario, and grow at an average of 2.6% p.a. thereafter. Mexico's trade surplus would shrink rapidly because of stagnating oil revenues, and show a deficit of nearly US$1 billion by 1991, one year earlier than with the higher oil prices under the base case. Mexico's net capital requirements under these conditions are US$8 billion higher than for the base case, amounting to a total of US$44.8 billion in 1989-94 (an extra US$ 1.4 billion per year), as shown in Table 2.

By assumption, the existing pipeline and new lending by the Bank, IDB and bilaterals, plus the US$600 million compensatory facility of the Fund and additional direct foreign investments are the same as in the base case. As a consequence, Mexico's financing gap increases to US$44.8 billion over 1989-94 under this low oil price scenario.

Zero Real International Interest. If Mexico were to pay a zero real interest rate (i,e. 5% nominal rate, as opposed to LIBOR plus a spread of 13/16, currently equivalent to 8.8% under the base case) on its foreign debt, all debt ratios would substantially improve. The debt to output ratio would drop to almost 40% by 1994, while debt service to output would be nearly halved to 4%. Interest payments would drop to below 3% of GNP immediately, decreasing further to around 2% by the end of the "sexenio". The current account would show much smaller deficits (about 0.5-0.7 percent of GDP) over 1989-1974. Net capital requirements would, as shown in Table 3, drop to US$10.9 billion, which is about a third of what is required under the base scenario.

The Table below shows the financial gaps under different scenarios for oil prices and world interest rates.

[6] Net disbursements, based on gross commitments of about 2 $bUS per year.

ANNUAL FINANCIAL GAP (US $ MILLIONS)

YEAR	BASE	LOW INT. RATES	LOW OIL PRICES
1989	2552	-783	3658
1990	5433	2014	6646
1991	7717	4189	9044
1992	7233	3655	8677
1993	7784	3937	9045
1994	6028	2707	7690
Total	:36448	15720	44761

The sensitivity of the financing gap with respect to external conditions suggests that any financing plan should include contingent provisions covering major unanticipated changes in external factors such as oil prices. Contingency facilities, even if not actually used, would contribute to expectations of a more stable environment, thus encouraging investment.

Options for Financing the Gap under the Base Scenario

Given Mexico's substantial net capital needs, it is necessary to develop a financing strategy that can address the issues of resource mobilization and burden sharing among Mexico's external creditors. The cumulative net flows for 1989-94 in Table 1 show that before any additional financing is obtained, the commercial banks take out a total of US$13.4 billion, and the IMF another US$5.1 billion. Furthermore, bilateral agencies increase their exposure only in the first three years, so that the net increase over the "sexenio" is US$2.5 billion. In view of this, an assessment will be made of the following: (a) what effort would the commercial banks have to make to cover the financing gap; (b) what would happen to the financing gap, if the commercial banks were to keep their stock of debt constant in real terms at end-1988 level; (c) what would be the effect of cofinancing in the amount of US$1.5 billion; (d) what would be the impact on the financing gap of an IMF standby, which might be put in place in the second half of the "sexenio"; and (e) what happens to burden sharing.

Financing Gap to be Covered by Commercial Banks. The total financing gap for 1989-94 is reproduced in Table 4, together with the net capital outflows under their existing pipeline. If these outflows of principal were to be fully refinanced by the banks, the remaining financing gap may be covered by a partial refinancing of commercial bank interest payments, the portion to be refinanced varying between 19% in 1989, which is the lowest in the whole period and 93% in 1993, which would be the highest. On average, over the six year period, two thirds of the commercial bank interest payments would have to be refinanced to fill the gap under the base scenario. This --as discussed earlier-- in consistent with the expected improvements of Mexico's debt indicators over the medium term, while the commercial banks increase their stock of debt by 23.0 billion in 1989-94, or by an average of US$3.8 billion each year.

Commercial Banks to Keep Real Term Stock of Debt Constant. If commercial banks were to keep constant their stock of debt in real terms at end-1988 level, they would have to roll over the net outflows under the existing pipeline and provide net financing to Mexico in an amount of US$16.7 billions over 1989-94, as shown in Table 4 (line 6). These net flows would always be in excess of the outflows projected under the existing pipeline. Therefore, to keep their stock of debt constant in real terms, they would have to refinance a varying portion of the interest payments. Because projected international inflation is relatively high in 1989, the portion of interest to be refinanced would have to be 71%, which is some what higher than the 18-60% levels required in 1990-93. On average, they would have to refinance one half of their interest payments in the six year period compared with the 2/3 required, if they were to fill the whole financing gap; in effect, under this scenario, they would cover roughly one half of the total financing gap.

Cofinancing. Table 4 shows that cofinancing in the amount of US$1.5 billion would have only a minimum impact, and only in the first two years. Assuming that the facility would disburse US$750 million in 1989 and 1990 each, for the commercial banks to fund the uncovered gap, they would have to refinance only 25% of their cumulative interest payments in 1989-90, instead of 38% without the facility. Cofinancing could thus have a beneficial effect especially in a short run. It does not make a significant difference over the whole six year period; the proposed amount is too small for that.

The Potential Impact of an IMF Facility. To examine what would be the impact of an IMF standby on Mexico's financing gap under the base scenario, it has been assumed that the Fund would put in a US$5.1 billion standby. This is equivalent to what it would take out in the six year period without a program. It is further assumed that the standby would be made in the second half of the "sexenio", in 1992. The benefits of a possible Fund program would not be insignificant, as the portion of commercial bank interest payments that would have to be refinanced in 1992-94 would drop from an average of 74% without a standby to 52% with the standby. While such a program would be clearly far from sufficient to cover the short fall in Mexico's financing needs, it would alleviate somewhat the effort that would otherwise be required of the commercial banks to keep Mexico on track of its growth oriented strategy.

The cumulative effect of cofinancing in the amount of US$1.5 billion and an eventual IMF standby around US$5 billion would help commercial banks keep the refinanced portion of their interest payments at little less than one half.

Table 1: Financing Requirements. Base Case
(in millions of US$)

	1989	1990	1991	1992	1993	1994	1989-94
Bonds	-265	-422	-270	-324	-43	-155	-1479
IBRD	1523	1135	657	535	476	374	4706
IDB	-77	-54	-24	-47	-78	-108	-387
Bilateral	1129	817	590	73	-17	-53	2545
Commercial Banks	-1009	-2404	-2441	-2536	-2723	-2327	-13440
Suppliers	-67	-73	-36	-18	-15	-12	-221
Private Non-Guaranteed	-1942	-1689	-1759	-676	-1140	-260	-7466
IMF	-307	-1244	-1328	-1156	-799	-221	-5055
Net Flows 1/	-1010	-3933	-4611	-4142	-4339	-2763	-20797
Additional Net Financing 2/	2552	5403	7717	7233	7484	5023	35448
Direct Foreign Investment	1625	1714	1899	2104	2247	2332	11921

Net Present Value

Net Flows 1/	-924	-3235	-3541	-2921	-2317	-1660	-15153
Additional Net Financing 2/	2335	4552	5326	5101	4860	3621	25795
Direct Foreign Investment	1487	1570	1741	1932	2063	1401	11321

1/ Based on pipeline and new commitments from IBRD, IDB and Bilaterals.
2/ Net flows from borrowing from unidentified sources

Table 2: Financing Requirements. Low Oil Price Case.
(in millions of US$)

	1989	1990	1991	1992	1993	1994	1989-94
Bonds	-265	-422	-270	-324	-43	-155	-1479
IBRD	1523	1136	657	535	476	374	4706
IDB	-77	-54	-24	-47	-78	-108	-387
Bilateral	1129	817	590	73	-17	-53	2545
Commercial Banks	-1009	-2404	-2441	-2536	-2723	-2327	-13440
Suppliers	-57	-73	-36	-18	-15	-12	-221
Private Non-Guaranteed	-1942	-1689	-1759	-676	-1140	-260	-7466
IMF	-307	-1244	-1328	-1156	-799	-221	-5055
Net Flows 1/	-1010	-3933	-4611	-4142	-4339	-2763	-20797
Additional Net Financing 2/	3658	5646	9044	8677	9045	7630	44751
Direct Foreign Investment	1625	1714	1899	2104	2247	2332	11921

Net Present Value

Net Flows 1/	-924	-3235	-3541	-2321	-2317	-1660	-15158
Additional Net Financing 2/	3347	5569	5945	6119	5874	4620	32473
Direct Foreign Investment	1487	1436	1458	1484	1459	1401	11921

1/ Based on pipeline and new commitments from IBRD, IDB and Bilaterals.
2/ Net flows from borrowing from unidentified sources

Table 3: Financing Requirements. 5% Interest Rate Case.
(in millions of US$)

	1989	1990	1991	1992	1993	1994	1989-94
Bonds	-265	-422	-270	-324	-43	-155	-1479
IBRD	1528	1136	657	535	476	374	4706
IDB	-77	-54	-24	-47	-78	-108	-387
Bilateral	1123	817	590	79	-17	-53	2545
Commercial Banks	-1009	-2404	-2441	-2536	-2723	-2327	-13440
Suppliers	-57	-73	-36	-18	-15	-12	-221
Private Non-Guaranteed	-1942	-1689	-1759	-576	-1140	-260	-7466
IMF	-307	-1244	-1328	-1156	-799	-221	-5055
	-----	-----	-----	-----	-----	-----	-----
Net Flows 1/	-1010	-3933	-4611	-4142	-4339	-2753	-20787
Additional Net Financing 2/	-783	2024	4189	3655	3927	2707	15720
Direct Foreign Investment	1625	1714	1899	2104	2247	2332	11921

Net Present Value

	1989	1990	1991	1992	1993	1994	1989-94
Net Flows 1/	-924	-3295	-3541	-2921	-2817	-1660	-15158
Additional Net Financing 2/	-716	1696	3217	2578	2550	1526	10951
Direct Foreign Investment	1487	1570	1741	1932	2069	1401	10139

1/ Based on pipeline and new commitments from IBRD, IDB and Bilaterals.
2/ Net flows from borrowing from unidentified sources

18-Nov-88

Table 4. Refinancing required to fill the financing gap. Base Case.
(US$ Millions)

	1989	1990	1991	1992	1993	1994	1989-94
1. Financing gap 1/	2552	5433	7717	7233	7484	6023	36447
2. Rollover of commercial banks net flows.	1009	2404	2441	2536	2723	2327	13440
3. Uncovered financing gap.	1543	3029	5276	4697	4761	3701	[illegible]
4. Commercial banks interest payments.	5850	5737	5494	5134	4840	4339	31454
5. (3)/(4) 2/	0.264	0.529	0.960	0.904	0.984	0.853	0.731
6. Net commercial flows (over and above rollover) required to keep real debt constant at 1988 level	4171	1056	2714	2817	2924	3036	16718
7. (6)/(4)	0.713	0.184	0.494	0.542	0.604	0.700	0.532
8. Commercial banks share in total stock of debt, if their real debt is constant.	0.652	0.653	0.659	0.666	0.673	0.680	
9. Commercial banks share in total stock of debt if they cover full financial gap	0.637	0.678	0.729	0.772	0.816	0.844	
10. IBRD share in total stock of debt	0.093	0.102	0.105	0.107	0.108	0.108	

A: Assuming US$ 1.5 billion from [illegible] ($750 million in 1989 and 1990)

	1989	1990	1991	1992	1993	1994	1989-94
1. Financing gap 1/	1802	4683	7717	7233	7484	6023	34947
2. Rollover of commercial banks net flows.	1009	2404	2441	2536	2723	2327	13440
3. Uncovered financing gap.	793	2279	5276	4697	4761	3701	21507
4. Commercial banks interest payments.	5850	5737	5494	5134	4840	4339	31454
5. (3)/(4) 2/	0.136	0.397	0.960	0.904	0.984	0.853	0.684
6. Commercial banks share in total stock of debt if they cover full financial gap	0.630	0.664	0.715	0.760	0.803	0.832	

B: As in A but with a stand-by from the IMF of US $ 5.1 billion in 1992

	1989	1990	1991	1992	1993	1994	1989-94
1. Financing gap 1/	1802	4683	7717	4683	4934	6023	29847
2. Rollover of commercial banks net flows.	1009	2404	2441	2536	2723	2327	13440
3. Uncovered financing gap.	793	2279	5276	2147	2211	3701	16407
4. Commercial banks interest payments.	5850	5737	5494	5134	4840	4339	31454
5. (3)/(4) 2/	0.136	0.397	0.960	0.413	0.457	0.853	0.522
6. Commercial banks share in total stock of debt if they cover full financial gap	0.630	0.664	0.715	0.737	0.760	0.789	

1/ Net financing to be covered from unidentified sources.
2/ The portion of commercial banks interest payments which would have to be refinanced to cover the full financing gap.

Glokia

Document of

The World Bank

FOR OFFICIAL USE ONLY

MEXICO PE REFORM

Report No. P-4954-ME

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED PUBLIC ENTERPRISE REFORM LOAN

IN AN AMOUNT EQUIVALENT TO US$500 MILLION

TO

NACIONAL FINANCIERA, S.N.C.

WITH THE GUARANTEE OF

THE UNITED MEXICAN STATES

MAY 22, 1989

CURRENCY UNIT - PESO (MEX$)

On April 10, 1989, the exchange rate in the controlled market was US$1 = Mex$2,355.00; the free market exchange rate stood at US$1 = Mex$2,370.00.

FISCAL YEAR

January 1 - December 31

PRINCIPAL ABBREVIATIONS AND ACRONYMS USED

AHMSA	-	Altos Hornos de Mexico, S.A.
BOD	-	Board of Directors
CEPROFIS	-	Certificado de Promocion Fiscal
CEO	-	Chief Executive Officer
CFE	-	Comision Federal de Electricidad
CGF	-	Comision Intersecretarial Gasto-Financiamiento
CMC	-	Carbon y Minerales de Cohahila, S.A.
CONASUPO	-	Compania Nacional de Subsistencia Populares
FERRONALES	-	Ferrocarriles Nacionales
FERTIMEX	-	Fertilizantes Mexicanos, S.A.
FSL	-	Financial Sector Adjustment Loan
ISPL	-	Industrial Sector Policy Loan
NAFIN	-	Nacional Financiera, S.N.C.
OECP	-	Organismos y Empresas Controlados Presupuestalmente
PA	-	Performance Agreement
Pacto	-	Pacto de Solidaridad Economica
PE	-	Public Enterprise
PECE	-	Pacto de Estabilisacion y Crecimiento Economico
PEMEX	-	Petroleos Mexicanos
PERL	-	Public Enterprise Reform Loan
QR	-	Quantitative Restriction
SARH	-	Ministry of Agriculture and Water Resources
SCT	-	Ministry of Telecommunications and Transportation
SECOFI	-	Ministry of Trade and Industry
SECOGEF	-	Controller General's Office
SEMIP	-	Ministry of Energy, Mines and Public Industry
SHCP	-	Ministry of Finance and Public Credit
SIDERMEX	-	Siderurgica Mexicana
SPP	-	Ministry for Programming and Budgeting
TELMEX	-	Telefonos de Mexico S.A. de C.V.
UCD	-	Unidad de Convenios de Desempeno

FOR OFFICIAL USE ONLY

MEXICO

PUBLIC ENTERPRISE REFORM

DECLASSIFIED

OCT 17 2022

WBG ARCHIVES

TABLE OF CONTENTS

Page No.

ANNEXES

MEXICO

PUBLIC ENTERPRISE REFORM

Loan and Program Summary

Borrower:	Nacional Financiera, S.N.C. (NAFIN)
Guarantor:	United Mexican States
Beneficiary:	United Mexican States
Amount:	US$500 million equivalent
Terms:	Repayable in 17 years, including 5 years of grace, at the standard variable rate.
Objectives:	The proposed loan, which is part of a program of Bank support to the Mexican Government's objectives of stabilizing its economy and resuming growth, will assist in the improvement of the efficiency of public enterprises (PEs). It aims to reduce the heavy burden they impose on the economy and, particularly, on the national budget.
Description:	The program includes: (i) a "disengagement" component to continue with the sale, liquidation and merger of PEs; and (ii) a program of reforms in the policy and institutional environment for PEs to improve the efficiency of the enterprises to be retained by the Government.
Benefits and Risk:	The above measures will improve the competitive environment and will provide greater managerial and financial autonomy and accountability to PEs. They will increase market forces, decentralize decision making, redefine the role of Government agencies, strengthen managerial capabilities and incentives and improve the allocation of resources. The main risks of the proposed program relate to the possibility of further deterioration in Mexico's public finances and macroeconomic environment--particularly inflation--which could lead to the re-emergence of increasing operational deficits and arrears of PEs, thus causing difficulties in balancing the duration and rigor of the reforms. There is also the risk that expected foreign financing would not materialize, thus undermining the macroeconomic objectives of stabilization and growth.

Estimated Disbursement: The loan would be disbursed against eligible imports in tranches of US$250.0 million and US$249.0 million, respectively. A US$1.0 million component would finance technical assistance and studies to carry through the initial effects of the reform. The first tranche would be available for disbursement at the time of loan effectiveness, upon fulfillment of specified conditions, including substantial progress in obtaining adequate financing for Mexico's requirement for 1989 and 1990, and also the drafting of regulations to the PE Law, defining the PE supervisory role of Government agencies, and the role and composition of PEs' Boards of Directors, in a manner consistent with providing parastatals with managerial and financial autonomy under clear accountability rules based on ex-post evaluation of performance. The second tranche would be released after November 30, 1989, upon fulfillment of specified conditions, including continued consistency of the macroeconomic policy framework with the public enterprise reform program; progress in obtaining adequate financing for Mexico's aggregate FY89/90 and for its medium-term requirements; progress in reducing Government transfers to parastatals; progress in implementing the liquidation, merger and sales program for 199 PEs; implementation of Performance Agreement Plans; development of an action plan to simplify, deregulate and make more flexible the annual budgeting system for PEs; and issuance of regulations to the 1986 PE Law. Disbursement of the entire loan is expected to be completed by June 30, 1991.

Retroactive Financing: US$100 million would be made available for retroactive financing of expenditures incurred after February 15, 1989, a date four months prior to expected loan signing.

Schedule of Disbursements:

Bank Fiscal Years	US$ million FY90	FY91
Annual	499	1
Cumulative	499	500

Rate of Return: Not applicable.

Appraisal Report: This is a combined President's and Staff Appraisal Report.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A PROPOSED LOAN IN AN AMOUNT EQUIVALENT TO US$500 MILLION TO NACIONAL FINANCIERA, S.N.C. FOR PUBLIC ENTERPRISE REFORM

1. I submit the following report and recommendation on a proposed loan to Nacional Financiera, S.N.C. (NAFIN) with the guarantee of the United Mexican States for the equivalent of US$500 million equivalent to support a program of reform of public enterprises. The loan would have a term of 17 years, including 5 years of grace, at the standard variable interest rate.

PART I - THE ECONOMY

A. Background

2. Between 1950 and 1974, Mexico enjoyed a remarkable period of high growth, low inflation and moderate external debt accumulation. Real growth averaged 6.4%, and inflation was in single digits throughout the period. This era of fiscal conservatism came to an abrupt end in the early seventies. Rapidly expanding government involvement in the economy pushed up the rate of economic growth. However, increasing government expenditure was not matched by rising public sector revenues. At the same time a decline in private savings incentives (real interest rates turned sharply downwards) prevented a matching increase in private savings. As a result, inflation tax and external debt became increasingly important sources of finance. The period of single digit inflation ended in 1973, the real exchange rate started to appreciate[1] and the accumulation of external debt accelerated above the GNP growth rate beyond 1973.

3. In 1976, Mexico experienced a serious, but comparatively brief financial and economic crisis, triggering a major devaluation of the Mexican peso and financial austerity measures. However, after major oil discoveries were announced the following year, the stabilization program was quickly terminated. In fact, the subsequent period was characterized by both rapidly expanding government revenues and vastly increased borrowing of the public sector. The Government's share in total value added increased by almost one third, and in total investment from 33.5% in 1970-75 to substantially over 40% in later years. Not surprisingly, the real exchange rate once again started to appreciate, eroding the gains of the 1976 devaluation. This expansion was largely fueled from abroad: Mexico's external debt increased from US$16 billion to US$86 billion between 1975 and 1982.

4. The situation changed dramatically in 1982 when rising world interest rates and falling oil prices put an end to Mexico's increasingly expansionary policies. The refusal of external creditors to roll over

---

1/ The real exchange rate is defined as the price of foreign goods relative to domestic goods. Appreciation means a decline in this relative price.

Mexico's short term debt left no option but fiscal retrenchment. Mexico, which had run non-interest current account deficits in each of the preceding thirty years, suddenly needed to run surpluses on that account in every following year. The ratio of external debt to GDP increased substantially under the influence of rising interest rates and falling growth rates. The gap between the real interest rates on external debt and real GDP growth went from -6.3% in 1980-1981 to a full +10.5% in 1983. Such a high difference meant that, even without a non-interest current account deficit, the debt burden would increase rapidly, simply through the compounding effect of interest on debt inherited from the past. In addition, there were substantial capital losses on external debt due to the necessary real exchange rate depreciation. Given the major decline in oil revenues and rise in real interest obligations, the real depreciation of the exchange rate was unavoidable, but it led to an increase in external debt to GDP ratio of almost 25 percentage points during the period 1982-1987.

5. The counterpart to the non-interest current account improvement was a sustained fiscal adjustment effort that is probably unmatched in any country. A primary fiscal deficit of 7.6% of GDP before the 1982 crisis was turned into a surplus of 4.9% in 1987 and an estimated 5.8% in 1988 (Annex I, Table 1). And this was achieved while revenues from oil exports declined by more than 7% of GDP between 1983 and 1988, and GDP growth declined dramatically. Non-interest Government expenditure was reduced from the equivalent of 35.4% of GDP in 1982 to about 22.6% in 1988. The public enterprise divestiture program was successful in closing or selling roughly 700 small and medium entities, out of a total of about 1200 in 1982. In addition, in the same period, Mexico has undertaken far reaching structural reforms at an accelerating pace.

6. An IMF supported stabilization program was launched in 1983, during which the fiscal deficit was halved, international reserves recovered, and inflation began to decline. However, in 1984 and 1985 there was some fiscal expansion and monetary relaxation. Moreover, the earthquake in late 1985 and a major terms of trade deterioration in 1986 due to falling oil prices worsened Mexico's prospects. In response, the authorities adopted a deeper and growth-oriented stabilization program in July 1986. In return for renewed monetary and fiscal austerity, this program also called for a concerted financing effort on the part of Mexico's creditors.

7. The 1986 package included new elements of policy designed to eliminate structural rigidities in the economy. The most significant change was a major reorientation towards fuller integration with the world economy. Exports of manufactures, spurred by a 42% real exchange rate depreciation over the July 1985-December 1987 period, have overtaken oil exports and more than compensated for the US$7 billion oil revenue loss experienced over the same time span. Since mid-1985, Mexico has undertaken a fast and far-reaching liberalization of the trade regime, aimed at expanding the tradeables sector, opening it to international competition and encouraging efficiency in both exporting, and import-substitution activities. In 1986 Mexico acceded to the GATT. The trade liberalization

process was supported by Bank operations (Trade Policy I and II, and Agricultural Sector I). While it will take some time before the full impact develops, the initial results are promising, incentives have been redirected and restructuring toward more efficient activity has begun. For example, in agriculture, the policy reforms initiated since 1985, and especially since October 1987, have substantially reduced direct and indirect price discrimination against producers. Exchange rate policy has become more favorable to all tradeable sectors. Import barriers have been sharply reduced for major agricultural inputs such as machines, pesticides, and other high technology inputs. Export restrictions on fruits and vegetables, which represent 25% of crop output, have been substantially reduced, and most producer prices have been moved into a band of between 90% and 125% of international prices.

8. The key reforms in the trade regime included reductions in the coverage of NTBs and tariffs. The progress has been impressive. Import licensing coverage is now less than one-quarter of what it was in June 1985, official reference prices have been completely abolished, the maximum tariff is now one-fifth and the average tariff about one-half of what they were in June 1985. Progress has gone beyond the Government's original schedule, GATT commitments, and the targets in the Trade Policy Loans I and II and the Agricultural Sector Loan I.

9. The ensuing fiscal retrenchment was unavoidable given Mexico's sudden difficulty in accessing the international capital markets and the adverse terms of trade shocks it experienced. As a byproduct, the severe fiscal cutbacks have greatly increased the efficiency of many of the remaining government operations. There is, for example, little doubt that few, if any, of the many dubious large projects of the late seventies remain in the public sector investment program. But, cutting back public investments from almost 10% of GDP in 1982 to around 4.4% in 1988, clearly has had its costs. Government investment has a role to play in areas that heavily complement private investment and in the social sectors. Also private investment has not made up for the decrease.

10. With lower investment on the one hand, and restrictive demand management on the other, real growth again stopped. There has been no real growth between 1982 and 1987, and hence a severe decline in per capita income (Annex I, Table 1). Also, inflation, rather than slowing down, in fact accelerated towards the end of the period, partially in response to a sharp nominal devaluation. This devaluation, however, had become necessary because of the abrupt oil price decline in 1986. The subsequent de-facto targeting of the real exchange rate, together with an increase in the frequency of wage and cost adjustments, introduced an element of inherent instability into the system. This latter became fully apparent towards the end of 1987. The stock market plunge and less than perfect management of private debt buy backs evolving from the 1987 debt rescheduling triggered a run on the peso in October 1987. This resulted in reserve losses and eventually a 37% devaluation, fueling inflation and expectations of further exchange rate depreciations. The Government responded with the "Economic Solidarity Pact" (Pacto), a concerted effort to bring down inflation that was running well into triple digits by end-1987.

B. Macroeconomic Development in 1988

11. The "Economic Solidarity Pact" (Pacto) was negotiated in December 1987 between Government, labor, farming, and business representatives. The program consisted of further tightening of fiscal and monetary policy, and renewed structural reform efforts. Trade liberalization was accelerated, credit subsidies substantially reduced, and the program of public enterprise divestiture reinforced. These measures were supplemented by a freeze of minimum wages, public sector prices and tariffs, and, what was a corner stone of the "Pacto", freezing the nominal exchange rate against the U.S. dollar. This partial freeze was originally intended for a couple of months only, but it was extended at three month intervals through the end of 1988.

12. On almost every target that is under direct or indirect control of the government, performance under the "Pacto" has been exemplary and often went beyond what was initially planned. Trade reform was accelerated, partly because of the potential efficiency gains, partly because of its restraining effect on price increases. The fiscal deficit was brought closely in line with the low inflation targets embedded in the "Pacto". This effort was all the more noteworthy, given the negative budgetary impact of further drops in oil prices and increasingly high real interest rates on foreign debt towards the end of the year.

13. Moreover, this has been achieved in spite of high domestic real interest rates. These have been at around 30% in real terms during most of 1988, and have crept up to a compounded real rate in excess of 40% towards the end of the year. And, it must be stressed that real interest rates on Government debt swung from a negative 3% in 1987. With the domestic debt in 1988 equivalent to around 20% of GDP, such a turn around caused a massive increase in real interest payments to service the domestic debt.

14. The fiscal measures, backed up by the exchange rate freeze and an array of formal and informal price controls, have had a dramatic success in reducing the rate of inflation. Inflation figures for October 1988 indicate a monthly rate of 0.8% for the CPI and 1.4% for the WPI. In November 1988, the WPI actually declined and the CPI inflation rate slowed down further to 1.3%. In December 1988, CPI inflation was 2.1%, substantial food price increases notwithstanding but the WPI went up by only 0.8%. This is a tenfold reduction compared with the beginning of the year; if the October-December 1988 rates could be sustained, Mexico's inflation rate would be at an annualized rate of approximately 15%. This would clearly be a dramatic change with respect to the 159% inflation rate in 1987.

15. The policy of a fixed Peso-Dollar rate came under increasing pressure in 1988 as the year went by. The real exchange rate against the US Dollar appreciated by 9.2% since January, and by 5.5% since March, the first month with low inflation. The appreciation of the dollar between March and September 1988 added to the pressure: on a trade weighted basis

the real exchange rate appreciated by almost 7.4% between March and August. This should be set against a sharp real depreciation of 42% on trade-weighted basis between July 1985 and December 1987. July 1985 was the month preceding a nominal devaluation of 17% and the beginning of a much more aggressive exchange rate policy. However, falling oil prices and rising international interest rates in the second half of 1988 added to pressure on the real exchange rate.

16. Doubts about the sustainability of the exchange rate may have been behind the second striking feature of 1988, an extraordinary surge in imports which increased by 48% in 1988. It seems that a substantial part of the import boom was related to speculation against the exchange rate, and, possibly, a gamble on future trade reform rollback.

17. At the same time, non-oil exports increased by 16% in dollar terms in 1988, (the 1987 over 1986 increase was 23.7%). But because of the falling revenues from oil, total exports grew by only 5% in nominal terms in 1988 over 1987. In addition there was a strong increase in exports from the "Maquiladoras," the import/export industries along the US border. While separate export and import data for the "maquila" sector are not yet available for 1988, preliminary data indicates that value added increased by 40% over 1987, adding a US$2.3 billion to the trade surplus in 1987 (as opposed to US$1.6 billion last year). The increase in exports was due to improved competitiveness since mid-85; as mentioned before, although the exchange rate depreciated in real terms by 42% between July 1985 and December 1987, some of the gains have been eroded since the beginning of 1988. Also, since 1985, Mexico's competitors have improved their competitiveness by almost 10%.

18. The net result was a deterioration in the current account of US$6.8 billion dollars from 1987 to 1988 (a swing to a deficit of US$2.9 billion in 1988 from a surplus of about US$3.9 billion in 1987).

C. Macroeconomic Policies in 1989

19. In December 1988 the Mexican Government and the various sectors of society agreed on a renewal of the "Pacto" as the initial phase of economic policies for 1989. This renewed Pacto now called Stabilization and Growth Pact--PECE aims to consolidate price stability and contains specific guidelines through the end of July 1989. Within this framework, public sector prices and tariffs were adjusted, minimum wages were increased by 8%, and the peso is being depreciated daily according to a pre-announced schedule of one peso a day. Under the PECE it is expected that inflation will decline from 52% during 1988 to 20% during 1989. The fiscal measures approved by Congress in the 1989 budget will contribute to a reduction of the operational deficit. The fiscal stance, in conjunction with appropriate monetary and exchange rate policies, should help bring about the gradual recovery of investment and output, as well as lower inflation and the strengthening of international reserves.

20. The first quarter of 1989 indicates that the PECE is performing very much like the Pacto, with the same successes and weaknesses.

Inflation, after accelerating to 2.1 and 2.4% respectively in December and January, came down to 1.4% in February and 1.1% in March. Current rates, if continued, are compatible with the Government's stated 20% year-end to year-end target (one percent a month until December implies 17% December to December inflation), an impressive reduction from the 159% and 52% inflation rates in 1987 and 1988, respectively. Also, the nominal daily devaluation of the Peso has led to a small real depreciation of the exchange rate against Mexico's main trading partner, the USA. Current exchange rate policy and inflation targets are broadly consistent with a stable real exchange rate (a small real depreciation from December 1988 to December 1989). Exchange rate policy will be monitored in the context of the proposed IMF's EFF.

D. Towards Renewed Growth

21. The predominant long term problem in Mexico is the continued low growth rate of the economy. This is not only an issue of great social concern, but also presents a major inefficiency and a threat to the success of the short term stabilization program as well. An efficiency issue, because it suggests that the rationalized incentive structure that is beginning to emerge as a result of the ongoing reform program is not sufficiently exploited; and threat to the stabilization effort because any fiscal deficit is much harder to finance at low than at high growth rates. Thus low growth rates increase the probability that recourse to reliance on the inflation tax is imminent. For all these reasons restoration of growth to the levels prevailing before the expansionary mid seventies is imperative.

22. It is clear, however, that because of the short-term problems, fiscal efforts cannot be the main engine of growth. In the short run, balance of payments considerations leave no option but export led growth. Then however, supply bottlenecks will develop in time, with the consequent need for additional investment. At present, investment is equivalent to 20.3% of GDP, public investment being at its lowest historical level. With fiscal retrenchment necessary in the face of low inflation targets and the likely negative impact of external shocks on public finance, private investment will have to lead the way. This is also more in line with the structural reforms currently underway in Mexico; these reforms seek to reduce rather than increase the role of the public sector. This then sets the stage for the three proposed adjustment operations: Financial Sector Adjustment Loan (FSL); Industrial Sector Policy Loan (ISPL) and Public Enterprise Reform Loan (PERL); how to restore private sector based growth within the constraints set by external creditworthiness. A starting point would, therefore, have to be the design of a policy-financing package that will provide the framework for the increase in private investment necessary for resumed growth. The proposed operations are clearly an important component of such a package.

23. The need for a solution to Mexico's external debt problems is not only essential for the recovery of growth, but would also contribute significantly to the chances of success of the stabilization effort. Clearly, cutting back Mexico's access to foreign capital markets would in

fact reduce Mexico's creditworthiness because it would slow down GDP growth. Sustained access to external capital markets is necessary to provide room for the additional investment needed for renewed growth. But fears of the consequences of a lack of access to capital markets, with its implications for fiscal and exchange rate policy, are clearly among the factors holding this investment back. In turn, the resulting sluggish growth performance and public finance problems are among the factors causing the lack of access to external capital markets to begin with, thus closing the vicious circle.

24. It is exactly in such a vicious circle situation that the Bank has a major role to play. On the one hand, it can provide external funds as, for instance, through the three proposed adjustment operations and help secure other sources of financing, thus relaxing the external constraint that is stifling growth. But, at the same time the Bank would, through the policy package it supports, give a signal that the increased external funds will indeed, trigger the increased investment necessary for growth. Thus, Bank lending would play a major catalytic role in the process of breaking out of the macroeconomic bind in which Mexico finds itself. This is the main rationale for the three proposed adjustment operations: to act as a catalyzing agent for a process of renewed growth, where Mexico and all its external creditors play an active participatory role.

E. External Debt and Creditworthiness

25. Mexico's gross external public and private debt increased by nearly US$11 billion during 1983-88, and net debt by about US$9 billion. The debt service ratio increased from 47.1% of exports of goods and non-factor services in 1982 to 60.5% in 1988, mainly due to large repayments of around US$3.5 billion of private sector debt and a decline in oil prices. At the end of 1988, the Bank's share of Mexico's long-term debt was 8.2%, and its share of Mexico's long-term debt service was 7.6%. Mexico's share in the Bank's total exposure was 8.7% in 1988. This latter ratio is expected to rise somewhat by the end of this decade because of Bank expanded assistance program, but will remain below 10% of the Bank's total portfolio. Provided that sound domestic economic policies continue to be pursued, and that the external environment remains favorable for the execution of these policies, Mexico is considered creditworthy for planned Bank lending.

PART II - THE PUBLIC ENTERPRISE SECTOR

A. Evolution of the Sector

26. One of the causes of Mexico's economic and financial crisis since the 1970s has been the large and weakly managed public sector, particularly the public enterprises (PEs). At present, these enterprises contribute about 12% of GDP, employ about one million people, and control the most important branches of basic industry and infrastructure. However, as noted below, PEs have persistently received substantial subsidies from the Government, aggravating fiscal deficits.

27. The establishment of most public enterprises in Mexico occurred on an ad hoc basis. During the 1970s, the sector grew rapidly without a clear definition of the roles of the Government and the private sector: there were 12 PEs in 1930, 491 in 1970, 845 in 1976, peaking at 1,155 in 1982. A major source of growth was the acquisition by the Government of bankrupt private firms to avoid their closure and maintain employment. Efficient administration of PEs was hampered by the fact that prevalent PE legislation at the time focused on processes and controls that relied heavily on the administrative capacity of the Government. This legislation had originally been developed to deal with Central Government operations, investment and procurement (Education, Health, Housing, etc.) and was not suited for industrial and commercial enterprises. Partly as a result of ineffective management, and also because PE prices and tariffs were generally below their economic opportunity costs, the deficit of the largest PEs, as a percentage of the total Federal Government deficit, grew to 38% in 1976. Direct budgetary transfers to the largest PEs were above 5% of GDP in 1982.

28. Since 1982 the Government has implemented a major "disengagement" program for most of the small and medium PEs and some of the larger ones (in mining, air transportation and capital goods). Of the 706 companies disengaged under the program, 32% were sold, 11% merged, 53% liquidated, and 4% transferred to local governments. By February 1989, this process has left only 449 entities in the public sector, of which 94 are in the industrial, energy and mining sectors. Excluding the oil and electricity companies, which must remain with the Government as dictated by the Mexican Constitution, the enterprises disengaged since 1982 in the industrial, energy and mining sectors represent 77% of the number of enterprises, 66% of labor, 41% of sales, and 23% of the asset value of the initial universe of PEs in these sectors in 1982 (para 50).

B. Supervisory Institutions for Public Enterprises

29. Since 1976, public enterprises have been under the control of Sector Ministries, acting as sector coordinators. The Ministries of Energy, Mines and Public Industry (SEMIP), Telecommunications and Transportation (SCT) and Agriculture and Water Resources (SARH) control the largest number of PEs. In addition to the Sector Ministries, the Ministry for Programming and Budgeting (SPP) exercises authority and control over the operating and investment budgets of the PEs. Further authority on operational, credit, and financial matters is exercised by the Ministry of Finance and Public Credit (SHCP) and the Controller General's Office (SECOGEF). Lastly, the Interministerial Committee for Expenses/Financing "Comision Intersecretarial Gasto-Financiamiento" (CGF), created in 1985 to resolve issues of public expenditures and funding, coordinates actions of SPP, SHCP and SECOGEF on public enterprise matters of relevance to both the budget and the macroeconomic stabilization program. CGF also approves particularly complex PE sales. There is significant duplication of efforts among these agencies, and some of them have gone far beyond their originally stipulated functions becoming deeply involved in the day-to-day management of public companies. This has caused disruptions which impede a more effective management of PEs.

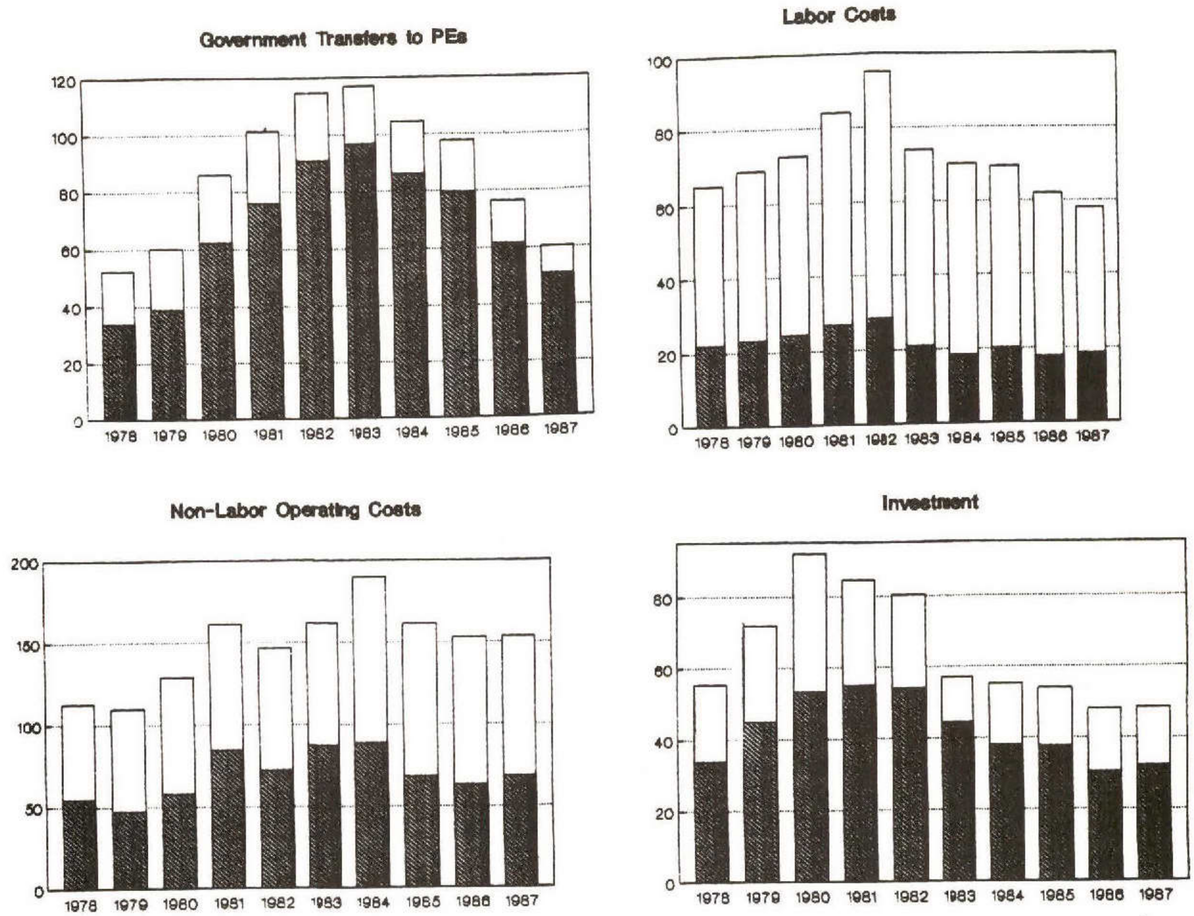
C. Past Performance of Public Enterprises

30. The economic and financial performance of PEs during the last decade has not been satisfactory. Since 1982, the disengagement program has helped, but other efforts have focused on immediate cost-containment measures rather than on long-lasting efficiency improvement measures. Though PEs' payroll and investment costs have dropped dramatically in real terms since 1981, many enterprises are still facing low capacity utilization, high operating costs, and financial losses. They continue to receive large subsidies from the Government: total transfer of Government funds to PEs amounted to approximately 2.8% and 2.1% of GDP in 1987 and 1988, respectively. About 67% of these transfers have been to service PE debt, 8% for new investments, and 25% to cover operating costs. Of the latter, the largest component represents indirect subsidies to consumers, because these transfers support PEs affected by Government controlled prices generally set below opportunity cost (e.g., fertilizers, food products and electricity). In addition to these direct transfers, the Government has also assumed debt of PEs; its service is estimated at about 1.8% of GDP in 1987 and 1.3% of GDP in 1988.

31. The financial performance of PEs during the 1980s can be depicted as follows. The large majority of small- and medium-sized PEs, which are commercial in nature and operate in non-monopolistic markets, have remained profitable throughout most of the decade; they have been prime candidates for the PE-sales program. On the other hand, a handful of companies, noticeably the larger ones with a mix of social and commercial objectives, account for most of the parastatal sector crisis in Mexico. In fact, the consolidated financial statements for these large enterprises--CFE (power), CONASUPO (food and grain marketing), FERRONALES (railway), FERTIMEX (fertilizer), and SICARTSA (steel)--show that during the first half of the 1980s, their cumulative value added (i.e., net sales revenues minus cash production cost other than labor) was negative. Consequently, the Government has financed labor costs, investment costs and debt service of these five large PEs through both budgetary transfers and, since 1985, the assumption of debt. During 1980 to 1985, budget transfers averaged 1.2 times the sales revenues generated by these PEs and were equivalent to 2.8% of GDP p.a. In addition, the PE-debt assumed by the Government reduced real interest payments of these PEs by nearly two thirds between 1984 and 1987.

32. Government's austerity and cost-containment efforts undertaken between 1982 and 1987 gradually resulted in drastic cuts in labor and investment costs of the above five large PEs. During this period, labor costs dropped by 36% and investment costs by 40%, in real terms. In spite of these efforts, federal transfers to these five PEs in 1987 still accounted for 90% of total direct budgetary transfers to PEs. This is partly because product prices were kept artificially at low levels. Furthermore, austerity measures failed to reduce direct non-labor operating costs of these PEs. Consequently, their consolidated gross margin remained negative. The evolution of Government transfers, labor costs, other operating costs, and investments of these large PEs, and of the rest of the parastatals under direct Government budgetary control, is detailed in Table 2, Annex VIII, and summarized in the following graphs (in constant 1978 billion pesos):

Graphs of Selected PE Cash Flows



Consolidated cash flow for CFE, CONASUPO, FERTIMEX, FERRONALES and SICARTSA.

Consolidated cash flow for other PEs under budgetary control, excluding PEMEX.

Source: "Ingreso-Gasto Publico de los Organismos y Empresas Controlados Presupuestalmente" in Sexto Informe de Gobierno, 1988.

D. Core Sector Issues

33. There are several core issues negatively affecting the performance of the public enterprise sector. Pricing policies for a few large PEs have been inadequate. Large PEs have conflicting social and commercial objectives. The overcentralized structure of budgeting and control has severely limited the managerial and financial autonomy of PEs, leaving little incentive for management to improve performance. Major budgeting, personnel, salary, investment, procurement and even some operational decisions of PEs are made at the ministerial level, often with a short-term cost-containment focus. This leads to duplication of effort, increased administrative and transaction costs, and missed opportunities. As indicated earlier, Government control agencies--SPP, SHCP, SECOGEF and the Sector Ministries--have gone far beyond their stipulated functions, and either by legal decree or by simple extension of accepted practice, have become ever more deeply involved not simply in the broad control, but in the day-to-day management of PEs. This has undermined the decision-making authority of PE management.

34. Financial autonomy of PEs is further limited by the current procedures under which the annual operational budgets of the large enterprises are formulated at the ministerial level. The role of the PEs in this budgeting process is most limited. These financial controls are major restraints on management autonomy to adjust to shifting macroeconomic, sectoral and market conditions. Furthermore, the budget for investments is approved by the Government annually and for a single year, with the result that projects cannot be implemented on time due to annual fluctuations in the overall budget, often resulting in lack of adequate financing for ongoing investments. In addition, many large capital intensive investments have been made without consideration for international competitiveness, with little intersectoral coordination.

35. Another sectoral problem is that many PEs have unmanageable levels of debt. This is due to excessively leveraged and poorly designed or implemented projects, controls that set prices at levels below economic costs, negative impact of real devaluations on foreign debt service, and ineffective management. Debt service problems are further aggravated by the prevailing high domestic real interest rates.

E. Actions Taken to Date

36. During the last six years, the Government has taken action to address some of the sectoral issues discussed above. The competitive environment for industrial and commercial activities has been significantly improved. The major policy reforms implemented since 1982 are as follows: (a) Import policy: Tariffs were reduced from a 0-100% range in July 1985 to 0-20% in December 1987, while import licenses and other non-tariff barriers reduced from 92.2% of production in July 1985 to 23.2% in April 1988. Official reference prices, used as substitutes of quantitative restrictions (QRs) on imports, have been completely phased out. (b) Export policy: Export controls have been reduced from 578 tariff positions in 1980 to 242 in September 1988. There are 12 items subject to official export reference prices and 61 items subject to export tariffs. QRs on exports remain on a number of agricultural and petrochemical products. (c) Price controls: The scope of price controls has been substantially reduced. Price controls on private producers in 1983 included 141 generic products under strict controls and 31 under flexible controls; by September 1986, only 21 products classified as "super" basic were under strict controls and 122 were under flexible controls. Still, a significant number of price controls on goods/services produced by large PEs have not been eliminated over the period. (d) Tax and incentive policy: A tax reform fully indexing the tax system to inflation is being gradually implemented since 1987 and, as of January 1989, a revised corporate income tax system is in place. Also, as part of the Economic Solidarity Pact (Pacto) and subsequently, the Stabilization and Economic Growth Pact (PECE), both aimed at controlling inflation, tax credits on industrial investment (CEPROFIS) were temporarily suspended except for micro and small-scale enterprises on a very limited scale. These two measures have increased the neutrality of the industrial tax/incentive system, virtually eliminating tax-related distortions on investment decisions and the incentive to leverage companies' finances beyond realistic levels.

37. In the area of reforms related more specifically to PEs, in 1986 the Government initiated a parastatal reform program, with the following main objectives: (i) implement a disengagement program to adjust the size and scope of the PE sector, selling, transferring to Regional Governments or merging a large number of firms and liquidating non-viable ones; (ii) provide greater enterprise autonomy; (iii) restructure physically, financially and organizationally a number of enterprises; and (iv) adjust prices and reduce Government subsidies. As part of the program, the Government enacted in 1986 the "Law of Parastatal Entities (PE Law)," a major and progressive step forward which created the legal conditions for a more appropriate balance between PEs'autonomy and accountability and which enabled the process of disengagement. However, the detailed interpretative regulations to this Law, which are essential for its implementation, have not yet been issued. Without these regulations, the PE Law is not operative and PEs are still subject to the existing web of legal, regulatory and administrative systems that deprive them of managerial and financial autonomy and negate their accountability. Reform of PEs has also been hindered by Mexico's tight economic situation, the inertia characteristic of large public organizations, and the political sensitivity of the issues. As a result of these constraints, substantive reform of the public enterprise sector has been mainly confined to the disengagement program.

38. During the past six years, the Government also took restructuring actions on a limited number of individual public enterprises, including initiating the restructuring of SIDERMEX (steel), FERTIMEX (fertilizers), CFE (power), AZUCARERA (sugar), FERRONALES (railways) and CONASUPO (markets and distribution of agricultural products). Restructuring was carried out within the framework of "Convenios de Rehabilitacion Financiera" (medium-term financial rehabilitation agreements) signed between the Government and the enterprises. However, the "convenios", while providing major up-front debt forgiveness, in most cases set target measures to improve efficiency too far in the future or too vaguely to be of value. Furthermore, their implementation has been hampered by budgetary regulations, with the result that investments have been often implemented with inordinate delays due to insufficient annual budgetary allocations and cost overruns.

F. Past Bank Involvement

39. The Bank has participated in PE projects in Mexico for many years. Loans have been made to several individual large PEs. Also, the Bank has supported PE sector restructuring and development through recent lending for steel, fertilizer and agriculture. While these operations have included some significant institution-building objectives of a cross-sectoral nature, they have proven insufficient to help the PE sector to address important issues, including those pertaining to the competitive environment, the role of Government agencies on PEs, and managerial and financial autonomy and accountability for PEs. The proposed operation focuses on these cross-sectoral issues.

40. In 1985, the Bank undertook a major in-depth review of the Mexican public sector investment program and process and identified a series of institutional, procedural and policy issues for the investment process in general and in the PE sector in particular. Subsequent reviews of the

fertilizer and steel sectors made extensive subsector specific reform recommendations, leading to the aforementioned Bank loans for their reshaping. The findings of the public sector investment review were discussed with the Mexican authorities in early 1986, where the first request for direct assistance to the PE sector as a whole was made. The proposed operation builds on the experience gained from past parastatal operations.

PART III - THE PROPOSED PUBLIC ENTERPRISE ADJUSTMENT PROGRAM

41. Mexico's macroeconomic growth prospects are highly sensitive to the availability of external finance. Adequate resource mobilization for Mexico in 1989-94 will therefore be of crucial economic and political importance. The success of sector adjustment programs to be supported under the three proposed parallel Bank adjustment loans, i.e., the Financial Sector Adjustment Loan (FSL), the Industrial Sector Policy Loan (ISPL) and this proposed loan, hinges on Mexico's access to external finance. Mexico has already initiated discussions with its principal external creditors, including creditor nation governments, key bilateral donors and commercial banks to design a financing package consisting of a blend of debt reduction, restructuring and new money in adequate amounts to alleviate net transfers abroad and meet the projected financing gap over the medium term. A condition for loan effectiveness would be substantial progress in obtaining adequate financing for Mexico's requirements for 1989/90. Continued substantial progress in obtaining financing for 1989/90 and for the medium term would be a condition for second tranche release.

42. It may be difficult for Mexico to obtain commitments for financing for a longer period, which would be needed to restore confidence and revive investments, thus helping recover economic growth. However, the expected presence of the IMF with a three-year program and the policy content of the proposed three parallel adjustment operations should offer a measure of comfort to Mexico's creditors as they consider providing a new financial package in 1989, including some form of debt relief that can reduce net transfers to external creditors from the current high level.

A. Objectives of the Program

43. Much of the success of Mexico in stabilizing its economy and resuming growth will depend on progress in public sector reform. The year 1989, the first one of the new Administration, calls for concerted actions to offset the fiscal impact of recent increases in international interest rates and to consolidate progress at the macro level to contain inflation. In the public enterprise sector, this will require a substantial effort to make the sector more efficient. For this purpose, the Government intends to act on two fronts. First, to continue to reduce the size of the public sector by further disengagement, particularly through PE sales. And second, to place a major effort to improve efficiency and reduce budgetary transfers to the remaining PEs. This will in turn require changes in their policy, regulatory and institutional framework to enable them to operate on a commercial basis in a competitive environment. The latter would place PEs on a similar footing with private firms, eliminating preferential treatment (e.g., subsidized input prices) and making subsidies and transfers more explicit and transparent. The proposed operation, which is largely based on in-depth analyses of five sectors with large PE presence

(steel, fertilizers, mining, capital goods, and basic petrochemicals) is intended to support a time-phased program of PE reform (referred to as the Program hereafter). The Program is defined in the Government's Letter of Development Policy (Annex IV) and Policy Matrix (Annex V).

44. In the area of further disengagement of PEs, the Program's key elements, described in Section B below, are the following. First, the Government has issued a policy statement enunciating its role in the production of goods and services, clearly defining the criteria for public sector participation under the concept of "priority areas". Second, the PE-Sales Unit in the Ministry of Finance has been strengthened, the process made more transparent, detailed privatization guidelines and the roles of the various actors in the PE-sales process have been established, and the level of past sales revenues and an assessment of results have been published. And third, further liquidations and sales of a large number of agreed upon parastatals, involving particularly complex economic, financial, social, and political issues, will be implemented. A total of 199 PEs have been selected by the Government for inclusion in the PE-disengagement program.

45. Even after completion of the disengagement program, there will be a number of companies that will remain under Government ownership. For these PEs, improvements in efficiency can be achieved by inducing them to operate on a commercial basis in a more competitive environment, with sufficient managerial autonomy and accountability to allow them to seek goals agreed upon with the Government under Performance Agreements, and with sufficient financial autonomy and accountability to assure financial discipline. For this system to work, the Government will implement reforms of the policy, institutional, and procedural framework under which PEs operate, as described in Section C below.

46. Success in the implementation of the above reforms is contingent on the implementation of a macroeconomic adjustment program consistent with the objectives of improved efficiency of PEs and a reduced size of the public sector. In consequence, for second tranche release under the proposed PERL, the Bank would be furnished with evidence satisfactory to it that: (i) the Government's macroeconomic policy framework is consistent with the reforms of PEs supported by the proposed loan; and (ii) the total operational plus investment transfers to PEs remain within the limits established in the FY89 budget, namely, a real reduction of 13% from FY88. To support this effort, and further reduce transfers in 1990 and beyond, a program of real price increases of goods and services produced by PEs with the largest deficits will be implemented.

47. The Mexican authorities agree on the urgency to improve the efficiency of the PE sector and the need to implement a corrective Program. The Program and implementation actions are described in the Letter of Development Policy (Annex IV) and in the Policy Matrix (Annex V). Institutional responsibilities for program implementation are indicated in paragraphs 88-89 and Annex VI. Program details are described below.

B. The Disengagement Program

48. As noted earlier, as a result of Government commitment to the program, from 1,155 public enterprises that existed in 1982, a total of 706

enterprises have been disengaged--that is, liquidated, sold or merged. Of the 449 enterprises still under public ownership, the Government exercises tighter control over the 22 largest ones, whose budgets are itemized in the Federal Budget (Budget-Controlled enterprises--Organismos y Empresas Controlados Presupuest lmente (OECP)). The sectoral distribution of the 449 PEs that remain under Government ownership is as follows:

Table 1: CURRENT GOVERNMENT-OWNED ENTERPRISES.

Sector	Budget-Controlled PEs (OECP) Number	Budget-Controlled PEs (OECP) Total value of assets (1987 Mex$ trillion)	Other PEs not itemized in the budget (number)	Total PEs (number)
I. Utilities & infrastructure	5	63.8	36	41
II. Industry, energy & mining	8	19.1	67	75
III. Pemex (Oil and oil Products)	1	76.4	-	1
IV. Agriculture & fisheries	5	4.6	40	45
V. Financial institutions	-	-	128	128
VI. Social sector & other agencies	3	4.9	156	159
Total	22	168.8	427	449

Source: Annex VII.

49. The impressive contraction in the number of parastatals has significantly reduced the burden on the Government of managing the sector. It has also resulted in efficiency gains. In fact, a recent assessment of the results of the Mexican privatization process, on the basis of financial analyses of a sample of 63 transactions, shows improvements that should yield greater efficiency. After disengagement, in the privatized petrochemical companies: (i) investments increased up to 75% of gross sales revenues in a period of three years; (ii) management of working capital improved significantly as shown by turn-over ratios; (iii) technological processes were upgraded; and (iv) management was streamlined and better remunerated. Sold companies in the auto parts industry, having benefitted from an industry-wide process of liberalization and restructuring, showed: (i) increasing integration with foreign technological partners; (ii) increasing capacity utilization as a result of a new export orientation; (iii) substantial supply and raw material cost reductions; (iv) streamlining of managerial echelons; and (v) high variability on employment, ranging from net reductions to increases by nearly one third (when the PE-sale was followed up by significant investment program undertaken by the new owners). In the other sectors, the assessment showed that the enterprises undertook relatively large investments for retrofitting and modernization. From the sample, it was found that 36% of the companies were acquired by investors with down-stream companies in the sector and 16% were acquired by their minority private partners. Twenty-five percent of the companies in the sample involved

foreign participation, mostly in auto parts, and in eleven cases (18% of the total), workers unions became partners in the new companies.

50. The disengagement program has been of special importance in the industrial, energy and mining sectors (under SEMIP), in which the number of PEs was reduced from 398 to 90. Table 2 below provides a summary of the impact of disengagement in SEMIP's holdings, excluding Pemex and CFE.

Table 2: SEMIP--IMPACT OF DISENGAGEMENT EXCLUDING PEMEX AND CFE
(Distribution Based on Figures as of October 1988)
(in percent)

	No. of para-statals	Total assets	Total liabil.	Total sales	Total labor	Government transfers
A. PEs retained by SEMIP (90 PEs)	22.6	76.6	66.2	59.3	33.6	80.2
B. Disengagement Process (308 PEs)	77.4	23.4	33.8	40.7	66.4	19.8
Sale (155 PEs)	38.9	18.6	23.4	37.9	47.2	16.5
Liquidation (116 PEs)	29.1	4.1	9.7	1.7	12.8	2.6
Other (37 PEs)	9.3	0.7	0.7	1.1	6.4	0.7
Total (398 PEs)	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bank estimates based on data published in SEMIP, Redimensionamiento del Sector Industrial Paraestatal, cuaderno de divulgacion 72, 1988.

51. The above table shows that, excluding PEMEX and CFE, SEMIP was able to reduce its number of enterprises by 77%. This reduction in the number of PEs resulted in reductions in PE labor force by 66%, reductions in PE sales by 41%, and reductions in total assets by 23%. The smaller reduction in the level of total assets highlights the fact that SEMIP still retains the more capital-intensive, larger enterprises.

52. PE Sale Revenues. With regard to the proceeds from the sale of enterprises, by October 1988, SHCP reported accumulated nominal gross sales proceeds of Mex$796.3 billion (equivalent to about US$765 million) on 136 transactions. In the process, the Mexican Government assumed Mex$98.6 billion in debt outstanding of the sold companies (about US$49.7 million equivalent). In addition, three large operations (i.e. Mexcobre--mining, Aeromexico--air transportation, and Tereftalatos--petrochemicals) were concluded in late 1988, generating about US$1.8 billion equivalent in gross revenues, with payments mostly made through the purchase of dollar-denominated Mexican obligations, traded at the time of the transactions at about one-half of face value.

53. The Disengagement Process. The disengagement process has evolved from a loosely defined system, decentralized among Sector Ministries, to a standardized procedure established by SPP and the CGF in April 1987. A flow chart of the process is provided in Annex IX. Currently, the selection of candidates for disengagement is made by the Sector Ministries based on financial and legal company conditions, market structure and prospects, previous bail-outs, level of employment and complexity of the case. Based on this selection, the decision to proceed with the disengagement is made by the CGF and is finally approved by the President of the Republic. The handling of the sales of enterprises is assigned to the PE-Sales Unit at the SHCP, which reports directly to the Minister of Finance. The Unit then identifies and selects the financial advisors (commercial banks) which will take charge of executing the sale transaction (e.g., asset valuation, pricing, marketing, financing, negotiating). Once the selection is completed, the Unit monitors the performance of the financial advisors. The process so far has proceeded discreetly with a minimum of Government infrastructure to administer and monitor the sales effort. The strategy followed, namely to start with small and medium sized PEs and entering them into the sale process based on the relative complexity of the case, has resulted in an impressive number of completed transactions. Civil servants and over 12 agent commercial banks participating in the process have accumulated knowledge that can be used in subsequent, more complex transactions.

54. Based on the recent experience of selling PEs, the Government recognizes that the next stage of the program might be more difficult to implement than the transactions completed so far for the following reasons: (i) many of the PEs to be sold are of larger size, complexity and political sensitivity; (ii) the decision to sell some larger parastatals will attract considerably more public attention than in the past, making wide public support for the program imperative for success; (iii) several of the possible candidates for future sale are companies operating in non-competitive markets, requiring sector-specific regulatory adjustments to ensure that the companies will operate on a commercial basis in a competitive environment; (iv) unlike most of the parastatals that have been sold to date, many of the remaining PEs are likely to require extensive organizational, financial and legal restructuring prior to initiating the divestiture process; and (v) the larger transactions are likely to require creative financial engineering in order to mobilize the necessary capital. Given this situation, and following discussions with the Bank, the Government has recently strengthened the PE-Sales Unit at SHCP and allocated budgetary resources for administering and monitoring the PE-sales program. In complex cases or large transactions, the Unit has the authority to establish an ad hoc committee that would draw as needed on other key Ministries that should be involved in the decision-making process. Also, resources are available for it to call on international and local specialized advice as needed. SECOGEF also strengthened its functions related to the auditing of the PE-sale process. In order to make the process more transparent, the PE-Sales Unit has recently issued clear privatization guidelines, as well as preliminary results of transactions realized until October 1988, including sales value and debt reductions. With the adjustments in the disengagement process recently implemented, the Unit should be able to continue the process in a satisfactory manner.

55. The Future Disengagement Program. As stated in its Letter of Development Policy, further disengagements constitute one of the key elements of the Government strategy to improve the efficiency of the PE sector. To implement the next stage of the disengagement program, during the preparation of this operation, the CGF requested all sectoral ministries to submit for review by the economic cabinet/CGF: (i) a list of new PEs to be disengaged, and (ii) the justification for the permanence of the remaining PEs in the public sector. Based on such information, a disengagement program consisting of 199 PEs has been established. Sixty three of such PEs will be prepared for eventual sale, 124 will be liquidated and 12 will be either merged or transferred to local governments. Satisfactory progress in the implementation of this program is a condition of second tranche release for the proposed operation.

56 Future Government Role in the Sector. In order to avoid a recurrence of the massive Government take-overs that happened in the 1960s and 1970s, and to clarify the relative roles of the private and public sectors, the Government has enunciated its policy on the direct role that it intends to play in the production of goods and services. In its National Development Plan to be issued in the second-half of 1989, it will state that the Government will limit its involvement to "strategic or priority" sectors. "Strategic" sectors are defined in the Mexican Constitution and are reserved for State intervention; they include oil, hydrocarbons, radioactive materials, electricity, basic petrochemicals, mail, satellite telecommunications, and railways. The Constitution also makes reference to "priority" areas, where state-ownership is allowed; however, these priority areas are not defined in the Mexican legislation and have been interpreted widely. Consequently, there is a need for a definition of the government role in these areas. The National Development Plan will reconfirm--that, in non-strategic areas, the Government will not get involved in enterprises--or establish new parastatals or PE subsidiaries, or acquire existing private sector companies--which are of a commercial nature or are involved in the production of tradeable goods, except in cases of significant market failures involving the production of goods/services with major social welfare impact. In order to minimize the risk of future backtracking in the process of reducing the size of the PE sector, and to ensure that the decision to establish any new public enterprise will receive serious scrutiny, the creation of PEs (or their subsidiaries) and the acquisition of existing companies by Government entities will be more strictly regulated. As a condition of second tranche release, CGF will be empowered to give final recommendation on a case-by-case basis on the creation of PEs (and subsidiaries) or the acquisition of companies by Government agencies--consistent with the redefined "priority" concept.

C. Measures to Improve Efficiency of Retained Enterprises

57. In addition to disengagement of PEs, the Government will strengthen its program to improve the efficiency of those PEs that will remain in the public sector. Following experience elsewhere, the Government believes that a valid strategy to encourage PEs to improve their efficiency is to force them to operate: (i) in a competitive environment that subjects them to market forces; (ii) with sufficient managerial autonomy and incentives to encourage them to seek agreed upon performance

goals and be rewarded (sanctioned) if the goals are (are not) achieved; and (iii) with sufficient financial autonomy and accountability to enable them to use the firm's resources effectively under a "hard budget" scheme. These three aspects of the system to encourage efficiency are discussed in the remainder of this chapter.

(i) Measures to Improve the Competitive Environment of PEs

58. In addition to being exposed to the effects of industrial deregulation, trade and financial sector reform, PEs operating in tradeables should be subject to competition with other public and private firms, and with imports. As noted in para 36 above, since 1982 the Government has already undertaken major reforms to liberalize the economy and increase its exposure to market forces. Additional major deregulation measures affecting the industrial and financial sectors will be taken in connection with the proposed ISPL and the FSL concurrently under consideration by the Bank. However, there are some other market imperfections and rigidities specific to PEs. The Government will implement a program to address these market imperfections affecting the operation of PEs, by carrying out the respective actions contained in Part II of the Policy Matrix (Annex V), and summarized in the following paragraphs.

59. Despite significant reduction in the number of products subject to price controls prior to the introduction of the Pacto and PECE, prices on tradeable products predominantly or exclusively controlled by PEs--for example, steel and fertilizers--have not yet been liberalized. When the Pact was implemented in January 1988, steel prices were roughly in line with border prices; fertilizers produced by FERTIMEX, however, were priced at about 60% of international values. Not surprisingly, in 1987, Fertimex accounted for about 13% of total Government transfers to controlled PEs. CFE, CONASUPO, FERRONALES and SICARTSA (Sidermex) also generated significant losses, accounting in 1987 for about 32%, 26%, 12% and 6% of total transfers to OECP, respectively. The pressing budgetary needs of the Federal Government call for prompt corrective action to reduce losses in these five enterprises which account for about 90% of Government transfers to PEs. Consequently, during negotiations for this operation and in connection with agreements under other Bank operations, the Government has developed programs of price adjustments on goods and services produced by these large five PEs, as follows: (i) For steel products, liberalize prices starting on August 1, 1989; thereafter, approval of price levels will be the responsibility of the Board of Directors of the PEs in the sector. (ii) For fertilizer products produced by FERTIMEX, increase prices by 18.8% in local currency terms on September 30, 1989; from 1990 onwards, increase prices semiannually at a rate of 12.3% per annum in constant dollar terms, at least until domestic prices reach international levels or FERTIMEX has achieved financial self sufficiency; ammonia prices will be adjusted accordingly and sulfur prices will be liberalized on September 30, 1989. (iii) For electric power, CFE rates will be increased by not less than 9% in real terms in 1990 and 1991, and by about 10% in 1992, which would allow CFE to achieve self-financing ratios of 61% in 1990, 63% in 1991, and 70% in 1992. (iv) For agricultural products marketed by CONASUPO, in connection with the Agricultural Sector Loan, price and other adjustments are being made, so that it is now fully expected that the

target of no more than US$85 million of Government operating transfers to CONASUPO during 1989 (excluding transfer to support targeted food subsidy programs for the poor) will be met. (v) For FERRONALES, though in 1989 tariffs will cover operating costs, ongoing discussions with Government aim at increasing internal cash generation to allow FERRONALES to finance a larger share of its ongoing investment program, thus reducing the need for Government transfers. Even after tariff increases in FERRONALES, the tariff structure may need to be adjusted further to reduce distortions among different traffic types. To assess the magnitude of these distortions and to provide a basis for pricing decisions beyond 1990, a study of the economic cost of railway transportation would begin on July 31, 1989.

60. The above price increases will ensure that Government transfers to PEs will continue to decline further from the levels achieved in 1988. Given the relationship between pricing and Government transfers to PEs, agreement was reached that, as a condition of second tranche release, the Government will make progress satisfactory to the Bank in restricting transfers to PEs to the reduced transfer levels for operations and investments contained in the initial Federal Budget for FY89, which were 13% below FY88 levels in real terms. The above price adjustments are also fully consistent with the Government's PE price policy as stated in the Letter of Development Policy (Annex IV), and which specifies its intention to move towards market-determined prices for tradeable products in competitive sectors, as soon as the macro-situation will permit it. For PEs in noncompetitive or non-tradeable sectors, pricing policies will strive to meet three basic objectives: (i) efficient allocation of resources; (ii) financial self-sufficiency under efficient operations; and (iii) affordability of basic services by the poorest segments of the population. Accordingly, in PEs in non-competitive markets, prices will be set to reflect the economic value of the goods or services produced (i.e., opportunity cost or long-run marginal costs, as appropriate).

61. Greater competition in the sectors currently dominated by PEs will be fostered by the redefinition of the role of the Government in direct productive activities and the disengagement program under implementation. By narrowing down the number of sectors where the Government will intervene directly, barriers to entry into non-"strategic" sectors by private firms will be reduced. In mining, for example, a large number of PEs have been sold to private investors. Moreover, some mining Government agencies are expected to play a primary role in the promotion of future private sector undertakings in the sector, both in exploration and mine development. The reduced presence of PEs in the mining sector, as well as the need to foster private investments, call for a reassessment of the role of Government mining agencies. The Government has agreed to commence such a study of mining sector agencies by October 31, 1989.

62. Many of the largest PEs in Mexico are highly integrated (vertically and horizontally) and operate in non-competitive markets. In some cases, their actual structure responds to a "natural monopoly" rationale; in others, to strategic and political arguments. To enhance the PEs' competitive environment in the railway monopoly, by July 31, 1989, the Government will commence a study to assess to which extent new available technology and contracting out possibilities would allow FERRONALES to separate its core activities from those that could be provided by private sector on a competitive basis.

63. Competitive behavior can also be enhanced by appropriate procurement legislation that does not give preference to public firms in the supply of goods and services to other Government entities. In this regard, a new public procurement law--the Ley de Adquisiciones y Prestacion de Servicios Relacionados con Bienes Inmuebles--approved in January 1988, permits PEs and the public sector to procure and import goods under competitive procedures, subject only to the payment of customs duties. The Regulations to the Law have not yet been issued, and current norms do not make clear the treatment of foreign and local suppliers. The issuance of these Regulations of the Procurement Law, which will make clear that there should be no discrimination between local and foreign suppliers, is condition for second tranche release for this operation.

64. The proposed loan will finance a series of consultant studies to improve the competitive environment for PEs. Details of these studies are provided in the section on Technical Assistance Program (para 85).

(ii) Measures to Foster Managerial Autonomy and Accountability

65. Despite the measures taken by Mexican authorities in the last few years, at present public enterprises do not enjoy the degree of managerial autonomy needed to improve efficiency nor do they have appropriate accountability to the Government. The major Government objective so far has been to ensure that public enterprises meet operating and investment budget constraints consistent with the Federal Budget, with economic and financial profitability receiving secondary consideration. In addition, the autonomy of PE managers is severely constrained by Government control measures which are excessive in number, overly detailed, ex-ante in nature and applied by a variety of Government agencies. The existing managerial/supervisory system for public enterprises involves too many actors, with excessively divided responsibilities. It is designed to minimize Government budget deficits and is not conducive to increased productivity and renewed growth. Recognizing the need to provide autonomy to PEs, the Mexican legislature passed the Federal Law of Public Enterprises, but the Law is not operational since its interpretive regulations were never issued. These regulations are crucial, since the PE Law is ambiguous on a number of key issues and it conflicts with previous laws that were interventionist in nature. Therefore, the process of granting greater autonomy to PE managers and BODs has not yet been carried out. The proposed Program is a vehicle for achieving this goal. The details of the agreed upon program are contained in Part III of the Policy Matrix (Annex V).

66. Redefinition of the Role of Government Agencies. The first and most urgent need is to redefine the roles of the Governmental agencies involved in PE guidance, performance and evaluation, with the objective of simplifying and rationalizing Government supervision, converting it from ex-ante control of inputs and operations into an ex-post control of results and performance. The roles of these agencies will be limited to policy setting, long-range planning, appointment of Board of Directors, and performance evaluation on an ex-post basis for PEs under Performance Agreements (PA, as described below). The remaining powers of these agencies will be transferred to the Boards of Directors (BODs) and management of the PEs. These changes would provide a clear demarcation of

the roles and responsibilities of the Government, the BODs and Management along their traditional roles of ownership for the Government, corporate policy and strategy for the Board, and day-to-day operations for Management. The BODs would begin to play their appropriate role as buffer between the needs of the enterprise and the interest of the owner. The roles of the Core Ministries will be reduced to the essence of their original assignments. Table 3 below provides a list of the main roles to be exercised by the the seven key actors in the process.

Table 3: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/ penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/ accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

67. Sector ministries will concentrate their activities on the priority task of defining policy for their area of activity as a whole; i.e., for private as well as public sector actors in their area. They will continue to play the role of identifying which PEs should be liquidated, merged or put up for sale. They must review their PEs' corporate plans, assure their consistency with sectoral policy and plans, and review investment programs. Sector ministries will also serve on the BODs, and--in accordance with the provisions of the PE Law--formally appoint and dismiss the Chairman of the Board, the majority of Board members and the CEO. Given the importance of the reform of the roles of Government agencies in the public enterprise sector, for loan effectiveness, a

satisfactory draft of the regulations, redefining the roles of these agencies, must be furnished to the Bank. Prior to second tranche release, the regulations must be issued.

68. The Performance Agreement Unit. Under the proposed reform program, a Performance Agreement Unit, attached to the CGF (Unidad de Convenio de Desempeno--UCD), has been recently established to exercise the Government ownership role. This is a small, non-executive, non-managerial technical secretariat, initially composed of 5 experts. The UCD's primary tasks will be to coordinate the negotiations with the PEs on ex ante annual performance targets under the Performance Agreements, monitor the achievements of the goals, and carry out a performance evaluation system to provide rewards and penalties linked to performance. Its only other responsibilities will be to advise CGF on recommendations to the sector ministries (who maintain the formal power of appointment and dismissal) of qualified candidates for the positions of Board heads and members, as well as on dismissal of BOD members based on performance evaluation, and to issue annual reports on the performance of management in companies using the performance agreement system. The UCD has prepared an Action Plan to develop and apply the Performance Agreement scheme. By second tranche release, the unit will be fully operational and satisfactory progress will have been made in the implementation of the Action Plan.

69. Performance Agreements. In order to ensure that increased autonomy is not misused, and that the enterprises will act consistently with the goals of the owner, there is a need to develop better accountability processes for PEs. Except for external auditing, these processes are presently limited. The proposed Performance Agreement system will provide such a process. It will: (i) require PEs to strictly adhere to well defined performance objectives and targets under annual performance agreements; (ii) measure the performance of the PEs against these targets in a transparent and systematic manner; and (iii) provide appropriate monetary rewards and penalties to induce management to obtain the goals. Based on this scheme, supervision can be converted from the current system of ex-ante control of operations to ex-post monitoring of results. With appropriate incentives and penalties, this system can act as a "market surrogate" that would induce PE management to undertake long-lasting and sustained searches for efficiency. The process of developing these performance agreements would be as follows. The specialists of the UCD review budget proposals prepared by the enterprise and previous enterprise performance. On these bases and in consultation with the appropriate sector ministry, agree with enterprise management and BODs on a set of performance criteria (goals), and criteria values (indicators). The goals will normally include the following: Short-term goals: financial gross margin, profit and rate of financial profitability (where applicable, expressed in economic as opposed to private profitability); quantified cost-containment measures; quantified physical productivity achievements. Long-term goals: research and development; improved corporate planning capacity; improved maintenance capability; efficiency in implementing investment programs; management and work force training plans and achievements. At the end of

the year, the levels of achievement in all areas are assessed, weighted and a score of achievement is awarded to the PE. Management is monetarily rewarded or sanctioned accordingly. If a low score is repeated over time, management will be dismissed.

70. There are many technical and administrative issues involved in the performance agreement/evaluation process. These include determining the short-term and long-term criteria values and, if appropriate, introducing the concept of social profitability, all to ensure that management is being graded on the basis of items within its control. Other issues include: the extent to which criteria and values should be enterprise specific; the method used to weigh the value of the various indicators; the determination of the scale of scores to be awarded to PEs, and the nature of the rewards and sanctions to be applied. Under this operation, all these elements would be worked out, with the aid of technical assistance, by second tranche release, and according to the agreed Plan of Action. Furthermore, before second tranche release, the system would have been implemented in the following agreed upon large enterprises: FERTIMEX, CMC, FERRONALES, SICARTSA, and AHMSA (para 82).

71. Boards of Directors. Under the proposed program, the BODs of PEs will assume many of the responsibilities embodied earlier in a number of Government agencies. To improve PE efficiency, the Government now realizes that it is not sufficient to change sector organization and regulatory systems. These are necessary but not sufficient conditions. A key condition is to change the pattern of decision-making to place it in the hands of those that can have the opportunity to respond quickly to a changing environment and to take advantage of opportunity windows, that is, the BODs and PE Management. The new regulations of the PE Law will establish the decision-making power of the Board of Directors and Management as set in Table 3 above. Regarding the composition of the Board of Directors, in addition to representatives of SPP, SHCP and the relevant sector coordinator, the Boards will contain persons of appropriate skills and experience from the private sector, academia, and social sectors. The regulations will state that BODs will contain a significant minority of members from these non-governmental sectors. Furthermore, Board members will receive monetary incentives for participation and Board performance will be reviewed annually by the Sector Ministry, in collaboration with the UCD. Non-performing BODs or individuals would be replaced. These elements of the program will be incorporated in the proposed regulations of the Law to be issued by second tranche release.

72. In order to assure that BODs perform their duties effectively, in the future, Board members would be given the time and the resources to prepare adequately for their assignments. The Law regulations will set the criteria for the purpose of determining the maximum number of BODs in which a Board member may serve, taking into account the complexity, size and other relevant parameters of the PEs. Board membership must become more than attending a meeting and ensuring that one's ministry's interests are not being threatened. For loan effectiveness, a satisfactory draft of the regulations to the PE Law of 1986, including a clear definition of the role and composition of the PEs' Boards of Directors and of the role of technical committees of BODs (see below), must be furnished to the Bank. Issuance of the regulation would be a second tranche release condition.

73. PE Management. The enhanced roles of PE Management are described in Table 3 above. Such responsibilities should enable PE Management to act as needed to operate the enterprises efficiently. In order to enhance further the flexibility of decision-making process of PEs, the role of technical committees of the BODs will be emphasized. These committees will meet with greater frequency than Board meetings, upon management request, in order to decide on key enterprise issues that require Board approval. This arrangement will allow Chief Executive Officers (CEOs) to propose and implement actions in a timely manner over key financial, technical and personnel aspects of their firms.

74. Training. Managers must have up-to-date knowledge and skills to allow them to use productively their newly found autonomy. Thus, under the proposed operation, short-term courses covering the new legal/regulatory structure and its enlargement of managerial autonomy, performance evaluation and management information system (MIS), will be arranged for managers, starting in selected key PEs. Short-term training on computer applications, budgeting techniques, and asset/liability management will also be made available to managers. This training could be combined with "twinning" arrangements (sustained assistance from a successful firm in an industrialized country to a sister firm in an LDC), especially for some of the most important poor performers. Management contracts stressing training features, and providing incentives for such, are another way to attack simultaneously long and short-term constraints: training Mexican managers and putting in place at once a management team able to stop the fiscal drain. The proposed reform package also provides government representatives sitting on the PE Boards with increased responsibilities. Therefore, short training seminars on the functions and powers of directors will be organized for Board appointees, as deemed necessary, by the respective Sector Ministry. UCD officials will receive training in how to devise a clear set of objectives for the performance agreements. UCD staff will ensure that management is being judged on the basis of factors within their control. They must be trained in how to assess results, and the intricacies of the assignment of rewards and penalties (the allocation of rewards and penalties will be done through the CGF, on the recommendation of the UCD).

75. Reporting, Financial Management and Accounting Systems. During the last few years, substantial improvements have been made in the development of accounting and auditing systems for PEs. These systems are presented in the Government's "Catalogo de Formatos e Instructivos del Sector Paraestatal". However, implementation among PEs is uneven. Consequently, by August 31, 1989, SPP will provide evidence about its implementation of a program to promote the knowledge and proper use of the "Catalogo" to ensure the use of the most reliable and timely financial and accounting information available. SPP will also analyze the adequacy of the accounting and audited information of the PEs to be subject to Performance Agreements, to ensure that they will be able to provide reliable and timely information for the negotiation and evaluation of performance agreements. For other information pertaining PEs, SPP has developed an integrated and centralized information system ("Sistema Integral de Informacion"), to collect monthly, quarterly, semiannual and annual PE data. To ensure that this data will be consistent with the requirements under Performance Agreements, by September 30, 1989, based on meetings with CGF, SECOGEF, SHCP, UCD, Sector Ministries and PEs'

representatives, SPP will issue a revised PEs integrated information system, improving the reliability and timeliness of the information that will be used by UCD, while minimizing the duplication of information flows. Finally, as required by the PE Law, starting on May 1989, Auditing Committees will be responsible for the analysis of issues, raised by the external audit reports, on PE finances. Auditing Committee members will include SECOGEF and SHCP representatives, the General Director of the Sector Ministry and the PE internal auditor and accountants.

76. For those PEs in which the Performance Agreement system will be first instituted, management's enhanced role will be supported by upgraded information systems, as needed. Areas to be improved include corporate planning (building on the experience of the "convenios de rehabilitacion"), budget and asset/liability management, automation and computerization. By August 31, 1989, Sector Ministries will issue TOR for consultants to identify, on selected PEs, areas to be improved, defining action plans. To assist the enterprises and the various agencies of the Mexican Government to carry out this extensive package of reforms, technical assistance will be required in several areas under the proposed loan, as detailed in para 85 and Annex X.

(iii) <u>Measures to Foster Financial Autonomy and Accountability</u>

77. The current budgeting system for public enterprises gives PE managers little financial autonomy to operate efficiently. In fact, the control by Government agencies over the implementation of the approved budget is much too rigid, as the Government exercises excessive power over details in PEs' cost and investment items in order to reduce the impact on the Federal Government budget. This has reduced the ability of managers to make timely decisions they are best equipped to take, as departures from the budget during the year require various levels of Government approvals, slowing down the decision-making process. Under the proposed reform program, by September 30, 1989, SPP will furnish to the Bank an Action Plan, based on a review of existing budgetary norms and regulations, to simplify, deregulate and make more flexible the budgetary process and its implementation. Accordingly, the Government will gradually change the budgeting process and implementation, first, for the enterprises selected in this operation and, subsequently, for most PEs. Also, and as indicated in Table 3 above, only PE large investments will be approved by SPP, providing flexibility for management to undertake maintenance, debottlenecking and retrofitting investment projects which are below a limit to be specified, subject to final approval by the BODs and in case the PEs have sufficient financing for such projects.

78. In order to ensure consistency of PE finances with the Federal budget, under the Performance Agreement system the UCD would agree with the PEs on specific levels of dividends or transfers/subsidies to or from the Federal Budget. PE managers will be given the autonomy to take measures to achieve these critical fiscal goals and would be rewarded or sanctioned accordingly. Together with the increased financial autonomy, financial accountability rules will be enforced. PEs will be expected to operate under "Hard Budgets": if the enterprises do not meet their financial targets, the Government will not bail them out through additional transfers. Consistently with macroeconomic targets, PEs' finances are expected to improve significantly, resulting in lower aggregate budgetary

transfers along the lines referred to in para 60 above. The reduction in transfers to PEs would be accompanied by the implementation of the program for the liberalization of controlled prices or their adjustment to economic levels as discussed in para 59 above, as well as greater flexibility to cut operating costs, in a framework that will permit PEs to reach a greater degree of self-sufficiency.

79. The above changes will be implemented in accordance with the 1986 Law of Parastatals--which foresees the necessary actions for increasing PE autonomy--once the Regulations of the Law are issued by second tranche release (para 67).

80. In order to enhance financial autonomy and accountability, the processes for <u>investment decisions</u> need to be upgraded, both at the Government and at the PE levels. The Government has recently upgraded budgetary procedures and payment systems for externally-funded investments by public enterprises. It will monitor implementation of this system, and exchange views with the Bank before August 31, 1989, to implement any further measures needed to improve project implementation and disbursement performance. The Government's review and approval processes for new investments is, however, deficient. In order to strengthen and expedite the screening of PE and other public sector investments, and in connection with recommendations under the FSL, the Government would submit to the Bank by September 1, 1989, the Terms-of-Reference for the preparation of guidelines for economic and financial project evaluation. Furthermore, in order to avoid the current investment delays due to lack of investment planning, SPP will establish a task force to study and develop a <u>multi-year investment budgeting process</u> for those projects that would require Government financing. This new process would establish criteria to separate projects into "core" priority investments which would be protected from fluctuations in budgetary availabilities, and "secondary" projects which would be subject to delays. In connection with this operation and the FSL, SPP would submit the TOR for the study to the Bank by September 1, 1989, commence the above mentioned studies by October 15, 1989, and furnish to the Bank a satisfactory plan of action to implement the study's recommendation by April 15, 1990. To guide PEs in the preparation of <u>corporate plans</u> consistent with sectorial and national development priorities, prior to second tranche release, SPP will submit evidence that satisfactory guidelines for the elaboration of sector plans and corporate programs have been included in the National Development Plan to be issued in mid-1989.

81. As PEs become financially self-sufficient and creditworthy through higher product prices and lower operating costs, they should be able to borrow from commercial banks on their own creditworthiness, without implicit or explicit Government guarantees. Recent far-reaching financial sector reforms supported by the Bank through the parallel FSL will facilitate this process. In the Policy Matrix for this operation (Annex V) the Government has stated its policy to disallow Government credit subsidies, guarantees or any other preferential treatment for PEs vis-a-vis the banking system. Banks will evaluate loan requests based on the creditworthiness of the PE and the commercial viability of the loan request. The Government will set individual borrowing limits for PEs only in connection with individual corporate plans and annual budgets of the PEs. These measures would ensure that commercial banks will be able to

exercise discipline in the sector, especially if banks in turn are supervised more strictly, as discussed with the Government and proposed under the FSL. The Government has already adopted many of the measures under the FSL, including reforms that liberalize all commercial bank interest rates and effectively reduce forced lending schemes to the Government. The emergence of a banking system that operates commercially, accompanied by improved prudential regulations and supervision, will help to improve financial autonomy and accountability for PEs.

D. Implementation of the Reform on Selected Enterprises

82. Under the proposed loan, the Government will implement reforms in the policy, institutional and procedural framework under which PEs operate, as discussed throughout Part III of the report. These changes will benefit public enterprises across all sectors. At the enterprise level, the proposed Program is far reaching and complex. Its implementation must be phased in a manner that maximizes its probability of success while, at the same time, incorporating a significant share of the larger PEs. Accordingly, agreement was reached with the Government that the Performance Agreement and Monitoring scheme will be implemented in the following five large PEs: FERTIMEX, the fertilizer complex which includes 40 operating plants, 5 plants under construction, as well as 98 distribution centers; CMC, a large iron and coal mining operation; FERRONALES, the national railway company; and SICARTSA and AHMSA, the two largest steel companies in Mexico, accounting for significantly more than 50% of the national raw steel installed capacity. These companies account for more than one-half of the total budgetary transfers to, and fixed asset value of all PEs under direct budget control, excluding CFE and PEMEX. Prior to second tranche release, the selected PEs will be fully operating under the Performance Agreement contracts (para 70).

83. Regarding the implementation of the disengagement program, as noted earlier, by second tranche release, the Government should have made progress satisfactory to the Bank in its implementation of the disengagement program consisting in 199 enterprises (para 55).

84. In addition to the reforms aimed at improving the competitive environment and managerial and financial autonomy/accountability, in order to assure the success of the reform program, some of the above enterprises will require restructuring of their operations and financial situations. Concrete measures for these enterprises are being discussed with the Government or being implemented in connection with other Bank operations. Some additional measures, agreed with the Government during the PERL negotiations are described in the Plan of Action in para 100 below.

E. Technical Assistance Program

85. Technical assistance (TA) to be financed under the Loan, will support overall implementation of the proposed Program. CGF will coordinate the TA program. Cost estimates and the implementation schedule of the proposed TA is detailed in Annex X. The qualifications and experience of the consultants will be satisfactory to the Bank. The

implementation of key activities under the TA program is a condition for second tranche release under the time-bound Plan of Action (para 99,viii). The TA includes the following:

(a) Studies. Consultants will assist the Government in the following studies: (i) economic pricing in FERRONALES (para 59); (ii) role of mining sector agencies (para 61); and (iii) private sector development in PE-dominated areas (para 62).

(b) Specialized Support. This includes consultant services to support four government agencies (SHCP, SPP, SEMIP, CGF) in the following areas: Performance Agreement development (para 70), improvement of existing financial management, accounting and reporting systems in selected PEs (para 76), development of a simplified integrated PE information and monitoring system (para 75), and preparation of PAs for the five selected PEs (para 70).

(c) Training. A training program will be designed to support: (i) the staff of the UCD; and (ii) PEs' senior management and BOD members in their new functions under the PA system for the PEs under the Program (para 74).

PART IV - THE PROPOSED BANK LOAN

A. The Proposed Loan

86. The proposed Bank loan of US$500 million equivalent would support the Government's Reform Program for PEs. It would support the efforts being undertaken by the Government to improve the efficiency of the sector through disengagement, improvement in the competitive environment for PEs, and greater managerial and financial autonomy and accountability. The Closing Date of the loan would be June 30, 1991. Negotiations for the proposed program were held in Mexico City between March 13 to 17, 1989, and April 24 to 28, 1989 with the Government delegation led by Lic. Enrique Vilatela, Director General, SCHP.

B. The Borrower and the Guarantor

87. The Government's development bank, Nacional Financiera S.N.C (NAFIN), will be the borrower of the Bank loan, in line with its function as Mexico's official financial agent of the Government. The loan would be guaranteed by the Mexican Government. As a condition of loan effectiveness, NAFIN would submit subsidiary agreements to the Bank for passing on the proceeds of the proposed loan to the Government, on terms and conditions satisfactory to the Bank.

C. Project Implementation

88. The SHCP will be responsible for overall project implementation and coordination. Specific project implementation arrangements and responsibilities are detailed below and summarized in Annex VI.

89. CGF will be responsible for the establishment and operation of UDC; the development of a revised integrated PE information and monitoring system; the coordination of the disengagement program; and the selection of

PEs for the PA scheme. SHCP will be responsible for the PE-sales program (i.e., through its PE-sales unit); the implementation of the PE real price adjustment program; the study to foster private sector presence in areas currently dominated by PEs; and the study to assess the economic cost of railway transport in Mexico. SPP will monitor the budget transfers to PEs; promote the use of the accounting and auditing rules included in the Catalogo de Formatos e Instructivos del Sector Paraestatal; develop an action plan to simplify, deregulate, and make more flexible the PEs' budget process and practices; undertake a study on multi-year investment evaluation and programming; prepare the revised regulations to the Procurement Law; and issue the guidelines for the preparation of sectoral and PEs' corporate programs. SECOGEF will issue the regulations to the PE Law and the Procurement Law. SEMIP will undertake the study on the role of Government agencies in the mining sector and coordinate studies and follow-up actions to upgrade the management and information system in selected PEs.

D. Disbursement, Procurement, Administration and Auditing

90. The proposed loan would be released in two tranches, of US$250 million and US$249 million, respectively. US$1 million would be allocated for technical assistance and to finance studies necessary to identify further areas of liberalization and deregulation. The first tranche would become available upon loan effectiveness, and the second tranche after November 30, 1989 and upon the fulfillment of specific conditions for tranche release. The closing date of the proposed PERL would be June 30, 1991.

91. The loan proceeds would be re-lent to the Government on terms and conditions satisfactory to the Bank, to finance 100% of the foreign exchange cost of imported goods required during the execution of the Program, except for those contained in a negative list (goods subject to quantitative import restrictions, goods financed from other official multilateral or bilateral sources, goods intended for luxury consumption or goods imported for military or paramilitary purposes). Taking into account the unprecedented growth in imports in 1988, retroactive financing is recommended up to an amount of US$100 million for eligible import expenditures incurred after February 15, 1989, the date four months prior to the expected signing of the proposed loan. Disbursements under the technical assistance component would finance 100% of the expenditures of consultants, and 100% of the cost of equipment and goods required for implementation of the agreed technical assistance programs.

92. The Borrower will be responsible for maintaining loan accounts and for the preparation and submission of withdrawal applications. Disbursements from the proposed loan would be made on the basis of statements of expenditure from Banco de Mexico detailing individual import transactions in each relevant period, and their eligibility under the proposed loan. Applications for withdrawal will be consolidated and submitted in amounts of not less than US$5 million.

93. Imports to be financed by the Bank up to US$5 million equivalent would be purchased under contracts awarded on the basis of the commercial procurement practices of the importer in the private sector, and standard

Government procedures in the public sector. The Bank has reviewed the Government's standard procurement procedures and found them satisfactory. Single purchases of goods costing in excess of US$5 million would be procured through international competitive bidding, in accordance with Bank Guidelines. Goods under the technical assistance program would be procured through shopping for items costing up to US$50,000 equivalent, and local competitive bidding above the threshold for contracts up to a value of US$300,000. Higher contract values are not expected.

94. Audits of the supporting documentation for statements of expenditure used for disbursements will be carried out annually by independent auditors acceptable to the Bank. The audit reports would be submitted to the Bank within six months of the end of the fiscal year.

E. Debt Reduction Support

95. As explained in the President's Report of the proposed FSL Loan, it may be difficult to mobilize new money in an amount sufficient to cover Mexico's financial gap over the medium term. However, any financing short of a multi-year commitment would compound macroeconomic problems and would lead to continued uncertainty about Mexico's public finances and tax and exchange rate policies. Therefore, the Government intends to include some form of debt reduction in its next financing package, which would be expected to restore confidence and thus spur investment and help recover growth.

96. Since without specific Bank assistance it may be difficult for the Government to put in place effective debt reduction schemes, the Bank has agreed that, subject to its agreement, up to US$125 million equivalent under the second tranche of the proposed loan could be used for the implementation of debt reduction plan which, in the Bank's judgment, shall meet the requirements of the Bank's support of debt reduction programs.

F. Loan Effectiveness and Tranche Release Conditions.

97. A series of specific conditions in the area of public sector reform have been met since appraisal, as follows:

(a) Agreement was reached on the aggregate operational plus investment transfers to PEs in 1989, which are significantly below the already reduced level of FY88, on the order of 13% in real terms. Such level of transfers are contained in the approved FY89 Federal Budget (para 60).

(b) In connection with PERL and other Bank operations in Mexico, the Government prepared a price adjustment plan for goods and services produced by the five PEs which receive the largest federal transfers (para 59). Also, a statement of the Government's price policy for PEs has been included in the Letter of Development Policy (Annex IV).

(c) Five of the largest PEs have been selected for the implementation of the PA plan (para 82), and 199 PEs have been selected for the disengagement program (para 83).

(d) The Government has stated its role and policy in the production of goods and services, defining clearly the concept of "priority" area for public sector participation, and agreed on the inclusion of such definition in the National Development Plan to be issued in mid-1989 (para 56).

(e) The PE-Sales Unit at SCHP was strengthened, clear guidelines on PE-sales procedures have been issued, and early results of past transactions have been published to enhance transparency of the process (para 54).

(f) The UCD has been established, appointing the Unit Coordinator and an action plan for the development and application of the PAs has been agreed upon (para 68).

98. As a condition of the proposed loan's effectiveness (i) the Government would furnish evidence that it has made substantial progress, satisfactory to the Bank, in obtaining adequate financing for its requirements for Fiscal Years 1989 and 1990 in the context of its adjustment program and growth targets as set in SHCP document on Mexico's Strategy (para 41 and Policy Matrix--Annex V); (ii) a satisfactory draft of the regulations to the PE Law of 1986 would be furnished to the Bank (paras 67,71,72); and (iii) NAFIN would submit subsidiary agreements to the Bank for passing on the proceeds of the proposed loan to the Government on terms and conditions satisfactory to the Bank (para 87). The loan's first tranche would be released upon effectiveness.

99. The second tranche would be released after November 30, 1989, and after an exchange of views with the Government and confirmation that the conditions for second tranche release have been met. To this end, the Bank would need to be satisfied that:

(a) The macroeconomic policy framework is consistent with the PE reform program (para 46).

(b) Continuous progress has been made in obtaining adequate financing for Mexico's requirements for 1989-90 and over the medium-term in the context of the adjustment program and growth targets set forth in "Mexico's Economic Strategy" issued by SPP (para 41). And

(c) That the following measures have been taken:

(i) CGF has been formally empowered to give final recommendation on a case-by-case basis on the creation of PEs, their subsidiaries and acquisition of companies by public sector entities, consistent with the redefined Government role in the production of goods and services (para 56);

(ii) continued progress in restricting transfers to PEs in a manner consistent with the approved FY89 Federal Budget (para 60);

(iii) issuance of regulations to the PE Law of 1986 defining among others: (i) Government agencies' role of supervising PEs (para 67), (ii) role and compositions of the PEs' BODs (para 71), and (iii) charters of PEs enhancing the role of BODs' technical committees (para 72);

(iv) satisfactory progress in the implementation of the Disengagement Program (para 55); and for the five selected PEs for the Performance Agreement scheme, that they have them operating under the PA system (para 70);

(v) the regulations of the Procurement Law has been issued (para 63);

(vi) the UCD is fully staffed and operating according to charter and satisfactory progress in the implementation of its action plan has been made (para 68);

(vii) satisfactory guidelines for the elaboration of sector plans and corporate programs are provided in the National Development Plan to be issued in mid-1989 (para 80); and

(viii) satisfactory progress in the implementation of the Loan's Plan of Action described below (para 100).

G. Other Loan Conditions under a Plan of Action

100. In addition to the proposed second tranche release conditions, Loan disbursement is also conditional to the satisfactory implementation, by the Mexican Government, of the following Action Plan.

(a) Competitive Environment

(i) Reduce Price Distortions: By July 31, 1989, begin study on economic prices on FERRONALES (para 59).

(ii) Reduce Barriers to Entry: By July 31, 1989, commence a study to increase private sector presence in areas dominated by FERRONALES, e.g., contracting out, leasing, etc. (para 62).

(iii) Institutional and Organizational Structure Reforms Conducive to a more Competitive Environment: By October 31, 1989, SEMIP to initiate a study on mining, to reassess role of DGMM, DGM, and CFM in light of the reduced share of PEs on total mining output (para 61).

(b) Managerial and Financial Autonomy and Accountability

(i) Establish Financial Management Tools, Systems and Procedures: By July 31, 1989, sector Ministry to issue TOR for consultants to assess and improve in selected PEs, financial management tools and propose remedial action as needed (para 76).

(ii) Improve and standardize Accounting and Auditing Systems applied in PEs: By August 31, 1989, SPP will provide evidence about the implementation of a program to promote the use of the accounting and auditing rules included in "Catalogo de Formatos e Instructivos del Sector Paraestatal" (para 75).

(iii) Rationalize Reporting Systems to Minimize Information Flows to Data Essential for Government Evaluation and Planning: By August 31, 1989, SPP to issue revised PE integrated information and monitoring system (para 75).

(iv) Simplify PE's Budgeting Procedures and Practices: By September 30, 1989, SPP to furnish to the Bank an Action Plan, based on a review of existing budgetary norms and regulations, to simplify, deregulate, and make more flexible the budgetary process and its implementation for PEs operating under Performance Agreements (para 77).

(v) Rationalize Budgeting Procedures and Investment Processing: By August 31, 1989, exchange views with the Bank on actions to improve the budgeting and funding (or funds releasing) procedures for externally financed investment. By September 1, 1989, SPP to submit acceptable TOR for a study to (a) strengthen investment planning and evaluation by issuing guidelines for economic evaluation for public investment projects; (b) strengthen budgeting procedures by introducing multi-year budgeting; and (c) establish a central monitoring unit. Commence the study by October 15, 1989. By April 15, 1990, submit to the Bank a satisfactory plan of action to implement the study's recommendation (para 80).

H. Monitoring and Reporting

101. Assessing the effectiveness of actions to be taken under the proposed loan will require monitoring of the adequacy and consistency of the macroeconomic framework and of the implementation of specific actions under the program detailed in the Government's Letter of Development Policy. The SHCP would be responsible for coordination of project implementation and would maintain regular contacts with Bank staff. NAFIN, as the Borrower, would prepare quarterly reports on the implementation of the Loan and on the progress of the public enterprise reform program. The Bank will also monitor these matters through regular supervision and exchanges of views with the Government.

I. Project Benefits and Risks, and Social Impact

102. The adjustment of the PE sector is a critical component of Mexico's medium-term recovery and development strategy. The proposed loan will provide technical and financial support to rationalize the role of the State in the economy and improve the operating efficiency of selected PEs.

103. The promotion of managerial and financial autonomy and accountability and the introduction of performance agreements programs will serve to streamline the respective functions of the State as owner or shareholder and the PE management as operator. The progressive disengagement of the State from commercially oriented activities should result in a more responsive operational environment with greater reliance on decentralized decision-making. With the reform of the investment approval system, properly appraised and economically viable operations should raise returns on investment. Reforms in the Government's budgeting procedures will ensure greater consistency among the allocation of resources, the future demands of the economy, and medium-term development objectives.

104. At the enterprise level, the improvement of management information systems, accounting and auditing will strengthen managerial decision-making and increase the transparency of operations. The specific restructuring programs and studies supported by this loan will help PEs adapt to an environment which is increasingly subject to market forces.

105. Reductions in Government transfers to PEs and adjustment of PEs' output prices to more realistic levels, and greater financial and managerial autonomy for the PE sector, will have positive effects on both the macroeconomic performance as well as the performance of individual enterprises. The accountability system under the Performance Agreement scheme will help improve PE financial discipline, help to enhance their internal cash generation and reduce their budgetary dependence, thus improving Government savings and reducing claims on credit to the economy. This will contribute to the goal of macroeconomic stabilization.

106. The incremental impact of the reform program on the broad macroeconomic aggregates is expected to result in a 13% real reduction of Government investment and operational transfers to public enterprises during 1989. Moreover, inflation pressures are expected to fall owing to productivity gains in the major PEs, and private sector activity is projected to grow as a result of the PE-sales program, more stable macroeconomic environment, and the redefined role of the Government in the production of goods and services.

107. Project risks are essentially financial, institutional and political in nature. Financial risks will be mitigated through: (i) the pursuit of a satisfactory fiscal stabilization program as addressed in a parallel operation, the Financial Sector Adjustment Loan; (ii) progress in working out a medium-term foreign financing plan consistent with the requirements of the macro-economic adjustment program and growth/targets; (iii) the programs to adjust real prices on goods/services produced by PEs currently accounting for about 90% of Government transfers to parastatals; and (iv) the formulation and implementation of policies and programs to decrease the weight of the PE sector in the economy through both, disengagement actions, and efficiency improvements in retained PEs, with consequential reduction in government transfers.

108. The main institutional risks are that existing vested interests within governmental institutions will resist the measures aimed at reforming the current situation, whereby various Ministries interfere with PE management and exercise ex ante controls over critical PE activity. This risk is mitigated through the role of the Interministerial CGF, which will promote the appropriate expression of ministerial interest in PE matters. The replacement of ex ante controls by ex post monitoring will be supported by appropriate accounting practices, independent auditing requirements and performance agreement plans.

109. Political risks relate to possible opposition to some of these reforms by the strong public sector labor unions and/or Congress. This risk is being mitigated by the commitment by the Government to continue to maintain open dialogue with the private sector, labor unions and Congress, as realized when the Pacto and PECE were developed. Also, as described below, specific actions will be taken to minimize the short-term social cost associated with the implementation of the proposed program.

110. A program that includes PE-sales and efficiency improvement in PEs could lead to a reduction in employment in the short term, although, as suggested by early findings on privatizations in Mexico (para 49), such reduction is not expected to be drastic. The Government will continue to address this issue through the provision of special measures such as adequate severance payments, and early retirement plans. Also, when employment alternatives do not seem suitable to the skills of affected labors, the Ministry of Labor (STPS) will design and implement retraining programs, on a case-by-case basis. It is also expected that under private ownership or when restructured, the industrial entities will become more competitive and efficient, resulting in higher growth of the economy and increase in employment in the longer run.

111. In addition to specific measures to address unemployment, upon assuming office in December 1988, the new Administration unveiled its "Programa Nacional de Solidaridad" to address poverty. In the first stage, the Program covers 1,276 rural municipios in the 10 poorest states of Mexico. The urban poor are addressed through a series of special measures in the metropolitan areas of Mexico City, as well as other state capitals. Total resources set aside for the program in 1989 are about US$400 million. Of the total, 20% will be spent on directly productive activities in agriculture, 30% on infrastructure-related activities and the remaining 50% on social services. The continued expansion of the program is expected to cost three times as much next year. The plan eventually is to set aside substantially larger resources to cover all poor groups by 1996. Salient features of the program include a food subsidy program targeted to the poor, popular kitchens in urban areas to provide subsidized nourishing meals to the urban poor, food supplement programs for the urban poor, subsidized milk and several other programs to provide general health care. Further information on measures being taken by the Government to alleviate the impact of its adjustment on the poor, as well as other nutritional and primary health care programs, are provided in the President's Report for the parallel FSL operation.

112. The capacity of existing Governmental institutions to implement a broad-ranging and complex reform, while monitoring the implementation of many enterprise restructuring programs, will be strained. This risk has been addressed through the organization of specialized task forces, assisted by consultants, to help Government agencies in implementing each of the tasks envisaged under the reform program. It should, however, be recognized that full achievement of the PE reform can only be accomplished in the medium term.

PART V - BANK GROUP OPERATIONS IN MEXICO AND GOVERNMENT DEVELOPMENT OBJECTIVES

A. Bank Operations

113. As of March 31, 1989, Mexico had received 111 loans from the Bank, amounting to US$11.5 billion, net of cancellations and terminations; of these, 75 loans, totalling US$5.5 billion, were fully disbursed and US$2.4 billion remained undisbursed. The Bank's exposure was US$5.89 billion (on book value basis) (Annex II), while on a cash basis this is equivalent to US$7.4 billion. Some 29% of Bank lending has been for agriculture and rural development, 18% for industry, 14% for transportation, 6% for power, and 17% for policy-based lending; the remaining 16% has been for water supply, tourism, urban development, and vocational training. Commitments for new loans reached US$1.7 billion in FY87 and US$2 billion in FY88. For FY89-90, the annual amount of Bank lending commitments, subject to the successful consolidation of agreed reforms, is expected to be about US$2.0 billion.

114. Currently, the Bank has 36 operations under supervision. Nine of these projects are in agriculture, 11 in trade, industry and finance, 12 in infrastructure (including transportation, urban, and water sectors and one earthquake emergency reconstruction operation), two in education, and two in low income housing. Project implementation, on the whole, has been satisfactory. Bank disbursements reached US$1.22 billion in FY87 and US$1.0 billion in FY88.

B. Government Development Objectives

115. The Government's overriding objective for the current Sexenio is the restoration of growth after six years of falling per capita income. But the experience of the past six years has made it clear that without macroeconomic stability and access to external financing, sustainable growth will remain out of reach; thus the Government considers the success of the stabilization effort and a resolution of the debt overhang problem as prerequisites for any success towards renewed growth. Moreover, increased growth will have to go together with increasing living standards for the poorer segments in society, both in its own right and to maintain the consensus underlying the Government's program. To this end the Government has embarked on a significant expansion in policies oriented towards poverty alleviation.

116. In addition, the Government strongly feels that growth should be private sector based, with the Government providing a supporting role. Thus the Government intends to continue its reform program towards a modern, rationalized incentive structure for the private sector. This will reduce the need for government intervention, improve private sector resource allocation and provide full support for efficient private sector investment by foreigners and domestic entrepreneurs alike. To allow the public sector to play a supportive role towards private sector based growth, the Government intends to modernize the machinery of the state and focus its role on legitimate public sector functions. This involves continued privatization/modernization where called for, and improvement of the efficiency of the remaining parts of the public sector.

117. With these in mind, the Government has adopted a policy agenda, consisting of the implementation of macroeconomic policies that are consistent with the objectives of the recovery of growth, increased fiscal efforts, improved efficiency of the financial system, reduction of interest subsidies and strengthened prudential regulation. To improve the efficiency of public enterprises (PEs), and to reduce the heavy burden they impose on the economy, the Government is focusing on: (i) "disengagement" of enterprises, including privatization, liquidation, mergers, and transfer of PEs to local governments; and (ii) a program of reforms in the policy and institutional environment to improve the efficiency of PEs which would be retained by the Government. These measures will improve the competitive environment and provide greater managerial and financial autonomy and accountability to PEs, increase market forces, decentralize decision making, strengthen managerial capabilities and incentives and improve the allocation of resources. To help complete the transformation of Mexico's industrial sector from its inward-oriented and highly protected structure to an open system where the factors of production and services compete freely, the Government is undertaking a broad deregulation effort. This is designed to provide, at the same time, for technological change and modernization, so as to ensure an adequate supply response to new policies.

118. Provided the Government is able to resolve these intertwined stabilization, debt, growth, and efficiency issues, maintains satisfactory progress in advancing the major structural adjustment policies already described, and benefits from a reasonably favorable international environment, the fundamentals for sustained rapid growth look promising. First, Mexico has a rich natural and human resource base and close proximity to the world's largest market. Secondly, the rationalization of the trade regime has created incentives strongly favoring international competitiveness and improved investment efficiency. Lastly, low Mexican unit labor costs make the country attractive as an industrial base. The Bank's base case macroeconomic scenario shows that with moderately favorable external conditions and consistent macro policies and deeper adjustment efforts, GDP growth would climb slowly from about 2% per annum in 1989 to about 5% per annum by 1994. The realization of this scenario is contingent on foreign financing. If this financing were not available, or if Mexico's external conditions were to deteriorate, output growth would slow down and employment opportunities would not keep pace with population growth. Mounting social pressures, in that case, would make it very difficult for the Government to stay the course and the efficiency gains of structural reforms may be lost. An under-financed adjustment program would simply compromise Mexico's ability to service even its current debt.

119. Given the fiscal crunch under which Mexico's policy makers must operate, more effective programs are necessary in the social sectors, including health, education, and nutrition, which are designed to target resources and cushion the needy against the impact of adjustment, while permitting the benefits of structural reform to be reaped. Therefore, the new Administration has, in December 1988, unveiled the "National Solidarity Program" to address the worst manifestations of poverty in the ten poorest states of the Union and the urban poor in Mexico City and all state capitals. Of the total of approximately US$400 million set aside for 1989, 20% will be allocated to agriculture, 30% to infrastructure, and 50% on social services.

120. Historically, ecological and natural resource management issues have ranked low on the list of Mexican policy priorities. However, over recent years extremely serious environmental problems have been affecting the health of most Mexicans and the country's economic growth potential. The worst problems have been encountered in air and water pollution, soil erosion and deforestation. These and other issues in Mexico's management of its ecology and natural resources have received increasing Governmental attention and the Government is now committed to put in place a strategy that can deal with these issues effectively over the medium and long term.

C. Bank Strategy

121. The Bank's assistance strategy is designed to support Mexico's major reform initiatives through an expanded policy dialogue and substantial volumes of lending, thus contributing to the consolidation of an outward-oriented development model and serving as a catalyst for mobilizing external finance in the required amounts for the restoration of the growth of the economy.

122. The Bank has transferred increasing amounts of resources to Mexico through policy-based and sector adjustment loans in the context of an adjustment-oriented framework that was supported by the 1986-87 commercial financing package; it has become Mexico's largest single source of new money. Six Bank loans in trade, exports, agriculture, and industry were linked to the multi-facility financing scheme, providing drawdown conditions for the parallel money and growth facilities which were mobilized fully in March 1988. The Bank also put up guarantees of US$750 million. In addition, the Bank facilitated Mexico's efforts to issue of securitized bonds for retiring old debt in January 1988. The Bank's strategy supported primarily policies designed to open the economy.

123. The objectives of the Bank's strategy are to engage the Mexican Administration in a wide-ranging dialogue on macroeconomic measures required to complete stabilization and spur growth, and on efficiency issues across the board, including finance, industry and agriculture, and to help tackle problems of structural poverty and alleviate the social cost of the adjustment process. The Bank has taken a staged approach in its support of the initiatives of the Government. As a first step, the Bank conducted an overview of Mexico's adjustment priorities and, jointly with the Government, agreed on the conditionality of three adjustment operations, (Financial Sector Adjustment, Public Enterprise Reform, and Industrial Sector Policy Loans). The policy content of these three operations provides the central element in the Bank's support for Mexico in 1989.

124. To provide the intellectual underpinnings for a continued dialogue, the Bank is carrying out jointly with the Government an expanded program of economic and sector work, including (a) a review of the current regulatory and financial framework in industry and agriculture; (b) a study of future tax reform options; (c) an intensive analysis of urban air pollution in collaboration with the World Health Organization; (d) an assessment of infrastructure and energy sector issues; (e) the development of strategies for integrated health and nutrition initiatives; (f) an assessment of improved programs to ameliorate rural poverty; and (g) an analysis of environmental issues to come up with a set of recommendations. This collaborative effort is also expected to help keep in place a robust lending program in 1990 and beyond, designed to support priority reform measures and optimize resource flows. In this context, the semi-annual country strategic and implementation review between the Bank and the Government -- introduced in 1985 -- affords the Bank a timely opportunity to make adjustments in the existing portfolio to adapt to new conditions.

D. Agriculture

125. Because of longstanding structural problems in agriculture and the sector's crucial importance for the one-third of the country's population living in rural areas, agriculture has been the leading sector for Bank lending. The Bank's lending program in agriculture is aimed at: (a) helping correct the incentives regime in agriculture through gradually reductions in input subsidies and export controls; (b) promoting more efficient and rationale use of natural resources supported by improved technologies and services; (c) generating employment-intensive investments in rural areas and effective assistance to small farmers; and (d) creating an integral framework for sound rural development. To support these goals, the Bank made a US$300 million Agriculture Sector Loan during FY88, and, starting in FY90, expects to support policy adjustment in agriculture, rehabilitation of the irrigation infrastructure, including improved cost recovery and maintenance operations, investments for agricultural marketing and storage facilities, food security, poverty alleviation, and forestry development.

E. Trade

126. The Bank has made two trade policy loans of US$500 million each in FY87 and FY88 in support of the Government's sweeping trade reforms. The two operations supported the speedy reduction of non-tariff barriers (quotas and official reference prices) and rationalization of the tariff system (reduced levels and dispersion). The Bank supported the development of non-oil exports through two export development operations in FY83 and FY87. These export development loans were intended to strengthen the supply response by Mexican industry to the new trade policy signals. A third export loan is under preparation, which would strengthen the temporary import regime, provide further support to indirect exporters, assure automatic access to finance by exporters under the various credit programs, streamline financial and administrative procedures, and seek further reductions in export controls.

F. Industry

127. The Bank's lending strategy for industry, covering small and medium-scale industry, mining, the capital goods industry, industrial restructuring and technology development, is designed to support: (a) trade policy reform; (b) financial sector policies to reverse the prolonged contraction of savings mobilization through interest rate decontrol and the development of a wider menu of savings instruments, and the rationalization of credit allocation in support of viable, competitive private companies; (c) industrial restructuring, regulatory reform, clarification of foreign investment rules, and export promotion to assure a vigorous supply response to trade liberalization and increased international competitiveness. Recent Bank operations provided support for restructuring of the fertilizer, steel, automotive parts, textile, and flower sectors, and other key private industrial subsectors demonstrating a capacity for undertaking integrated restructuring operations.

G. Infrastructure

128. Lending for infrastructure is focussing on regional development, decentralization, more efficient public investment allocation, and improved cost recovery. Recent Bank loans supported the highway, railways and port sub-sectors. Emphasis was placed on obtaining more realistic user fees and deferring all but the highest-yielding investment projects so as to permit a minimum of budgetary outlays for maintenance expenditures and protect the existing capital stock. Proposed loans would support the Government's decentralization initiatives, cost-based pricing, and managerial improvements. Loans are being prepared to finance the upgrading, rehabilitation, and maintenance of roads at the state level, the construction of toll roads cofinanced with the Mexican private sector, the restructuring of several ports, water supply and sewerage, urban transport, and power.

H. Housing

129. Government housing programs designed to improve cost recovery, while providing transparent and controlled credit subsidies only to the truly needy, have also benefitted from Bank financing. A Second Housing Finance loan would support graduated loan cost recovery linked to the income of final borrowers, thus ensuring a reduced drain on the fisc and affordability for low-income beneficiaries.

I. Social Sectors and Environment

130. The Bank is assisting the Government in redesigning public health, education, and human resource programs to make them more cost effective and targeted to meet the needs of the poor. A proposed health project would support decentralization measures, finance new primary health facilities, and strengthen professional services. Similar initiatives are being pursued in education and nutrition. A pilot project under preparation would improve the well-being of women in rural areas. It includes the provision of water wells, health and educational services, training for productive activities, and credit for launching new microenterprises.

These focussed operations would be followed by broader programs, once the institutional conditions and capacity for project implementation can support a larger Bank presence.

131. The Bank is also undertaking jointly with the Government and the World Health Organization a major review of air pollution issues to determine how the Bank could best contribute to new Government programs for cleaning up polluted urban environments. With strong Government commitment, the Bank would focus on technical assistance operations, include strengthened environmental components in investment loans, and -- as soon as the policy framework and suitable institutional arrangements are there -- make loans for sector-wide environmental programs and in support of remaining environmental policy issues.

J. IFC Operations

132. The IFC has worked with the Bank to: (i) identify private sector investment opportunities likely to thrive in the current climate of growth-oriented adjustment and greater integration with the world economy; and (ii) assist in strengthening the country's capital markets through economic sector work and venture capital operations. As of March 31, 1989, the IFC had invested US$990.7 million in 37 companies in Mexico, of which US$690.2 million had been sold, repaid, or cancelled.

PART VI - COLLABORATION WITH THE IMF

133. Bank/IMF collaboration has been close over the years, especially since 1982, when the Fund began to assist the Government to help address the underlying causes of the economic crisis. Since that time the Government benefited from an EFF of SDRs 3.6 billion, a special emergence drawing of SDRs 291 million after the 1985 earthquake, and a stand-by of SDRs 1.4 billion. Currently, the Government is committed to its commercial creditors under the terms of the 1986 multi-facility financing package to engage the Fund in an enhanced surveillance of the macroeconomic program. Since the ending of stand-by in 1988, the first such review has taken place in the beginning of 1989.

134. Consultations have taken place between Fund and Bank staff concerning Mexico's current economic situation and prospects, covering fiscal, monetary, financial and exchange and interest rate policies, and there is an understanding about the measures that will be needed to wind down the stabilization program, strengthen the balance of payments and recover growth in 1989. Since the time of appraisal, discussions between the Government and the Fund have advanced considerably about a possible EFF. Currently, it is expected that a three-year facility would be in place before the scheduled Board date of the proposed loan. Further consultations would take place between the two institutions to monitor macroeconomic performance during the implementation period of the proposed adjustment loans.

PART VII - RECOMMENDATION

135. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the proposed loan.

Barber B. Conable
President

Attachments

May 22, 1989
Washington D.C.

MEXICO - ECONOMIC INDICATORS

PAGE 1 OF 3

Mid-1987 Population (mils.)	82
1987 Per Capita GNP in US$:	1830

	A. Shares of Gross Domestic Product (from current price data)						B. Growth Rates(% per annum) (from constant price data)				
	1965	1973	1980	1986	1987	1988 p/	1965-73	1973-80	1980-87	1987	1988 p/
Gross Domestic Product m.p.	100.0	100.0	100.0	100.0	100.0	100.0	6.9	6.2	0.5	1.4	1.1
Net Indirect Taxes	4.3	5.0	8.3	8.5	10.4	..	..	..	..	..	..
Agriculture	13.9	11.1	8.2	9.4	9.2	..	3.1	3.4	1.4	0.5	-3.6
Industry	27.1	29.0	32.8	33.8	35.5	..	8.3	7.0	-0.3	2.0	1.3
(of which Manufacturing)	19.7	22.1	22.1	24.8	25.1	..	8.3	6.7	0.0	2.5	2.3
Services	59.1	59.9	59.0	56.8	55.3	..	6.9	6.1	0.8	1.3	1.8
Resource Balance	-1.9	-1.9	-2.3	4.3	7.2	2.3	..	..	..	..	..
Exports of GNFS	7.7	6.9	10.7	16.9	19.2	16.3	6.2	8.5	7.8	12.2	7.3
Imports of GNFS	9.6	8.8	13.0	12.6	12.0	14.0	6.9	9.7	-8.9	3.5	33.9
Total Expenditures	101.9	101.9	102.3	95.7	92.8	97.7	6.9	6.3	-1.5	-0.3	1.7
Total Consumption	80.2	79.9	75.1	76.8	74.2	77.4	6.6	5.8	0.4	-1.3	4.2
Private Consumption	73.8	71.6	65.1	67.7	65.6	69.0	6.3	5.6	-0.1	-1.4	..
General Government	6.3	8.2	10.0	9.1	8.6	8.4	8.7	7.3	3.2	-1.0	..
Gross Domestic Investment	20.5	20.0	27.2	18.5	18.6	20.3	8.4	7.8	-7.9	-4.3	4.5
Fixed Investment	17.6	19.2	24.8	17.6	18.9	18.5	9.5	7.2	-6.4	-0.8	0.7
Changes in Stocks	2.9	0.8	2.4	0.9	-0.3	1.8	..	..	..	..	..
Gross Domestic Saving	18.5	18.1	24.9	23.2	25.8	22.6	8.4	8.5	-4.6	7.6	-8.4
Net Factor Income	-2.8	-4.1	-2.9	-5.9	-5.0	-4.3	..	..	..	..	..
Net Current Transfers	0.0	0.1	0.1	0.4	0.5	0.3	..	..	..	..	..
Gross National Saving	15.7	14.1	22.1	17.7	21.3	18.6	18.2	7.7	-5.0	33.7	-32.1
In billions of LCUs (at constant 1980 prices)	1965	1973	1980	1986	1987	1988 p/					
Gross Domestic Product	1682	2892	4470	4725	4793	4846	6.9	6.2	0.5	1.4	1.1
Capacity to Import	116	200	479	443	459	519	6.7	12.3	-2.0	3.6	13.1
Terms of Trade Adjustment	-61	-95	0	-318	-395	-398	..	..	..	..	..
Gross Domestic Income	1622	2797	4470	4407	4398	4448	6.9	6.4	-0.8	-0.2	1.1
Gross National Product	1592	2866	4341	4477	4709	4742	7.7	5.9	0.6	5.2	0.7
Gross National Income	1532	2771	4341	4159	4314	4344	7.8	6.2	-0.8	3.7	0.7

	(1980 = 100)						Inflation Rates(% p.a.)				
C. ıdices	1980	1984	1985	1986	1987	1988 p/	1965-73	1973-80	1980-87	1987	1988 p/
Consumer Prices (IFS 64)	100.0	679.0	1071.2	1994.9	4624.7	9906.1	4.3	20.3	73.0	131.8	114.2
Wholesale Prices (IFS 63)	100.0	686.0	1053.4	1984.4	4675 9	9506.1	4.0	22.3	73.7	135.6	103.3
Implicit GDP Deflator	100.0	614.5	963.5	1679.3	4081.3	8326.4	5.9	21.2	68.9	143.0	104.0
Implicit Expenditures Defl.	100.0	625.0	992.1	1763.6	4487.3	..	5.8	20.9	71.1	154.4	..

D. Other Indicators:	1965-73	1973-80	1980-87	
Growth Rates(% p.a.):				
Population	3.4	2.7	2.2	
Labor Force	..	..	..	
Gross Natl. Income p.c.	4.3	3.4	-2.9	
Private Consumption p.c.	2.8	2.8	-2.2	
Import Elasticity:				
Imports (G+NFS) / GDP(mp)	1.0	1.6	-17.2	
Marginal Savings Rates:				
Gross National Saving	12.5	36.9	..	
Gross Domestic Saving	17.6	37.3	-85.3	
ICOR (period averages):	..	3.7	23.8	
Share of Total Labor Force in:	1965	1973	1980	1987
Agriculture	49.6	41.8	36.5	..
Industry	21.9	25.7	29.0	..
Services	28.5	32.5	34.5	..
Total	100.0	100.0	100.0	..

MEXICO - ECONOMIC INDICATORS

E. Merchandise Exports	Volume Index 1980	1984	1985	1986	1987	1988 p/	Value at Current Prices (millions US$) 1980	1984	1985	1986	1987	1988 p/
Oil	100.0	181.5	170.9	154.8	154.4	154.4	10441	16601	14767	6307	8630	6701
Manufactures	100.0	189.4	172.7	220.7	294.7	..	3030	5595	4978	7116	9807	11616
Other	100.0	106.2	112.2	183.0	233.0	261.7	2040	2000	1918	2608	2219	2341
Total Exports FOB	100.0	173.1	163.5	171.4	192.2	203.1	15512	24196	21663	16031	20656	20658
F. Merchandise Imports												
Consumer goods	100.0	29.2	37.1	29.0	25.3	..	2449	848	1082	846	768	1922
Intermediate goods	100.0	60.5	70.2	62.6	68.8	..	11209	7833	8966	7632	8825	12951
Capital goods	100.0	60.5	70.2	62.6	68.8	..	5174	2573	3165	2954	2631	4031
Total Imports FOB	100.0	50.3	59.0	51.5	54.5	77.6	18832	11254	13212	11432	12223	18903

G. Terms of Trade	1980	1984	1985	1986	1987	1988
Merch. Exports Price Index	100.0	90.1	85.4	60.3	69.3	65.6
Merch. Imports Price Index	100.0	118.4	118.6	117.4	120.8	130.8
Merch. Terms of Trade	100.0	76.1	72.0	51.4	57.4	50.2

US$ millions (at current prices):

H. Balance of Payments	1980	1984	1985	1986	1987	1988 p/
Exports of Goods & NFS	23456	30156	27624	21891	27520	28905
Merchandise (FOB)	16066	24196	21663	16031	20656	20658
Non-Factor Services	7390	5960	5961	5860	6804	8247
Imports of Goods & NFS	25684	16080	18368	16172	17111	24814
Merchandise (FOB)	18896	11255	13212	11432	12223	18903
Non-Factor Services	6788	4825	5156	4740	4888	5911
Resource Balance	-2228	14076	9256	5719	10409	4091
Net Factor Income	-6209	-10247	-9021	-7852	-7587	-8030
(interest per DRS)	4591	10262	9393	7737	7091	8338
Net Current Transfers	132	230	312	260	668	575
(workers remittances)	0	0	0	0	391	437
Curr A/C Bal before Off. Transf	-8305	4059	547	-1873	3881	-2927
Net Official Transfers	143	181	690	204	..	..
Curr A/C Bal after Off. Transf	-8162	4240	1237	-1669	..	..
Long-Term Capital Inflow	7897	2632	280	638	4356	276
Direct Investment	2186	390	491	1523	3248	2980
Net LT Loans (DRS data)	6839	1619	-96	899	4217	-2831
Other LT Inflow (Net)	-1271	443	-808	-1988	-3522	-852
Total Other Items (net)	1366	-4541	-3558	1761	-1313	-4475
Net Short Term Capital	5136	-3527	-1693	694	-3157	-3610
Capital Flows N.E.I.	0	0	0	0	..	..
Errors and Omissions	-3770	-1014	-1865	1067	1844	-864
Changes in Net Reserves	-958	-2150	2731	-526	6924	7127
Net Credit from the IMF	-136	1100	610	1091	1103	104
Other Reserves Changes	-822	-3250	2122	-1617	5821	7023
As Share of GDP:						
Resource Balance	-1.1	8.0	5.0	4.4	7.3	2.2
Interest Payments	2.4	5.8	5.1	6.0	5.0	4.5
Current Account Balance	-4.3	2.3	0.3	-1.4	2.7	-1.6
Memorandum Items:						
Reserves excl. Gold (mil. US$)	2960	7272	4906	5670	12700	5518
Reserves incl. Gold (mil. US$)	4175	8019	5679	6791	13715	6588
Official X-Rate (LCUs/US$)	22.95	167.83	256.87	611.77	1366.00	2250.00
Index Real Eff. X-R Base 1980	100.00	114.00	111.70	145.90	151.40	122.40
GDP (millions of current US$)	194766	175604	184539	129791	143126	177111

MEXICO - ECONOMIC INDICATORS

PAGE 3 OF 3

I. Consolidated Public Sector	Share of GDP (%) 1980	1984	1985	1986	1987	1988 p/	Growth Rates 1980-84	1986	1987	1988 p/
Current Receipts	26.9	32.2	31.2	30.3	30.2	30.0	4.1	-6.2	..	..
Current Expenditures	23.3	32.1	32.6	38.0	38.9	35.3	8.3	21.4	..	..
Current Budget Balance	3.6	0.1	-1.4	-7.7	-8.7	-5.3	..	..	..	..
Capital Receipts	..	..	..	..	..	..	..	..	..	..
Capital Expenditures	9.6	6.7	6.0	6.0	5.5	4.4	-8.5	-3.2	..	..
Adjustments	-1.0	-1.4	-1.5	-1.1	-1.6	-3.2	..	..	..	..
Overall Deficit	-7.0	-8.0	-8.9	-14.8	-15.8	-12.9	..	..	..	..

J. External Capital Flows, Debt and Debt Burden Ratios	Net Disbursements (US$ millions) 1980	1984	1985	1986	1987	1988 p/	Debt Outstanding & Disbursed (US$ millions) 1980	1984	1985	1986	1987	1988 p/
Public & Publicly Guar. LT	5139	1235	805	1189	5054	562	33987	69812	72711	75991	82771	81362
Official Creditors	795	837	803	1373	1746	1749	4481	6997	8836	11736	15940	18722
Multilateral	501	681	729	924	387	580	3189	4393	6017	8177	10380	10289
of which IBRD	333	430	505	592	418	676	2063	2852	4034	5566	7346	7427
of which IDA	0	0	0	0	0	0	0	0	0	0	0	0
Bilateral	294	155	73	449	1359	1169	1291	2605	2820	3559	5560	8433
Private Creditors	4344	398	2	-184	3308	-1187	29507	62815	63875	64255	66831	62640
Suppliers	-52	-156	18	27	100	-13	257	208	228	258	263	445
Financial Markets	4397	554	-15	-211	3208	-368	29250	62607	63647	63997	66569	58233
Private Non-guranteed	1700	384	-901	-290	-837	-3393	7300	16296	15745	15103	14148	9576
Total LT	6839	1619	-96	899	4217	-2831	41287	86108	88456	91094	96919	90938
IMF Credit	-134	1234	300	723	414	-104	0	2360	2969	4060	5163	5059
Net Short-Term Capital	5136	-3527	-1693	694	-3157	-3610	16163	6440	5450	5900	5800	8066
Total incl. IMF & Net ST	11841	-674	-1489	2316	1474	-6545	57450	94908	96875	101054	107882	104063

Bank and IDA Ratios	1980	1984	1985	1986	1987	1988 p/
Share of Total Long-Term DOD						
1. IBRD as % of Total	5.00	3.31	4.56	6.11	7.58	8.17
2. IDA as % of Total	0.00	0.00	0.00	0.00	0.00	0.00
3. IBRD+IDA as % of Total	5.00	3.31	4.56	6.11	7.58	8.17
Share of LT Debt Service						
1. IBRD as % of Total	2.73	3.05	4.11	6.66	9.38	7.61
2. IDA as % of Total	0.00	0.00	0.00	0.00	0.00	0.00
3. IBRD+IDA as % of Total	2.73	3.05	4.11	6.66	9.38	7.61
DOD-to-Exports Ratios						
1. Long-Term Debt/Exports	167.64	265.20	297.39	384.65	325.56	287.00
2. IMF Credit/Exports	0.00	7.27	9.98	17.14	17.34	15.97
3. Short-Term Debt/Exports	65.63	19.83	18.32	24.91	19.48	25.46
4. LT+IMF+ST DOD/Exports	233.27	292.30	325.70	426.71	362.41	328.42
DOD-to-GDP Ratios						
1. Long-Term Debt/GDP	21.20	49.04	47.93	70.23	68.28	49.40
2. IMF Credit/GDP	0.00	1.34	1.61	3.13	3.64	2.75
3. Short-Term Debt/GDP	8.30	3.67	2.95	4.55	4.09	4.38
4. LT+IMF+ST DOD/GDP	29.50	54.05	52.50	77.91	76.01	56.53
Debt Service /Exports						
1. Public & Guranteed LT	32.08	34.77	35.75	37.20	30.14	37.60
2. Private Non-guranteed LT	5.89	14.26	13.05	14.74	8.24	14.01
3. Total Long-Term Debt Service	37.97	49.03	48.80	51.93	38.38	51.60
4. IMF Repurchases+Serv. Chge.	0.59	0.38	0.73	1.89	2.33	3.61
5. Interest only on ST Debt	..	..	..	..	..	..
6. Total (LT+IMF+ST Int.)	38.56	49.41	49.53	53.82	40.71	55.21

STATUS OF BANK GROUP OPERATIONS IN MEXICO 1/

A. Statement of Bank Loans
(As of March 31, 1989)
(US$ million)

Loan No.	Fiscal Year	Borrower	Purpose	Amount less Cancellations	Undis-bursed
	75 loans fully disbursed			5,462.00	
1706-5	1979	NAFIN	Irrigation	81.80	15.14
1858-5	1980	NAFIN	Irrigation	64.40	15.15
1990	1981	BANOBRAS	Urban Development II	144.16	10.01
2043	1982	NAFIN	Integrated Rural Dev.	175.00	8.07
2142	1982	NAFIN	Capital Goods Industry	152.30	0.40
2154	1982	NAFIN	Pollution Control	13.09	4.40
2262	1983	NAFIN	Agricultural Marketing	115.00	12.21
2281	1983	BANOBRAS	Third Water Supply	100.30	30.34
2325	1983	NAFIN	Third Sm/Med Industry	175.00	1.34
2331	1983	BANCOMEXT	Export Development	350.00	4.22
2428	1984	BANOBRAS	Highways	200.00	85.00
2450	1984	BANPESCA	Ports	56.30	39.22
2526	1985	NAFIN	Chiapas Agric. Dev.	58.00	42.63
2546	1985	NAFIN	Sm/Med Scale Mining II	105.00	39.12
2559	1985	NAFIN	Vocational Education	81.00	23.90
2575	1985	BANOBRAS	Railways V	300.00	167.34
2612	1986	BANOBRAS	Low Income Housing I	150.00	28.07
2658	1986	NAFIN	Proderith II	88.30	71.20
2665	1986	BANOBRAS	Earthquake Rehab	400.00	38.55
2666	1986	BANOBRAS	Municipal Strengthening	40.00	36.62
2669	1986	BANOBRAS	Solid Waste Pilot	25.00	19.58
2745	1987	BANCOMEXT	Trade Policy Loan I	500.00	10.59
2746	1987	NAFIN	Industrial Recovery	150.00	55.33
2747	1987	NAFIN	Technology Development	48.00	34.67
2777	1987	BANCOMEXT	Export Development II	250.00	38.16
2824	1987	BANOBRAS	Urban Transport	125.00	101.12
2837	1987	NAFIN	Agricultural Credit	400.00	51.55
2858 3/	1987	NAFIN	Sm/Med Industries IV	100.00	100.00
2859	1987	NAFIN	Agricultural Extension	20.00	16.95
2875	1987	BANOBRAS	Highway Maintenance	135.00	125.00
2876	1988	NAFIN	Manpower Training	80.00	63.68
2916	1988	NAFIN	Steel Sector Restruct.	400.00	342.63
2918	1988	NAFIN	Agricultural Sector Loan	300.00	201.99
2919 3/	1988	NAFIN	Fertilizer Sector Loan	265.00	265.00
2946 3/	1988	BANOBRAS	Ports Rehabilitation	50.00	50.00
2947 3/	1988	BANOBRAS	Housing Finance	300.00	300.00
		Total		11,459.65	
		Of which has been repaid		3,112.85	
		Total now outstanding		8,346.80	
		Amount sold : 92.34			
		Of which has been repaid: 92.34		0.00	
		Total now held by Bank 2/		8,346.80	
		Total undisbursed			2,449.18

1/ The status of the projects listed in Part A is in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.
2/ Prior to exchange adjustment.
3/ Not yet effective.

B. Statement of IFC Investments
As March 31, 1989
(US$ Million)

Fiscal Year	Obligor	Type of Business	-----Original Approvals--------- Loan	Equity	Total
1958/59	Industrial Perfect Circle, S.A. a/	Industrial Equipment	0.80	0.00	0.80
1958	Bristol de Mexico, S.A. a/	A.C. Engine Overhal	0.50	0.00	0.50
1961	Aceros Solar, S.A. a/	Twist Drills	0.30	0.00	0.30
1962/5/6/8	Fundidora Monterray, S.A. a/	Steel	2.30	21.40	23.70
1963	Tubos de Acero de Mexico	Stainless Steel Pipes	0.90	0.10	1.00
1963	Quimica del Rey, S.A. a/	Sodium Sulphate	0.70	0.00	0.70
1964/6	Industria del Hierro, S.A.	Construction Equipment	0.00	2.00	2.00
1970	Minera del Norte a/	Iron Ore Mining	1.50	0.00	1.50
1971	Celanes Mexicana, S.A. a/	Textiles	12.00	0.00	12.00
1972	Promotora Papel Periodicos, S.A. de C.V. a/	Pulp and Paper	0.00	b/	b/
1973/9	Cementos Veracruz, S.A.	Cement	15.90	0.00	15.90
1974/81	Cancun Aristos Hotel	Tourism	1.00	0.30	1.30
1975/78	Mexinox, S. A.	Stainless Steel	12.00	3.20	15.20
1978/81/84	Papeles Ponderosa, S.A.	Pulp and Paper	10.70	5.00	15.70
1978	Tereftalatos Mexicanos, S.A.	Petrochemical	19.00	0.00	19.00
1979/81/87	Hotel Camino Real Ixtapa, S.A.	Tourism	0.00	4.20	4.20
1979/84	Empresas Tolteca, S.A.	Cement	168.00	7.90	175.90
1979	Conductores Monterray, S.A.	Electrical Wire & Cable	18.00	0.00	18.00
1980	Industrias Resistol, S.A.	Particle Board	25.00	0.00	25.00
1980	Vidrio Plano de Mexico, S.A.	Flat Glass	114.90	0.00	114.90
1980	Minera Real de Angeles, S.A.	Mining	110.00	0.00	110.00
1981/86	Celulosicos Centauro, S.A.	Pulp and Paper	59.50	0.00	59.50
1981	Corporacion Agro-industrial S.A.	Agri-Business	11.30	3.00	14.30
1984	Capital Goods Facility a/	Capital Goods Financing	100.00	0.00	100.00
1984/88	Metalsa, S. A.	Auto Chasis	8.00	1.40	9.40
1985	Proteison, S.A. de C.V.	Agri-Business	2.00	0.80	2.80
1985	Promociones Industriales Mexicanas, S.A. de C.V.	Petrochemical	16.40	0.00	16.40
1986	Celulosa y Papel de Durango, S.A. de C.V.	Pulp and Paper	10.00	3.10	13.10
1987	Agromex Phase I (AESA)	Veg and Fruit Processing	1.50	0.50	2.00
1987	Industrias Sulfex, S.A. de C.V.	Chemical & Petrochemical	2.00	0.50	2.50
1988	Sealed Power de Mexico	Auto Assembly	9.00	0.00	9.00
1988	Spasco, S.A. de C.V.	Cement	46.00	0.00	46.00
1988	Salumi, S.A. de C.V.	Food and Food Processing	20.10	2.00	22.10
1988	Crescent Market Aggregates	Construction Material	37.00	0.00	37.00
1989	Grupo Femsal Visa	Consumer Goods Conglamorat	80.00	0.00	80.00
1989	Serfin	Development Finance	60.00	0.00	60.00
1989	Polimar (ABS)	Petrochemical	14.50	0.00	14.50
	Gross Total Commitments		990.80	55.40	1046.20
	Less Cancellations, Terminations, Repayments and Sales		690.20	28.40	718.60
	Total Commitments Now Held by IFC		300.60	27.00	327.60
	Total Undisbursed (Including Participants)		76.60	0.10	76.70

a/ Investments which have been fully cancelled, terminated, written off, sold, or repaid.

b/ US$25,000.

MEXICO

PUBLIC ENTERPRISE REFORM

Supplementary Loan Data Sheet

Section I - Timetable of Key Events

(a) Time taken by the country to prepare the loan:	1 month
(b) Appraisal Mission:	Oct./Nov. 1988
(c) Completion of Negotiations:	April 1989
(d) Planned Date of Effectiveness:	July 1989

Section II - Special Bank Implementation Actions

None

Section III - Special Conditions

(a) The following Government actions have been taken between appraisal and Board presentation:

(i) agreement was reached on the aggregate operational plus investment transfers to PEs in 1989, which are significantly below the already reduced level of FY88, on the order of 13% in real terms (para 60).

(ii) in connection with PERL and other Bank operations in Mexico, the Government prepared a price adjustment plan for goods and services produced by the five PEs which receive the largest federal transfers (para 59). Also, a statement of the Government's price policy for PEs has been included in the Letter of Development Policy (Annex IV).

(iii) five of the largest PEs have been selected for the implementation of the PA plan (para 82), and 199 additional PEs have been selected for the disengagement program (para 83).

(iv) the Government stated its role and policy in the production of goods and services, defining clearly the concept of "priority" area for public sector participation, and agreed on the inclusion of such definition in the National Development Plan to be issued in mid-1989 (para 56).

(v) the PE-Sales Unit at SCHP was strengthened, clear guidelines on PE-sales procedures have been issued, and early results of past transactions have been published to enhance transparency of the process (para 54).

(vi) the UCD has been established, appointing the Unit Coordinator and an action plan for the development and application of the PAs has been agreed upon (para 68).

(b) The following are the additional conditions of loan effectiveness:

(i) that the Government would furnish evidence that it has made substantial progress satisfactory to the Bank in obtaining adequate financing for its requirements for FY89/90 in the context of its adjustment program and gross targets as set in the SHCP document on Mexico's strategy (para 41 and Policy Matrix--Annex V);

(ii) that a satisfactory draft of the regulations to the PE Law of 1986 would be furnished to the Bank (paras 67, 71, 72); and

(iii) that NAFIN would submit subsidiary agreements to the Bank for passing on the proceeds of the proposed loan to the Government on terms and conditions satisfactory to the Bank (para 87).

(c) The release of the second tranche is conditional on the Bank being furnished with evidence satisfactory to it that: (i) the macroeconomic policy framework is consistent with the PE reform program (para 46); (ii) continuous progress has been made in obtaining adequate financing for Mexico's requirements for FY89/90 and over the medium term in the context of the adjustment program and growth targets set forth in "Mexico's Economic Strategy" issued by SPP (para 41). In addition, the Bank would need to receive satisfactory evidence that:

(i) CGF has been formally empowered to give final recommendation on a case-by-case basis on the creation of PEs, their subsidiaries and acquisition of companies by public sector entities, consistent with the redefined Government role in the production of goods and services (para 56);

(ii) continued progress has been made in restricting transfers to PEs in a manner consistent with the approved FY89 Federal Budget (para 60);

(iii) issuance of regulations to the PE Law of 1986 defining among others: (a) Government agencies' role of supervising PEs (para 67); (b) role and compositions of the PEs' BODs (para 71); and (c) charters of PEs enhancing the role of BODs' technical committees (para 72);

(iv) satisfactory progress in the implementation of the Disengagement Program (para 55). For the five selected PEs for the Performance Agreement scheme, have them operating under the PA system (para 70);

(v) the regulations of the Procurement Law has been issued (para 63);

(vi) have the UCD fully staffed and operating according to charter and satisfactory progress in the implementation of its action plan (para 68);

(vii) satisfactory guidelines for the elaboration of sector plans and corporate programs are provided in the National Development Plan to be issued in mid-1989 (para 80); and

(viii) satisfactory progress in the implementation of the Loan's Plan of Action (para 100).

G.H.1

ESTADOS UNIDOS MEXICANOS

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

MINISTRY OF FINANCE AND PUBLIC CREDIT

México, D.F., May 12 ,1989

MR. BARBER B. CONABLE
PRESIDENT
WORLD BANK
Washington, D.C.

1. In the last several years the Mexican Government has undertaken a comprehensive adjustment program to correct imbalances and to remove distortions from the economy, giving high priority to measures that will further reduce inflation. The Present Administration is fully committed to deal promptly with the current economic situation and to restore the internal conditions for economic growth. For this purpose, and in strict compliance with the Mexican Constitution, the Government has implemented structural changes in the public sector enterprises. The objectives of these actions are to provide an institutional and regulatory environment which will increase the efficiency and competitiveness of the public sector enterprises (PE).

2. Since 1982, the Government has implemented specific actions in order to rationalize the assets held by the PEs, to improve their efficiency and to reduce their deficit.

3. In the last years the Government has undertaken an adjustment program in order to remove any constraints to their efficiency. The three main objectives of the program have been: i) to adjust the size and the scope of the non-strategic and non-priority PEs, by gradually disengaging or merging a large number of firms and liquidating the non-viable ones; ii) to restructure the operations, finances and organization of PEs; and iii) to adjust prices and to reduce injustified Government subsidies. In addition, the 1986 "Law of Parastatal Entities" was enacted to foster PE autonomy and accountability. The disengagement program has been successful in reducing the number of PEs to 411 (in march 1989) from 1155 six years ago.

4. The Mexican Government will continue its efforts to improve the efficiency of PEs, particulary through disengagement of the non-strategic and non-priority ones and will implement the reforms needed to run the remaining PEs more efficiently. The regulatory and institutional framework will be further adjusted to enable PEs to operate within market conditions, consistent with the efforts to maintain the primary surplus as approved in the Federal Budget by Congress.

G.H.1

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

5. The Government's role in the production of goods and services will continue in those strategic areas mandated by the Mexican Constitution which empowers the Government to participate in priority areas. This concept has been precisely defined in order to clarify the Government's role and that of the social and private sectors in the economy. Accordingly, and in addition to the strategic sectors mentioned above, the Government, might get involved under certain circumstances, in the production of other priority goods and services with a major social welfare impact.

6. Further disengagements of the non-strategic and non-priority PEs constitute a key element of the Government's strategy to improve the efficiency of the sector. Therefore, the Government will continue the actions on those PEs which are not considered as strategic or priority.

7. In addition to the disengagement program, the Government will continue to take strong measures in order to improve the competitive environment and the efficiency of the remaining PEs. This objective will be met through: i) competitive cost and pricing policies; ii) sufficient managerial autonomy and incentives; and iii) sufficient financial autonomy and accountability.

8. Cost and pricing policies. It is the Government's policy that in the case of PEs in non-competitive or non-tradeable sectors, pricing policies will strive to meet three basic objectives: i) efficient allocation of resources; ii) financial self-sufficiency under efficient operations; and iii) affordability of basic services by the poorest segments of the population. To achieve these objectives, the prices of PEs for tradeables in competitive industries will be liberalized. Tradeables in non-competitive industries prices will be set to reflect their economic opportunity cost; Non-tradeable goods and services prices will be based on their long-run marginal cost. If prices to low income consumers exceed affordable levels, the tariff structure may be further adjusted to provide relief to these targeted groups.

9. Budget transfers to PEs in 1989 will be consistent with the 1989 Federal Budget approved by Congress.

G.H.1

ESTADOS UNIDOS MEXICANOS

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

10. Managerial autonomy. In order to foster managerial autonomy and accountability in PEs, in 1986 the Government enacted the "Law of Public Entities". The corresponding regulations are being currently reviewed and will be issued on october 1989. The balance between the needed autonomy and the required monitoring by the Government was achieved by: i) simplifying the excesive regulatory framework and administrative controls to which PEs were subjected to; and ii) providing greater decision-making capacity to the Board of Directors of the PEs to strengthen their autonomy.

11. To ensure accountability of management and to assure that PE´s will perform in accordance with agreed objectives, the Government has already established a Performance Agreement (PA) Unit and appointed the Unit Coordinator, within the Comisión Intersecretarial Gasto-Financiamiento.

12. Financial autonomy. The PA will be based on medium-term corporate plans prepared by the enterprises and approved by the Sector Secretariats in accordance with the Law of Public Entities. To ensure consistency with sectoral and national development priorities, guidelines on the elaboration of PE medium-term corporate plans will be included in the National Development Plan.

PEDRO ASPE ARMELLA
MINISTER OF FINANCE AND PUBLIC CREDIT

MEXICO

PUBLIC ENTERPRISE REFORM[1]

PART I: Disengagement Program

Policy objectives	Actions taken	Proposed measures	Monitorable actions and timing
I. Continue the process of disengagement of non-strategic PEs, to satisfy the Government's fundamental objectives of improved enterprise efficiency, and adequate financial returns. Private sector will assume primary role in undertaking and reassuming economic activity in a competitive environment. Government role focus on policy or regulation, with the exception of parastatals that are in strategic and priority sectors.	Enactment by Congress of the Parastatal Law enabling disengagement of public sector enterprises (PEs). Established a flexible process for the sale, transfer and liquidation of PEs. Reduction in the number of PEs from 1155 (1982) to 411 (March 89). In the process, sold over 200 small- and medium-sized PEs.	1. Define clearly the role of the Government in the productive sector, to guide further disengagements and regulate establishment of new PEs, in accordance with the principles stated in the Constitution and the corresponding Laws. 2. Strengthen and continue the PE sales process of non-strategic PEs. 3. For remaining large companies that will require significant restructuring and sector policy change prior to sale, initiate regulatory changes that permit these enterprises to operate on a commercial basis in a more competitive environment, during the restructuring and sale period.	1. Government Role in Production of Goods and Services By Board presentation, define Government's role and policy in the productive and services sectors, and clearly define criteria of "priority" sector for Government participation, in accordance with the Constitution and the corresponding laws. These criteria, as were presented in the document "Criterios Generales de Politica Economica" submitted to Congress, state that, except for the "strategic" sectors constitutionally defined, the Government will not get involved in enterprises or establish new parastatals or PE subsidiaries, or acquire existing private sector companies which are of a commercial nature or involved in the production of tradeable goods, except in cases of significant market failures involving the production of goods/services with major social welfare impact. Such role is being incorporated in the National Development Plan. 2. Strengthen and Continue the PE Sales Process By Board Presentation, strengthen the overall PE sales process: (i) establish a competitive and transparent process; and (ii) establish clear, objective and flexible PE sales procedures, appropriate to more complex cases. 3. Restructuring Before Board presentation: (i) make final decision for the selection of the following five PEs to incorporate them into the Performance Agreement scheme: Ahmsa, Carbon y Minerales de Coahuila, Ferronales, Fertimex and Sicartsa; and (ii) furnish to the Bank the universe of PEs already included in the Government's Disengagement Program. For second tranche release: (i) for the five selected PEs, have them operating under the Performance Agreement Plan; and (ii) satisfactory progress in the implementation of the Government's Disengagement Program. 4. Permanence of Reforms For second tranche release, Comision Gasto-Financiamiento will be formally empowered to give final recommendation on a case-by-case basis on the creation of PEs (and subsidiaries) or the acquisition of companies by Government offices--consistent with the redefined "priority" concept.

1/ All actions scheduled by Board presentation in Parts I to V under the sections "Monitorable actions and timing" have already been implemented.

MEXICO

PUBLIC ENTERPRISE REFORM

PART II: Improvements in the Competitive Environment for Public Enterprises

Policy objectives	Actions taken	Proposed measures	Monitorable actions and timing
I. Reduce price distortions and increase competition to improve resource allocation.	Agreed programs to liberalize prices in steel and reach international non-subsidized prices in fertilizers. These programs, however, have been temporarily suspended due to the implementation of both the ESP and PECE.	1. (i) Government's PE pricing policy to meet objectives of efficient allocation of resources, financial self-sufficiency under efficient operations, and affordability of basic services by the poor. (ii) In order to further reduce Government transfers to PEs, and to make them financially self-sufficient, take measures to improve revenues of PEs.	1. By Board presentation, (i) furnish to the Bank the Government's statement on price policy for PEs, specifying its intention to move towards market-determined prices for tradeable products in competitive sectors, and to set prices in non-competitive markets based on economic opportunity costs (international prices or long-run marginal costs, as appropriate); and (ii) in connection with other operations for Fertimex, Sidermex, Conasupo, CFE, and Ferronales, Government has developed appropriate programs of price adjustment.
	Preliminary study on economic pricing of electricity in CFE.	2. Assess degree of price distortions for its later elimination.	2. Start, by July 31, 1989, a study to determine the economic price of railway transportation in Mexico.
	Public procurement law for goods allows free choice of suppliers.	3. Issue revised regulation to the PP Law.	3. For second tranche release, issue the revised regulations to Public Procurement Law clarifying treatment to local and foreign suppliers.
II. Reduce barriers to entry and exit to increase competition in PEs operations.	Redefinition of Govt. role and execution of the divestiture program for PEs, which included some PEs in priority sectors, in accordance with the Constitution and appropriate laws .	4. Reduce barriers to entry by defining priority sectors, in accordance with the Constitution and appropriate laws. Reduce barriers to exit by gradually phasing out direct and indirect subsidies to PEs, as defined above.	4. See respective actions recommended under Part I of this matrix.
III. Reduce factor market distortions to improve resource allocation.	Efficiency improvements undertaken in connection with ongoing operations.	5. Increase private sector participation, in accordance with the Constitution and appropriate laws, in sectors currently dominated by PEs, aimed at reducing entry barriers to some segments of these sectors by promoting contracting out activities.	5. Start, by July 31, 1989, a study to increase private sector presence in areas dominated by large PEs (e.g., contracting out, leasing, etc.).
IV. Institutional and organizational reforms conducive to a more competitive environment.	Steel sector strategy is being finalized. Fertilizer plant closure plan under implementation and FERTIMEX's establishment of profit centers is under study. A reduced number of "basic" petrochemicals has been reclassified as "secondary" products.	6. On mining, due to the significant reduction of PE presence in the sector, as well as the need to foster private investment, reassess the role of government agencies.	6. By October 31, 1989, SEMIP to commence a study to reassess the role of government mining agencies.

MEXICO

PUBLIC ENTERPRISE REFORM

PART III: Measures to Foster Managerial Autonomy and Accountability

Policy objectives	Actions taken	Proposed measures	Monitorable actions and timing
I. To improve efficiency PEs will be accorded greater managerial autonomy. Appropriate accountability mechanisms will be established and strengthened.	Enactment of Law of Public Enterprises. "Convenios de rehabilitacion" signed in nine major enterprises. "Convenios Deficit Superhabit" signed in the majority of industrial PEs. Development of (i) an integrated PE information system; and (ii) a computerized data bank for PEs' audited financial statements.	1. Reduce size and define roles of Government agencies dealing with PEs, to move them away from ex-ante controls towards ex-post supervision mechanisms, based on performance agreements.	1. For Effectiveness, Government to furnish to the Bank draft regulations under the PE Law of 1986, defining PE supervisory roles of Government agencies, changing the responsibilities as listed in the attached Table 1, and covering the points noted below.
		2. Redefine membership, qualifications and powers of PE Board of Directors (BODs) by appropriate implementation of 1986 PE law.	2. By Second Tranche, PE Law regulations on BODs should be issued, establishing that: (i) the BODs of PEs, in addition to representatives of SPP, SHCP and the relevant sector ministry, will include a significant minority of members from non-governmental sectors, except when prohibited by the PEs' By-Laws; (ii) Board members will receive incentives for participation and their performance will be reviewed annually by the Sector Ministry, in collaboration with the UCD; non-performing BODs members would be replaced; (iii) Board members would be given the time and the resources to prepare adequately for their assignments; and (iv) criteria will be set for the purpose of determining the maximum number of BODs in which a Board member may serve, taking into account the complexity, size and other relevant parameters of the PEs.
		3. Redefine role and attributions of PEs' management, to allow it, in conjunction with BODs and BODs' technical committees, and in the framework of performance agreement systems to be implemented, greater latitude on operational decisions and to act in a timely manner.	3. By Second Tranche, issue regulations of the PE Law of 1986, emphasizing the role of technical committees of BODs, to provide flexibility to the PE decision-making process and facilitate the frequency of decision meetings, upon management request.
		4. Develop and introduce a system of Performance Agreements, to be implemented by a new Unidad de Convenios de Desempenos (UCD), to set quarterly and yearly goals/objectives, monitor performance, provide monetary rewards and penalties, and issue annual reports.	4. By Board presentation: (i) establish the Unidad de Convenios de Desempeno (UCD), attached to the Revenue/Expenditure Commission, to be the technical secretariat which will coordinate the negotiations--in consultation with the "globalizadoras" and Sector Coordinators--of Performance Agreements with PEs; (ii) appoint the Unit Coordinator; and (iii) UCD to issue a Plan of Action for the development/first application of the system. Performance Agreements will include indicators of profitability, cost containment, physical productivity, efficiency in implementing investment programs and other similar indicators. By second tranche: (i) UCD to be fully operating according to mandate; (ii) sign PAs in the five selected PEs and have them operating under the PA system; and (iii) satisfactory progress in implementation of UCD's Plan of Action.
		5. Establish/upgrade financial management tools, systems and procedures.	5. By July 31, 1989, Sector Ministry to issue TORs and request for bids for consultants to propose action plans to assess and improve in selected PEs financial management tools, develop corporate planning process, and propose remedial measures, as necessary.
		6. Standardize accounting and auditing systems applied in PEs.	6. By August 31, 1989, SPP will furnish satisfactory evidence about the implementation of a program to promote the knowledge and proper use of the "Catalogo de Formatos e Instructivos del Sector Paraestatal," to ensure the use of the most reliable and timely financial and accounting information available.
		7. Rationalize reporting systems to minimize information flows to data essential for Government evaluation and planning, and needs of UCD.	7. By September 30, 1989, CGF to issue revised integrated information system, based on recommendations of SPP-organized meetings among PEs, SECOGEF, SHCP, Sectoral Coordinators, UCD and the Technical Secretariat of Revenue/Expenditure Commission.

MEXICO

PUBLIC ENTERPRISE REFORM

PART IV: Measures to Foster Financial Autonomy and Accountability Component

Policy objectives	Actions taken	Proposed measures	Monitorable actions and timing
I. To eliminate budget restrictions on PEs, providing them with financial autonomy to become more efficient and accountable.	A Law on Parastatal entities was promulgated in 1986 to enhance financial autonomy.	1. SPP to review budget process to provide PEs with greater autonomy and accountability.	1. By September 30, 1989, SPP will furnish to the Bank an Action Plan, based on a review of existing budgetary norms and regulations, to simplify, deregulate, and make more flexible the budgetary process and its implementation for PEs under PAs.
II. To rationalize the overall investment programming process, to avoid delays in implementation, and to prioritize project implementation.		2. Develop at SPP a system of multi-year investment planning for projects that require Government financing. The system should include actions aimed at improving the efficiency in planning, preparing and implementing public investments.	2. (a) By September 1, 1989, present Terms of Reference to the Bank for a study of multi-year investment evaluation and programming, economic, financial and technical criteria for investment evaluation, establishment of centralized unit for investment monitoring, and issuing manuals; (b) by October 15, 1989, commence such study; (c) by April 15, 1990, provide to and discuss with, Bank, a satisfactory plan of action for measures in respect to (a) above; and (d) monitor implementation of new budgeting procedures for externally funded investment projects, and exchange views with the Bank by August 31, 1989 on implementation of additional measures, if necessary.
III. To improve the quality of PEs' corporate plans.	Several PEs, their sector Secretariat and the SPP have improved the quality of their corporate plans over past years.	3. Sector Ministries to develop plans as framework for PEs to develop corporate plans and investment programs.	3. For second tranche release, furnish to the Bank the guidelines which will stem from the National Development Plan for the elaboration of sector and corporate programs.
IV. To allow PEs to gradually become financially self-sufficient thereby relieving Federal Government's fiscal burdens.	The aggregate amount of transfers to PEs has been significantly reduced during the past years.	4. PEs should reduce operating costs, and adjust prices gradually to eliminate operating deficits.	4. By Board presentation, agreement that the aggregate budgetary operational plus investment transfers to PEs in 1989 will be in accordance with the approved 1989 Federal Budget. For second tranche release, continued progress in maintaining transfers in accordance with the approved 1989 Federal Budget.
V. Allow PEs and domestic banks to establish new relationship on an arms' length basis upon the creditworthiness of PEs.	Recent far-reaching financial sector reforms (see FSL), including a reduction in forced commercial lending to the Government.	5. Set individual borrowing limits per PE in connection with individual corporate plans and annual budgets approved by Congress of the PEs. Disallow Government credit subsidies, guarantees or any other preferential treatment for PEs vis-a-vis banks that would be inconsistent with the objective. Banks will evaluate loan requests based on the creditworthiness of the PE and the commercial viability of such loan requests.	

MEXICO

PUBLIC ENTERPRISE REFORM

PART V: Macroeconomic Management and External Finance

Policy objectives	Actions taken	Proposed measures	Monitorable actions and timing
I. Macroeconomic consistency.			1. Before Board presentation, satisfactory assessment of the medium-term macroeconomic framework and agree on the necessary policy actions to ensure the achievement of the macroeconomic program. For second tranche release, satisfactory assessment of the medium-term macroeconomic framework and agreement on any additional policy actions to ensure the achievement of the macroeconomic program.
II. Financing plan.			2. By Effectiveness, substantial progress has been made in obtaining adequate financing for Mexico's requirement for 1989 and 1990 in the context of the adjustment program and growth targets set forth in "Mexico's Economic Strategy" issued by SHCP. By second tranche, continuous progress has been made in obtaining adequate financing for Mexico's requirements for 1989 and 1990 and over the medium term in the context of the adjustment program and growth targets set forth in "Mexico's Economic Strategy" issued by SHCP.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/ penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/ accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements.	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements.	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/ penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/ accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements.	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements.	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/ penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/ accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

Table 1: MAIN SUPERVISORY ROLES ACCORDING TO PE LAW

Role of SPP	Role of SHCP	Role of Contraloria	Role of Sector Ministry	Role of Unidad de Convenios de Desempeno (UCD)	Role of Board of Directors	Role of PE Management
- Approves overall PEs' Budgets and their major investments - Approves transfer for operational / debt subsidies. - Serves on Board.	- Sets overall ceilings to banks on credits to PEs, and some few enterprise specific credit limits. - Serves on Board. - Approves individual requests for foreign loans. - Through the PE Sales Office, administers and monitors the PE sale process. - Approves monopoly pricing.	- Exercises Comisario role and defines external auditing rules. - Attends Board (voice not vote). - Issues regulatory guide-lines for internal audits of PEs and the auditing committees.	- Defines business charters and proposes liquidations and sales. - Sets overall policy and strategy for the sector as a whole. - Estimates and approves investments by PEs over certain limit, and submits for final approval of SPP. - Assures consistency of corporate plans with sectoral medium-term plans. - Serves on the Board. - Appoints/dismisses majority of Board members. - Appoints & dismisses CEO.	- Advices CGF for it to recommend appointments & dismissals, by Sector Ministry, of Chairman of BOD & Board members. - Coordinates the Negotiation of performance goals with PE. - Monitors performance on quarterly and annual, ex-post basis. - Issues annual reports. - Sets rewards/ penalties based on performance.	- Appoints, upon recommendation of CEO, 2nd & 3rd level managers. - Defines bylaws. - Approves annual budget. - Sets pricing. - Approves investments and borrowings. - Monitors performance closely (bimonthly) & provides discipline value to management. - Approves financial statement/ accounts of PE. - Approves corporate plan submitted by management and forwards it to Sector Ministry. - Approves dividend payments. - Approves major procurements	- CEO recommends appointment and dismissal of middle managers. - Guides the PE towards agreed upon goals. - Approves salary structures for 2nd & 3rd levels of management. - Decides on investment parameters (location, product line, etc.). - Proposes annual budgets on the basis of received guidelines. - Signs collective agreement with labor.

MEXICO

PUBLIC ENTERPRISE REFORM

Institutional Responsibilities for Program Implementation

SHCP
OVERALL PROGRAM COORDINATION

CGF

- Establish Unidad de Convenio de Desempeno
- Select PEs for Performance Agreements
- Coordinate Disengagement Program
- Issue simplified PEs integrated information system

SPP

- Coordinate and monitor budgetary transfers reduction program
- For PEs moving into the Performance Agreement (PA) system, provide flexibility and simplify their budgeting process and practices
- Prepare multi-year investment evaluation and programming
- Revise the regulations to the Procurement Law
- Issue guidelines for elaboration of sector plans, corporate plans, and project appraisal
- Promote use by PEs of acceptable accounting and auditing practices

SHCP

- Strengthen and monitor PE-sales process through PE-Sales Unit
- Implement PE price adjustment program
- Study on barriers of entry to PEs' dominated non-strategic areas
- Study on economic prices in FERRONALES

SECOGEF

- Issue 1986 PE Law Regulations

SEMIP

- Study Government mining sector agencies' role
- Issue bidding TORs for establishment of financial management tools in selected PEs

MEXICO

PUBLIC ENTERPRISE REFORM

A. Inventory Summary of Parastatals

	Number of parastatals (no.)	Total assets of PEs itemized in the budget (1987 Mex$ trillion)	(%)	Candidates for the PE Reform Program: assets value as % of total assets of itemized PEs in budget (excl. PEMEX & CFE) (%)
I. Utilities				
A. Larger PEs Itemized in the Budget				
Power generation	1	43.53	25.8	
Power distribution	1	5.77	3.4	
Railways	1	11.34	6.7	
Airports	1	1.37	0.8	
Roads	1	1.82	1.1	
Telecommunications[a]	1[a]	N.A.	N.A.	
Metro[a]	1[a]	N.A.	N.A.	
Subtotal		63.83	37.8	
B. PEs Not Itemized in the Budget				
Urban transport	2			
Ports	17			
Communications agencies	5			
Road/transport agencies	10			
Subtotal	41			
II. Oil Production, Refinery & Basic Petrochemicals	1			
Subtotal		76.35	45.2	
III. Industrial & Mining				
A. Larger PEs Itemized in the Budget				
Truck/tractor manufacture	2	0.78	0.5	1.6
Fertilizer	1	4.98	3.0	10.2
Rail car manufacture	1	0.11	0.1	0.2
Paper manufacture	1	0.20	0.1	0.4
Sugar mills (30) & distribution	1	1.07	0.6	2.2
Steel mills	2	12.01	7.1	24.6
Subtotal		19.15	11.3	39.3
B. PEs Not Itemized in the Budget				
Foundries	3			
Shipyards	3			
Small mining	18			
Sugar mills	30			
Small paper manufacture	4			
Refractory bricks	2			
Rubber manufacture	2			
Tube manufacture	1			
Turbine & electric motor manufacture	2			
Secondary petrochemical	1			
Holding for other steel mills	1			
Subtotal	75			

	Number of parastatals (no.)	Total assets of PEs itemized in the budget (1987 Mex$ trillion)	(%)	Candidates for the PE Reform Program: assets value as % of total assets of itemized PEs in budget (excl. PEMEX & CFE) (%)
IV. Agriculture & Fisheries				
A. Larger PEs Itemized in the Budget				
Food marketing centers	1	3.57	2.4	
Fishery	1	0.83	0.6	
Forestry	2	0.05	0.0	
Coffee	1	0.13	0.1	
Subtotal		4.58	3.1	
B. PEs Not Itemized in the Budget				
Food distribution/storage	24			
Small agroindustries	11			
Fisheries & fish cold storage	5			
Subtotal	45			
V. Financial Institutions (Not Itemized in the Budget)				
Commercial & development banks	39			
Insurance companies	4			
Money agencies	2			
Real estate invest. & dev. agnc.	19			
Trust funds for sectoral credits	30			
Trust funds for sectoral support	34			
Subtotal	128			
VI. Social Services & Other Agencies				
A. Larger PEs Itemized in the Budget				
Social security	2	4.71	3.1	
Lottery	1	0.17	0.1	
Subtotal		4.88	3.3	
B. PEs Not Itemized in the Budget				
Education research/support inst.	59			
Theaters & publishing companies	21			
Research institutes	17			
Consumer support agencies	5			
Social security support inst.	12			
Health institutes & hospitals	16			
Mining & industrial support agencies	9			
Urban development	11			
Other agencies	6			
Subtotal	159			
Total: PEs itemized in budget	22	168.79	100.0	
Other PEs	427			
GRAND TOTAL	449			

Sources: Asset data--SPP, "Cuenta de la Hacienda Publica Federal 1987"; number of enterprises--SHCP.

a/ Though classified as "Organismos y Empresas no Controlados Presupuestalmente," (DECP) the detailed itemized budget of both PEs is included in the Annual Economic Report of the President. (See "Ingreso Gasto Publico de los Organismos y Empresas No Controlados Presupuestalmente" in "Sexto Informe de Gobierno 1988").

MEXICO

PUBLIC ENTERPRISE REFORM

Table VIII.1: Mexico - PE Investments in 1981-87

	1981	1982	1983	1984	1985	1986	1987
In billions of current pesos							
Total PEs	385	505	640	979	1,369	2,187	5,268
PEMEX	231	285	348	469	598	953	2,292
Other PEs	154	221	292	509	771	1,234	2,977
In billions of constant pesos							
Total PEs	305	249	166	159	142	130	129
PEMEX	183	140	90	76	62	57	56
Other PEs	122	109	76	83	80	73	73
As % of GDP							
Total PEs	6.3	5.2	3.6	3.3	2.9	2.8	2.7
PEMEX	2.8	2.9	1.9	1.6	1.3	1.2	1.2
Other PEs	2.5	2.3	1.6	1.7	1.6	1.6	1.5

Source: Secretaria de Hacienda y Credito Publico.

Table VIII.2: Cash Flow for all PEs Included in the Federal Budget, Excluding PEMEX
(In Constant 1978 Mex$'000 million)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Net sales revenues	174.9	185.4	192.0	201.9	221.0	198.9	244.1	228.3	219.9	227.4
Wages	64.9	68.8	72.5	84.1	95.1	73.8	69.9	69.3	61.9	58.0
Other direct costs	112.7	109.9	128.9	161.5	146.5	161.7	189.8	161.4	152.8	153.6
Gross margin (before int.)	-2.7	6.8	-9.4	-43.7	-20.6	-36.5	-15.6	-2.4	5.2	15.8
Interest	15.5	18.7	23.4	26.7	37.8	57.4	62.1	53.8	38.2	31.2
Internal cash generation	-18.2	-11.9	-32.8	-70.5	-58.4	-93.9	-77.7	-56.2	-33.0	-15.4
Investment	55.5	72.0	91.7	84.6	80.4	57.0	55.2	54.1	48.1	48.4
Financial gap (before net debt flows & govt. transfer	-73.8	-83.9	-124.5	-155.0	-138.8	-150.9	-132.8	-110.3	-81.1	-63.8
Government transfers	52.3	60.2	86.0	101.3	114.7	117.0	104.5	97.6	76.5	60.3
Cash available for debt amortization (i.e., principal)	-21.5	-23.7	-38.6	-53.7	-24.1	-33.9	-28.3	-12.6	-4.5	-3.5
Gross mrgn/net sales (%)	-1.6	3.7	-4.9	-21.6	-9.3	-18.4	-6.4	-1.1	2.4	6.9
Int. cash gen/net sales (%)	-10.4	-6.4	-17.1	-34.9	-26.4	-47.2	-31.8	-24.6	-15.0	-6.8
Financ. gap/net sales (%)	-42.2	-45.3	-64.9	-76.8	-62.8	-75.9	-54.4	-48.3	-36.9	-28.1

Table VIII.3: CFE, CONASUPO, FERTIMEX, FERRONALES and SICARTSA's Consolidated Cash Flow
(In Constant 1978 Mex$'000 million)

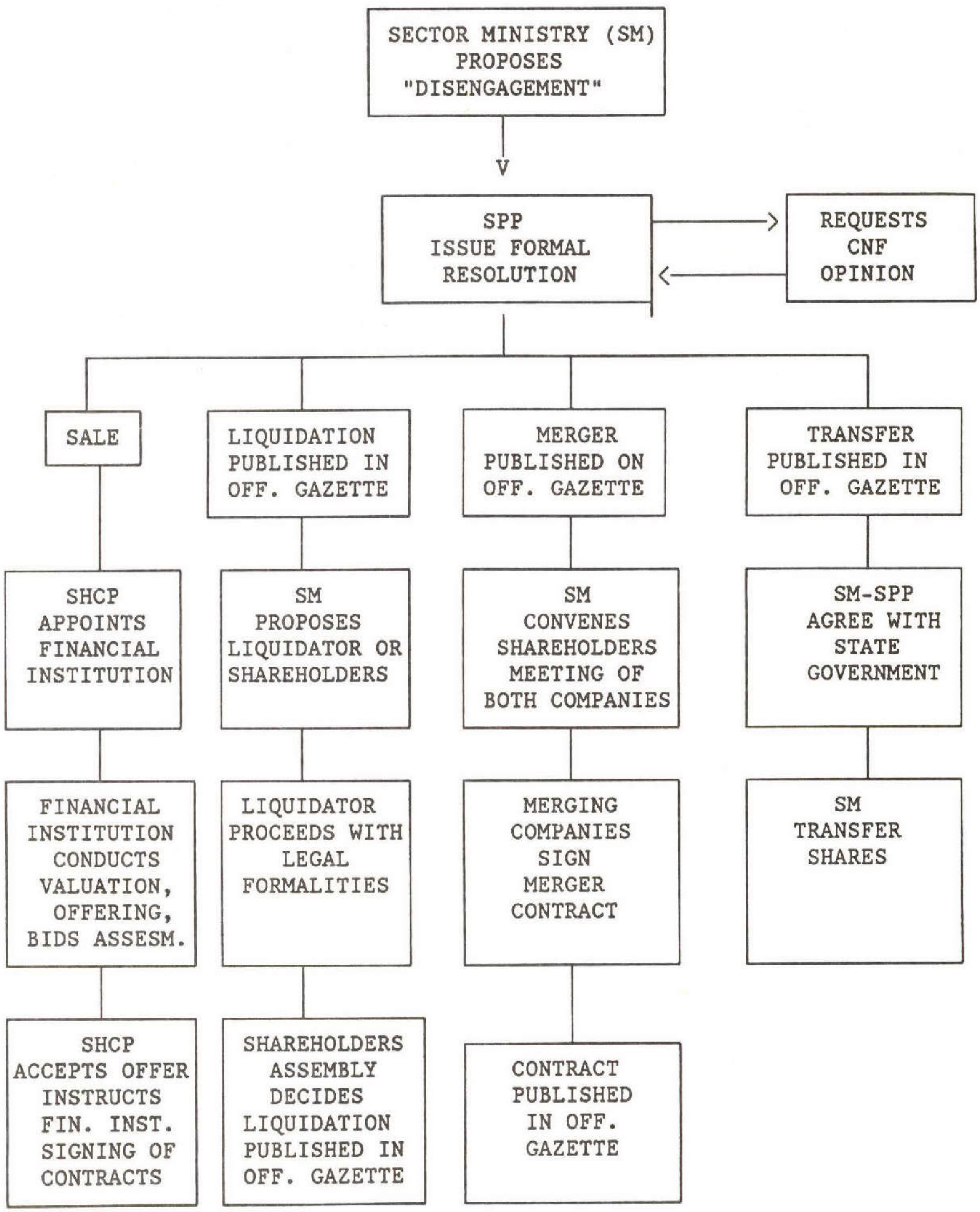
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Net sales revenues	65.1	66.3	64.7	65.5	76.5	70.1	83.5	75.0	72.3	75.9
Wages	22.0	23.3	24.6	26.9	28.7	21.0	18.4	20.1	17.7	18.5
Other direct costs	54.4	47.4	57.9	84.6	72.2	87.3	88.6	68.1	63.1	68.0
Gross margin (before int. & deprec.)	(11.3)	(4.3)	(17.8)	(46.1)	(24.3)	(38.2)	(23.5)	(13.2)	(8.5)	(10.5)
Interest	13.4	16.6	21.4	24.4	35.8	47.4	48.1	39.8	28.5	16.7
Internal cash generation	(24.7)	(21.0)	(39.2)	(70.4)	(60.1)	(85.6)	(71.5)	(53.0)	(37.0)	(27.2)
Investment	34.0	45.0	53.3	55.0	54.1	44.4	38.1	37.6	30.5	32.1
Financial gap before net debt flows & govt. transfer	(58.7)	(66.0)	(92.5)	(125.4)	(114.2)	(130.0)	(109.6)	(90.6)	(67.5)	(59.3)
Government transfers	33.7	38.9	62.3	76.0	90.8	96.9	86.1	79.7	61.7	50.7
Cash available for debt amortization (i.e., principal	(25.0)	(27.1)	(30.2)	(49.4)	(23.3)	(33.1)	(23.5)	(10.9)	(5.8)	(8.6)
Gross mrgn/net sales (%)	-17.4	-6.5	-27.5	-70.3	-31.8	-54.5	-28.1	-17.6	-11.7	-13.9
Int. cash gen/net sales (%)	-37.9	-31.6	-60.7	-107.5	-78.6	-122.1	-85.6	-70.7	-51.1	-35.8
Financ. gap/net sales	-90.2	-99.4	-143.1	-191.5	-149.2	-185.5	-131.2	-120.9	-93.3	-78.1

MEXICO

PUBLIC ENTERPRISE REFORM

Alternative Disengagement Procedures

Chart 1: "DISENGAGEMENT" PROCESS - FLOWCHART



Detailed Procedures for Disengagement

The required initial disengagement steps, common to all of the four methods--sale, merger, liquidation, or transfer--are as follows:

Step

1 Informal coordination/consensus is reached among interested Secretaries.

2 The Sector Secretary (SEMIP for industry, energy and mines) formally proposes a list of candidates for disengagement to SPP. On the basis of company analysis it might be sale, liquidation, merger, or transfer. The proposal might also include specific recommendations to consider during the process, e.g., regional employment, monopoly status, etc.

3 SPP requests the opinion of CGF (the Inter Secretarial Commission on Expenditures and Financing), and issues the formal Resolution (in agreement with the President's office) authorizing the disengagement. SPP also decides on the utilization of the expected proceeds. (Arts. 8 and 9 Budget Law; Arts. 16 and 32 Parastatals Law; and Arts 11 and 32 Public Administration Organic Law)

4 The resolution is not published in case of sale. It is published in the Official Gazette in all other cases.

5 (i) Authorization to Liquidate. The liquidation and dissolution of PEs is carried out under the provision of both the Corporate and Parastatals Law. The shareholder's assembly appoints the executor with a full mandate to liquidate the company. For group subsidiaries, the holding company is responsible; other cases are taken care of by the SCU. According to Law (Sociedades Mercantiles, Ley Gral. de Bienes Nacionales), the process must include formal steps like technical appraisal of corporate assets, and public bidding for selling assets among others. Once the sale of assets and cancellation of liabilities is performed, the shareholders assembly approves the dissolution of the company. This resolution is published in the Official Gazette.

(ii) Authorization To Merge. According to Law (Federal law of Parastatals, and General Law of Corporations), PEs are authorized to independently merge among themselves. Nevertheless, each SCU has traditionally requested a formal authorization from SPP to proceed with the merger. The execution of the merger is proposed by the SCU as a shareholder, or by the respective holding group. The Merger Agreement is then ratified by a shareholders assembly of both corporations. It is published in the Official Gazette.

(iii) Authorization to Transfer. Transfers are performed under the provisions of the Budget and Public Administration Organic Law. The related SCU executes the transfer, while SPP and the

State Governor sign the Agreement by which the Federal State freely transfers the shares of the corporation.

(iv) Authorization to Sell. CG-F issued a formal Sale Procedure for non-strategic and non-priority parastatal agencies on March 25, 1987. Accordingly, the Secretary of Hacienda (SHCP) is responsible for the execution and monitoring of the sales process (Art.3). SHCP first appoints a financial agent from a core group of 5 state-owned Banks that will have full responsibility for the valuation, marketing, and sale of the company under the provisions of the Law. (Economic Cabinet Resolution 08/05/85; and Art. 31 Public Administration Organic Law). The financial agent undertakes the following activities: (a) makes the corporate financial/technical analysis; (b) defines the method of sale; (c) recommends a minimum price; (d) produces the Offering Memorandum; (e) contacts potential purchasers; (f) requests, receive, and assess the bids; (g) reports to SHCP the results of the bids; and (h) once approved by SHCP, formalizes the sale contract. If the minimum price is not achieved, the Commission on Expenditures might review the case, setting new selling criteria, or declaring the sale ineffective and opting for another divestiture option. The procedures stipulate that at least two bids must be received in each case, and also provides a right-of-first refusal to existing private shareholders, and the company's union. (Art. 32 of the Parastatal Agencies Law.) The regulations on sale proceeds appropriations established by the CGF are as follows: (i) deposited without recourse in the National Treasury in the case of disposing directly federally owned PEs; (ii) in interest-bearing accounts of the controlling holding group in the National Treasury for subsidiaries of other PEs; (iii) in all cases the proceeds should previously compensate reimbursable transfers outstanding from the Treasury, or liabilities for the assumption of foreign debt; and (iv) the accumulated balances should finance social programs, if they are already included in the Federal Budget.

MEXICO

PUBLIC ENTERPRISE REFORM

Technical Assistance

Action	Responsible Agency	Action Date	Estimated Cost ($'000)
I. Studies to Be Commissioned			
(i) Economic Prices in FERRONALES	SCT	7/31/89	60
(ii) Role of mining sector agencies	SEMIP	9/31/89	60
(iii) Private Sector Development in PE dominated areas.	Sector Ministry	7/31/89	75
II. Specialized Support on the Following Tasks			
(i) Development of the Performance Agreement blueprint	CGF	5/89	60
(ii) Support to improve financial management tools in selected PEs	SHCP/SPP	7/89	90
(iii) Issue a simplified integrated information system for PEs monitoring	CGF	7/89	60
(iv) Performance Agreements preparation for selected PEs.	CGF	7/89	150
III. Training			
(a) UCD	CGF		90
(b) PEs	CGF/Sector Ministry		225
IV. Unallocated			130
TOTAL			1,000

IBRD 15553
JANUARY 1981

MEXICO T.E. REFORM

Suddenly, this summer

The bidding war for the privatisation of Mexico's banks has already started. After eight years of government control the sector is gearing up for its new freedom

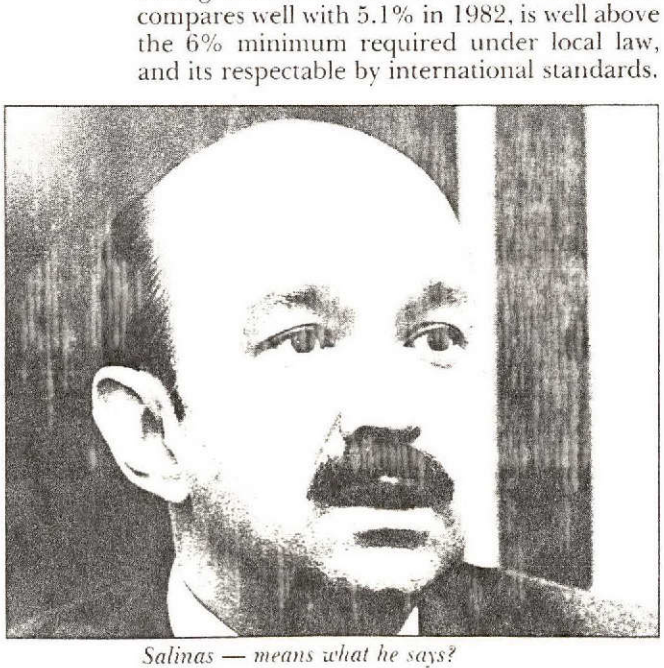
If all goes according to plan, Mexico's 18 commercial banks will be back in private hands before the end of the year. Potential buyers have had 11 months to finger the merchandise and study the bottom line, with some 19 financial groups, most put together over the past two years, showing interest.

Several have made bids for up to three players in the hope that one bid will come off. But foreign interest has been sparse: there are still limits on foreign ownership, and US banks reckon Mexico will eventually open up its financial sector and allow them to compete in their own right.

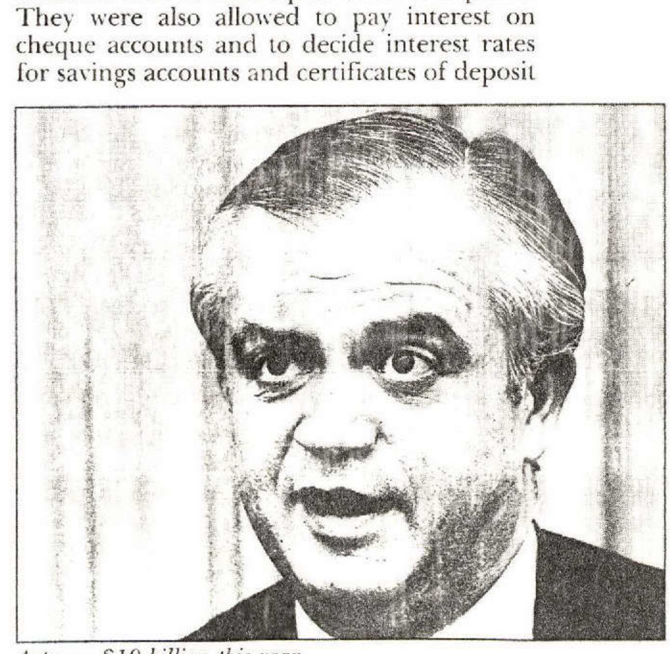
Local bidders have few doubts they are on to a good thing; indeed, most of the banks will emerge from eight years of government control in remarkably healthy condition. The divestiture of bank stock into private hands since 1987 has played an important part in strengthening banks' capitalisation, which averaged close to 8% at the end of 1990. This compares well with 5.1% in 1982, is well above the 6% minimum required under local law, and its respectable by international standards.

The 18 banks made a combined profit of almost US$2 billion in 1990. By July Banamex had made US$175 million, Bancomer US$131 million, and Banca Serfin US$123 million. Most of the others racked up good to modest gains in the first seven months; beyond that no reliable figures are available. The net worth of the 15 players listed on the local stock exchange is said to be between US$5.5 billion-6 billion, with the three unlisted ones adding a further US$300 million. Total book value of the 15 listed banks is roughly US$4.4 billion, making the ratio of price to book value around 1.28 — rather better than the forecasts of some US banks which had reckoned on two to three times book value.

Recent legislation has made the banks more competitive and freed funds for lending to the private sector. The March 1989 banking regulations slashed the effective legal reserve requirement from 90% to 30%, leaving institutions free to lend up to 70% of deposits. They were also allowed to pay interest on cheque accounts and to decide interest rates for savings accounts and certificates of deposit



Salinas — means what he says?



Aspe — $10 billion this year

(previously set by the monetary authorities), and ordered to distinguish between interest rates paid to companies and individuals, publishing both rates on a daily basis. The regulation eliminated most special credit lines for so-called "priority sectors" and allowed a big reduction in the difference between lending and deposit rates.

In August 1989 complementary regulations came out. Outfits no longer had to keep deposits in the central bank for regulation purposes. This effectively got rid of legal reserve requirements and spurred a sharp increase in credit to the private sector, which jumped by 30% in real terms by the end of 1990. The government now estimates that credits to the private sector will rise by 14% in 1991 even though economic growth is likely to be modest. Last year 85% of commercial bank loans went to the private sector and only 15%

"The sell-off of the banks will be the high point of a privatisation drive that started in 1983"

to the public sector. The contrast with 1988, when the government swallowed over 50% of available credit, has provided strong proof that President Salinas means what he says when he talks about private business being the country's "engine of future growth."

Although banks did not immediately adjust their interest rates for deposits in March, they were forced to in July when rates on the government's 28-day treasury bills (*cetes*) fell from more than 55% to less than 34% during the month. This was largely because of the announcement of a tentative agreement on the country's external debt.

In December 1989 there was another instalment in the never-ending spate of financial legislation. This divided banks' capital into three types of stock. A stocks, accounting for 66% of ordinary capital, could be owned only by the federal government; B stocks (34%) could only be owned by Mexicans, with no individual or company owning more than 5% of a bank (previously 1%); and C shares ("additional capital") carried no vote. Foreigners could buy up to 34%. These reforms also allowed banks to invest in companies providing "complementary or auxiliary" financial services. Foreigners were now permitted to own up to 49% of insurance, financial leasing and bonding companies, bonded warehouses, and investment societies. Under previous law, these were required to be 100% Mexican-owned.

The most significant measure in the package was authorising private financial groups. Some already existed and, in this respect, the government was simply recognising reality; the new ingredient was that the groups were now allowed to own various types of financial intermediaries and provide integrated services.

But the salvo of legislation fell short of its target. In March 1990 the government not only shot down the 1982 bank nationalisation (by a constitutional amendment) but also blew holes in the previous package rubber-stamped by Congress in time for Christmas the previous year. This time it decided that A shares would represent 51% of banks' capital and would be available to Mexican citizens, the federal government, Mexican development banks, the Bank Fund for Savings Protection, and the financial holding companies it had taken such pains to encourage. In fact, the groups would be the only stockholders to be allowed to buy more than 10%, thus giving them majority control of any bank they might decide to buy.

Meanwhile, B shares, representing 49%, could include anyone entitled to buy A shares, Mexican companies not controlled by foreigners, domestic bonding and insurance companies, pension funds, investment societies, and other approved Mexican institutional investors. C stocks, defined as "up to 30% of the capital of each bank," could be acquired by those qualified to buy B stock, plus all other Mexican or foreign non-governmental or non-official entities. The law also limited the size of loans that could be made to directors, to individuals or companies that own the banks, and to employees.

The sell-off of the banks will be the high point of a privatisation drive that started in 1983. Former president Miguel de la Madrid sold or liquidated more than 600 state-owned companies and agencies and his successor, Salinas, has got rid of more than 60 since taking office at the end of 1988. However, de la Madrid disposed of mainly small, troubled outfits and sold off only 150 of them, for about US$500 million. Salinas has garnered a further US$2.5 billion from such companies as Mexicana Airlines and the giant Cananea copper complex, plus almost US$4 billion from last December's sale of Telefonos de Mexico.

Finance Minister Pedro Aspe expects around US$10 billion this year from privatisations — up to US$4 billion from two giant state-owned steel complexes and a huge fertiliser company, plus up to US$6 billion from the sale of the 18 banks. That would be enough to cover an expected US$4 billion-5 billion current-account deficit and leave an unaccustomed budget surplus. Part of that surplus will be used to reduce the government's domestic debt, now close to US$60 billion, and encourage the slide of Mexican interest rates, which have now fallen below 30%.

The reason why Salinas wants to begin privatising the banks before August's crucial mid-term elections is that he believes it will not be a significant electoral issue. He can point out that part of the money will also go to help the poor and unemployed, who have so far got little from his reforming zeal. This could well bring the ruling Institutional Revolutionary Party (PRI) through the elections slightly stronger than before, leaving Salinas with a completely free hand to remodel the economy.

Meanwhile, the new financial groups, clustered around the leading brokers, are preparing to bid for the banks. Acciones & Valores, headed by former stock exchange president Roberto Hernandez, failed in a bid for the telephone company and now has its eyes on either Banamex or Banca Serfin. As the broker has members on the board of both banks, as well as Bancomer and Comermex, it would seem to have the inside track here. But Banamex is also being eyed by Agustin Legorreta, once its general director, whose family ran the bank almost from its foundation in 1982. Legorreta owns prosperous broker Inverlat and is chairman of the board of Seguros America, his group's large insurance company. Inverlat dropped out of the bidding for the telephone company to concentrate on Banamex. It is also interested in the smaller multi-regional Banca Confia, whose assets, deposits and net worth all grew by about 70% in 1989 and continued to grow last year.

Other former bankers would like to recover their property. Carlos Abedrop Davila was chairman of Banco del Atlantico before nationalisation; he now heads broker Fimsa and insurer Seguros Olmeca, as well as sitting on the board of AeroMexico, formerly the national flagship. Chihuahua industrialist Eloy Vallina once owned Multibanco Comermex and has let it be known he would like to have it again. In 1989, he sold some business interests to Israel and Pablo Brener, who have substantial hotel holdings and are majority owners of Mexican Airlines. They could be bidding for Multibanco Mercantil, based in Mexico City and known for its dealings with the textile industry.

Alberto Bailleres owns broker Casa de Bolsa Cremi, has a controlling interest in Seguros Nacional Provincial, and is the largest shareholder in Penoles, the world's largest private producer of silver; he used to own Banca Cremi and will make a bid for it. Rolando Vega, who owned Banca Confia until nationalisation swept it away, controls broker Interamericana and insurer Seguros & Fianzas Atlas. Adrian Sada Trevino, once a large shareholder in Banpais, has let it be known that he is actually more interested in Banca Serfin. He holds a controlling share in Operadora de Bolsa, Mexico's largest stockbroker, and in Vitro, the country's largest glass manufacturer.

Former Bancomer owner Manuel Espinosa Yglesias appears out of the running, having sold most of his assets to Claros Slim Helu, who made the winning bid on Telefonos de Mexico. Slim controls broker Inversora Bursatil, the large store chain Sanborns and several other industrial firms. Slim covets Bancomer, on whose board he once sat. Jose Madariaga Lomelin, current president of Mexico's stock exchange, owns broker Probursa; he is likely to go after Banco Internacional.

Some of the industrial groups are also ready to acquire a bank. Valores Industriales, a large brewery firm, once had a controlling interest in Banca Serfin and would like to regain it. Another Monterrey group, ALFA, has Banamex in its sights.

Bernardo Quintana Isaac heads Mexico's largest construction firm, Ingenieros Civiles Asociades (ICA), and has plenty of liquidity from the recent sale of large cement company, Cementos Tolteca; he could make a bid for Somex. The Garza Laguera and Roma Garza families, another offshoot of the prosperous Monterrey clan, own broker Vector and insur-

Mexico's majors: basic data

	Year end	Core capital (Mex$ billion)	Assets (Mex$ billion)	Pre-tax profits (Mex$ billion)	Capital/ assets (%)	Profits/ assets (%)	Profits/ capital (%)	Employees (no.)
Nacional Financiera	31 Dec 89	2,707	44,393	181	6.10	0.41	10.27	3,100
Bancomer	31 Dec 89	1,708	42,070	1,015	4.06	2.41	70.43	34,000
Banamex	31 Dec 89	1,424	48,610	429	2.93	0.88	33.50	30,000
Serfin	31 Dec 89	671	22,688	347	2.96	1.53	63.17	20,600
Nacional de Comercio Exterior	31 Dec 89	598	19,083	92	3.13	0.48	16.86	1,500
Banobras	31 Dec 88	512	15,116	40	3.39	0.26	11.50	na
Multibanco Comermex	31 Dec 89	308	9,207	121	3.34	1.31	50.99	12,300
Banco International	31 Dec 88	147	4,790	168	3.06	3.52	168.10	na
Banco Mexicano Somex	31 Dec 88	140	3,792	106	3.69	2.80	na	7,500
Banca Promex	31 Dec 89	106	1,797	119	5.87	6.60	144.00	4,100

Source: published reports; The Banker

er La Comercial; they will be in the running for Banca Serfin. Other potential bidders are Jeronimo Arango, who owns three store and supermarket chains, and Lorenzo Servitje, owner of Bimbo bread company; but they are reckoned to stand more chance of acquiring one of the large number of multi-regional banks.

Each party can bid for up to three banks. The first lot to be privatised will be three multi-regionals (defined as those with branches in more than one state). Multibanco Mercantil is the country's 13th largest, with 92 branches and a market value of US$92 million. Banca Cremi, which covers the state of Jalisco and Mexico City, has an asking price of US$116 million. And Banpais, one of three banks still unlisted on the stock exchange and in the past few years propped up by government subsidies, could go for about US$90 million – if there are any takers. By 11 March bidders needed to have declared an interest and put down a deposit. The Finance Ministry then decides which are eligible and the bids go in over the following six weeks. The three banks should be well and truly in the private sector by early summer, if everything goes to plan.

Deadlines are still to be announced for the four other multi-regionals, the five regionals and the Big Six (Banamex, Bancomer, Serfin, Somex, Comermex, and Banco Internacional). The last cover the whole country and make up about 83% of the value of the banking sector. The seven government development banks are not on offer – or at least not officially. But it is known that Operandora de Bolsa would like to bid for Banrural, the government agricultural bank, and (rumour has it) that construction company ICA would like part of National Public Works Bank.

Bidders for the Big Six will have a long, hot summer. The competition could be fierce. Banamex is the largest, measured by deposits and assets, although it has lost some ground to Bancomer over the past two years in profits and net worth. It is particularly strong in money-market operations, investment banking and trade finance; it has about 750 branches and employs nearly 30,000 people. The asking price will be around US$1.8 billion.

Bancomer is a strong retail bank with a wide branch network and an even larger staff than Banamex. In 1989 it came top in both net profits and net worth. Its price will be about US$1.5 billion. Banamex is the second largest bank in Latin America (after Banco do Brasil) and Bancomer third.

Banca Serfin, Mexico's third and Latin America's fourth largest, was one of the first to provide integrated financial services. The government encouraged it to compete with the two largest players and it has increased its share of the market. Serfin has expanded international operations and trade finance, and has been active in the privatisation of state-owned companies; its price tag is some US$650 million.

Among the multi-regionals, the worst performers are Banco de Credito & Servicio (Bancrecer), which with Banpais and Banco de Cedulas Hipetacrias (BCH) is not listed on the stock exchange, and Banca Cremi. Indeed, Bancrecer, Banpais and BCH will need some attention to be sold at all. The regionals are all in fairly good shape and one or two look like bargains.

Among foreign banks said to be showing interest are Spain's Banco Santander, France's Banque Nationale de Paris and Paribas, Japan's Nomura, and the Netherland's NMB

Bidders for the Big Six will have a long, hot summer. Competition could be fierce

Bank. None of the US majors has joined in the bidding to date. One reason for this dearth of foreign interest is that no single foreign buyer can take more than 10% of a bank, although foreigners can now hold up to 30% of voting stock. Some US banks are bothered by Mexican attitudes toward foreign investment and worry about possible policy changes under future governments. Others remember the hits they took in Latin America in recent years. And some of the larger US players, already under pressure at home, see Mexico as an even greater risk.

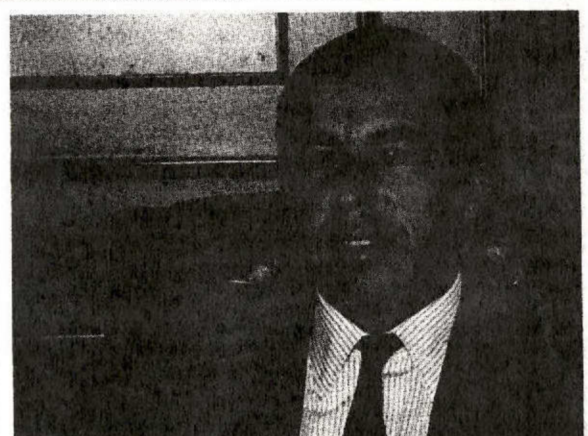
But as far as US banks are concerned, there is a feeling that Mexico's financial services could be further opened up as a result of the US-Mexico Free Trade Agreement now being negotiated. Citibank has been in the market (with restrictions) for 29 years and several US players believe it is only a matter of time before they can come in as well. Some observers see foreign banks operating in the country in the next two to three years in direct competition with many of the local financial groups.

Any more dreams? There is one that still floats about in the corridors of power: that Mexico could one day replace Panama as the region's offshore banking centre. Cherished by some, opposed by others, this one could take a little more time. □

The banks go on the block

The auction of eighteen state banks is part of financial reforms meant to ready Mexico for hemispheric free trade. But gigantism could afflict the broker-bank conglomerates that result.

BY LUCY CONGER



Finance under secretary Ortíz: "Financial deregulation ended distortions and has stimulated competition for financial markets"

■

Banco Internacional's Corredor: "The most important principle is to ensure that the main elements of the financial system remain in Mexican hands"

Just two weeks after Mexico defaulted on its foreign debt in August 1982, departing president José López Portillo stunned the country by nationalizing its banks. A scant nine years later, the government is busy unwinding that rash and ill-advised act.

The sale of all eighteen government-held commercial banks is Mexico's biggest privatization so far, and it is a critical component of President Carlos Salinas de Gortari's economic strategy. Privatization is expected to promote efficiency in the financial system so that Mexico can gear up for the competition that will erupt when it signs a free-trade agreement with the U.S. and Canada, possibly as early as next year. Mexico expects the agreement to attract foreign investment badly needed to create jobs. Concern for quick approval runs so deep in the administration that Salinas' press secretary recently wrote a letter to Xerox Corp., reproaching the U.S. giant for sponsoring a magazine that published articles critical of Mexico.

More immediately, sale of the government's 66 percent interest in the banks (34 percent was sold off earlier) should bolster investor confidence and, not incidentally, pour as much as $4 billion into Treasury coffers to help compensate for the growing current-account deficit. And the extra income for government projects won't hurt in this sensitive election year: Salinas' ruling Institutional Revolutionary Party faces close competition in many of the seven gubernatorial and midterm congressional races. In this context, the administration wants, first and foremost, a smooth privatization. Visions of false starts — such as two failed attempts to sell Mexico's Cananea open-pit copper mine (the third did the trick) — haunt government bankers. "Everyone is afraid of a blunder," says a banking sector official. "They want a smooth sale."

The government wants to diversify the capital base of the banks, or "democratize" it. This was a leading condition of opposition party congressmen for approving privatization. Individual shareholders are restricted to a maximum 5 percent stake in the capital of any one bank, although this can be expanded to 10 percent by special dispensation of the Finance Ministry. "The government is clearly trying to create a banking sector made up of share combinations," says a government official.

To get the financial modernization moving, Salinas launched a series of deregulation and reform intiatives, beginning with the lifting of interest rate controls in 1989. That was soon followed by the liberalization of reserve requirements and the elimination of obligatory directed lending for public housing and agriculture programs, which had consumed more than half of bank resources. "The financial deregulation ended distortions and has stimulated competition for financial markets," says Finance Ministry under secretary Guillermo Ortíz. The changes are of fundamental importance for potential investors. "The process of deregulation lets the bank work as a bank," notes Roberto Hernández, president of Acciones y Valores (known as Accival), Mexico's most powerful brokerage firm.

"Everyone is afraid of a blunder. They want a smooth sale."

Financial supermarkets

Mexico's Congress has also approved reforms to liberalize the insurance and securities industries, as well as to set out the ground rules for forming financial groups and holding companies. Financial groups may be headed by a holding company, a bank or a brokerage house. A holding company that controls a bank must own at least 51 percent of it. While no individual may own more than 10 percent of a holding company, there is no stipulation against a group of individuals, each owning 10 percent, acting together. Thus Finance Ministry officials privately express doubts that the limitations on individual shareholding will democratize the banking sector. The package of reforms effectively encourages the creation of financial supermarkets.

Most of Mexico's foremost financiers were already in the race by the time the first three banks — Banpaís, Banca Cremi and Multibanco Mercantil de México — were put up for bids on February 18. In hottest pursuit are fifteen of the nation's 25 securities houses, which see the banks as the vital third element to complement brokerage and insurance services in their fledgling financial groups. Hernández of Accival is favored to land giant Banco Nacional de México, known as Banamex, which commands $10 billion in deposits and is valued at approximately $2 billion. Other brokerages in the running for banks include Inverlat (headed by former Banamex chief Agustín Legorreta), Multivalores, Finamex and Value.

"Surely this is the only country in the world where brokerage houses are buying banks," quips Edgardo Mendoza, executive vice president of brokerage ProBursa's international division. In a sense, it is a logical progression from their activity throughout the prolonged recession triggered by the 1982 economic crisis; Mexico's brokers functioned as an alternate banking system as savings poured out of banks and into certificates of deposit, Treasury bills and stocks in the panic following bank nationalization.

Major industrial groups are also preparing to bid for the banks. Manuel Senderos, who heads Grupo Desc, is challenging Accival for Banamex. "The two groups are first-class," comments Banamex director general Antonio Ortíz Mena. Among the other industrial groups are GrupoVisa and Pulsar.

Although Mexico's new financial laws carve out a niche for foreign investors, "perhaps the most important principle is to ensure that the main elements of the financial system remain in Mexican hands," says Banco Internacional director general Jaime Corredor Esnaola. Consequently, the legislative package limits a foreign investor, individual or institutional, to a 5 percent stake (or 10 percent with special permission) in banks, brokerages and holding companies of financial groups; collectively, foreigners may hold up to 30 percent, but that ceiling could rise in the near future as a result of the free-trade negotiations, says finance under secretary Ortíz. Some Mexican financiers are less than enthusiastic about having foreign partners. "We don't want foreign investors if they stir up trouble for us," says one.

He needn't worry. Foreign interest is sluggish, particularly on the part of American bankers, who have problems of their own at home. Feelers are coming in from Canadian and European banks, which are less sensitive than Americans about taking minority positions. Banque Nationale de Paris has teamed up with Mexico's former bank association chief Carlos Abedrop in a bid for the No. 6 bank, Banco Mexicano Somex, and bankers from Spain, Germany, France and the Netherlands are reportedly browsing.

Finance Ministry officials claim they want foreign partners to come in only after the banks are securely in Mexican hands. But, one observer insists, "there is less foreign interest in the banks than Mexicans want." Analysts say there is enough Mexican capital to buy most of the banks, but that foreign participation may be needed to sell off the two biggest — Banamex and Bancomer. The government's 66 percent stake in each bank is worth about $1.3 billion.

Fifteen of the banks being sold are solidly profitable. The other three — Banco BCH, Banpaís and Bancreser — have been troubled for some time, but are now operating in the black, according to Finance Ministry officials. However, other aspects of banking operations may give foreign investors pause. "Lots of things have to be done in Mexican banks to make them competitive," says Guillermo Chávez, vice president of the Mexico City office of Grupo Santander, the investment banking arm of Spain's Banco Santander. Computerization and telecommunications at all but the very largest banks are hopelessly outdated; consumer lending lags badly (it is very difficult for Mexicans to get a home or automobile loan); and the delivery system is inadequate — not a single new branch office has been established since the government takeover. Trimming inflated staffs presents a special challenge.

These problems aside, there are two serious technical hurdles that must be overcome before the sale can get under way. The valuations — the assessments of the accounting and business worth of the banks — will likely raise questions. "Given [that] they are Mexican banks run by Mexican politicians and have had a brain drain in recent years, it is not clear how the value can be determined with exactitude," says a U.S. investment banker.

The other hitch is the $5.4 billion in interbank credit that by gentleman's agreement has been carried over without restructuring in successive debt renegotiations. The interbank lines could be valued at nominal or secondary market value; if restructured, they become nonperforming loans for U.S. banks. A few of the interbank lines are in the process of being renegotiated, but the bulk of the problem remains.

A letter to Santa

Mexican Treasury officials have floated a variety of proposals, which include swapping the lines for stock in the recently privatized telephone company, Teléfonos de México, or for bank shares. The bank share-swap proposal is "ridiculous," says one banker. In some cases the interbank credit lines far exceed the 30 percent ceiling allowed for foreign capital. "The Finance Ministry sent a letter to Santa Claus," comments a foreign banker.

Among prospective Mexican buyers, interest in the privatization remains keen despite these problems. In the provinces, businessmen are eager to buy the highly successful regional banks, and Mexico City brokerages continue to fear they will collapse if they fail to pick up a bank. General indicators point to continued investor interest: the price of CAPs, the stocklike certificates issued in the initial 1986 divestment of 34 percent of the government's bank holdings, remains high. The nation's leading bank, Banamex, is pioneering a partial management buyout scheme that could serve as a model for all fifteen banks listed on the Mexican Stock Exchange. Banco Internacional's Corredor is supporting a similar management buyout proposal.

In the meantime, synergy has become the buzzword among the yuppies who people the go-go brokerages strung along Mexico City's upscale Paseo de la Reforma. They, along with the former bankers, are eyeing the banks with relish and whipping up visions of holding companies or financial groups spanning the full range of services. The ProBursa brokerage, for example, is now integrating its leasing, foreign exchange, factoring, warehousing, bonding, mutual fund management and insurance operations into a holding company. ProBursa is going to bid for Banco Internacional, Mexico's fifth-largest bank, which gained a favorable reputation for its role as agent in the December 1990 privatization of Telmex. "One of the main objectives of the holding company is to become international — to obtain technology and capital and expand the customer base," says ProBursa's Mendoza.

Another leading financier who is angling for a bank has drafted the design for a holding company that would include an investment bank as well as factoring and credit operations. Each unit would be self-sustaining.

Grand ambitions

The schemes for financial groups — grandiose as they may be — pale beside the ambitions of the men who are poised to move into the privatized banking sector. These men, including the Brener brothers, Inverlat's Legorreta, Visa's Eugenio Garza Lagüera and Pulsar's Alfonso Romo, are fascinated with the concept of linking financial groups with some of the diversified industrial conglomerates in Mexico that command a near-monopoly at home in products such as cement and glass and are also major exporters. Two of the earliest bids for banks came from brokerages with close links to industrial groups: InverMéxico, tied to Grupo Desc, and Acciones Bursátiles, tied to Femsa, part of the giant Visa group.

"Some bank owners might trend in the direction of certain industries," admits Claudio X. González, CEO of Kimberly Clark de México and foreign investment adviser to President Salinas. But, he points out, government restrictions on loans from financial companies to industrial concerns are meant to dampen moves to create financial–industrial conglomerates. And some older financial analysts caution their younger colleagues about the boom-and-bust cycle that overcame some of Mexico's supposedly invincible industrial giants. It took a $600 million government loan in

1982 to prop up a chastened and slimmed-down version of the Grupo Alfa consortium after its M&A orgy was over. Others are skeptical of the synergy approach for broader reasons. "If financial supermarkets have not worked in other countries, why would they work here?" asks a stock market analyst.

"Individuals are restricted to a maximum 5 percent stake in the capital of any one bank."

Once the banks are in private hands, they can begin to develop services for markets that are expected to grow. "The mortgage market is where the most growth will occur," especially for middle-class housing, says Banco Internacional's Corredor. Inflation and bureaucratic sluggishness have held down potentially flourishing markets in credit for cars and consumer durables. Mexico is also on the verge of creating a major pension funds market that is expected to pull savings out from under mattresses and put them into the bourse. The insurance industry is slated to manage pension funds; in fact, many of the large insurance companies are already linked to brokerages.

Other opportunities

For foreign investors shying away from the bank sale, there are other opportunities in what many predict will be a burgeoning financial services sector. Since setting up shop in Mexico in 1989, Grupo Santander has traded bonds, extended margin loans and financed more than \$100 million in bridge loans for the purchase of two former government enterprises: Hules Mexicanos, maker of carbon black, and the Real del Monte silver mine. In just three months last year, Santander negotiated the sale of \$100 million in nonvoting stock in top Mexican companies — including Telmex, Kimberly Clark and Grupo Alfa — to American and European investors. Last October it teamed up with Nomura Securities Co. and PaineWebber to launch the \$60 million Emerging Mexico Fund, which is listed on the New York Stock Exchange. Recently, the group bought the small Seguros La Iberomexicana insurance firm, anticipating expansion in the insurance and pension funds industries.

"Deregulation has led to a foreign invasion of the insurance industry," says Ed Kennedy, president of Grupo Asesores, a leading Mexican insurance brokerage. The government opened up the 42 firms in Mexico's protected market to 49 percent foreign ownership in 1989, and since then the insurance industry has been the focus of lively trading. In the last year alone, American International Group, Connecticut General Corp., Cigna Corp., Germany's Allianz Group, Spain's Mapfre, Britain's Commercial Union Assurance Co. and Italy's Assicurazioni Generali, the industry giant, have each bought stakes of more than 40 percent in Mexican insurers.

The depth and breadth of the reforms set in motion by former president Miguel de la Madrid Hurtado and expanded by Salinas are undeniably impressive. The bank sale will set Mexico on a new course: Financiers will resume their roles as bankers, and bureaucrats will return to their desks as regulators. Yet some analysts sense that it will be business as usual in the Mexican economy.

The policies favor gigantism. Many government officials believe that huge holding companies and industrial conglomerates represent Mexico's best chance of being able to compete in the international marketplace. "There will be fewer companies because the government insists on tremendous capital increases," notes Kennedy, who anticipates a wave of mergers in financial services and insurance.

The protagonists, though, will remain the same: Only the superrich can play the bank-buying game. Some 300 of Mexico's leading businessmen have control over Mexico's economic apparatus and economic policy measures. Wealth became increasingly concentrated in ever-fewer hands in the 1980s and the trend will continue. Just six firms controlled 51 percent of all brokerage operations in 1990. Two of the eighteen banks hold half of all bank assets, and the top six banks control fully 85 percent of all assets.

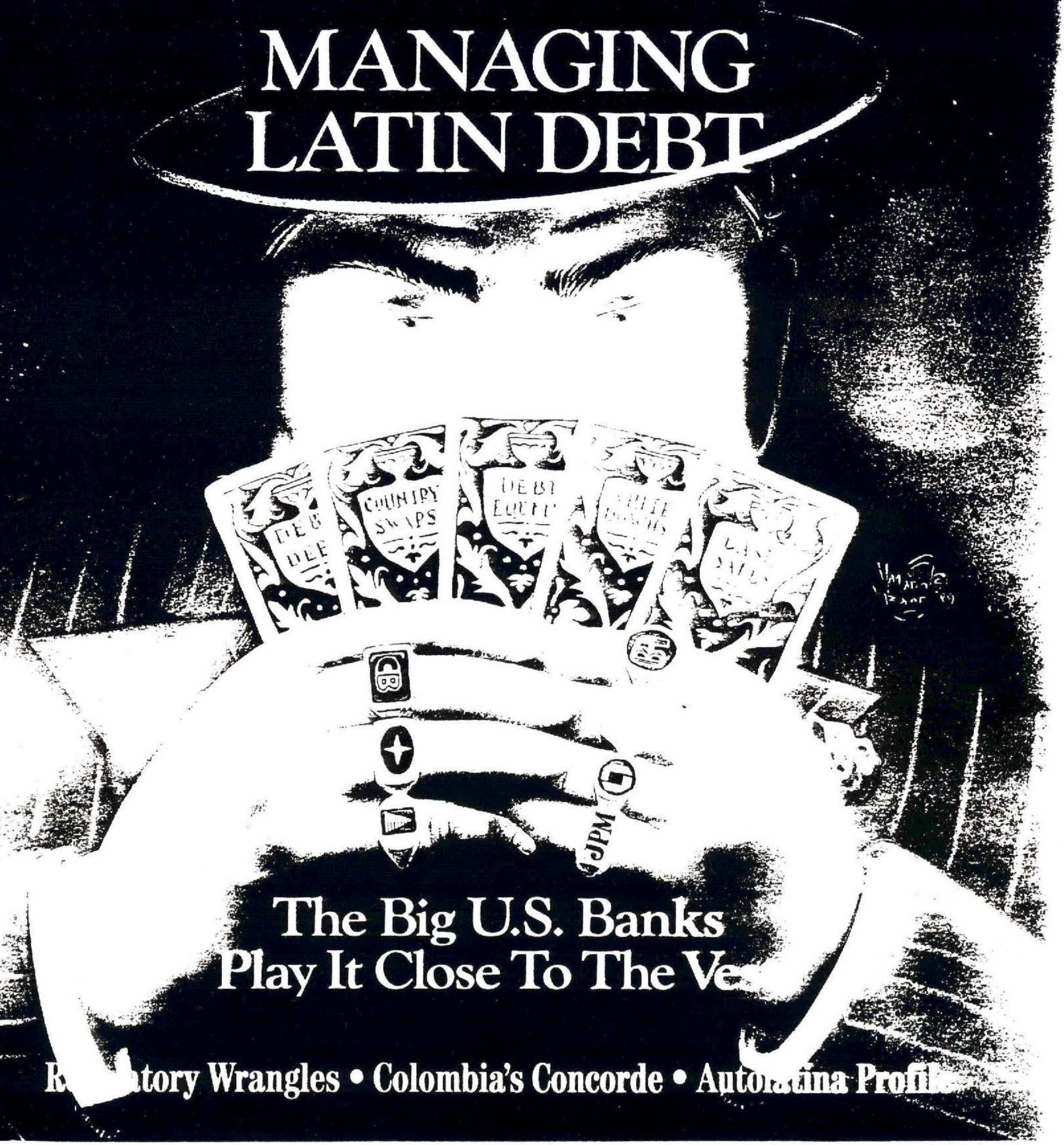
The symbiotic relationship between the ruling Institutional Revolutionary Party and the business class weathered the dark days of bank nationalization. Now financial deregulation presents an opportunity for renewing the close ties between politicians and businessmen. "It's a concessional system. The majority of [businessmen] are pro-government, and they get concessions in exchange for not criticizing the political system," says Gerardo Valdéz, an economic consultant. "The government will continue to give opportunities to those it trusts fully." ♜

MAY 1989 NUMBER SEVEN

LATINFINANCE

A EUROMONEY PUBLICATION

MANAGING LATIN DEBT



The Big U.S. Banks Play It Close To The Ve

R atory Wrangles • Colombia's Concorde • Auto tina Profil

LATINFINANCE™

A EUROMONEY PUBLICATION

CONTENTS

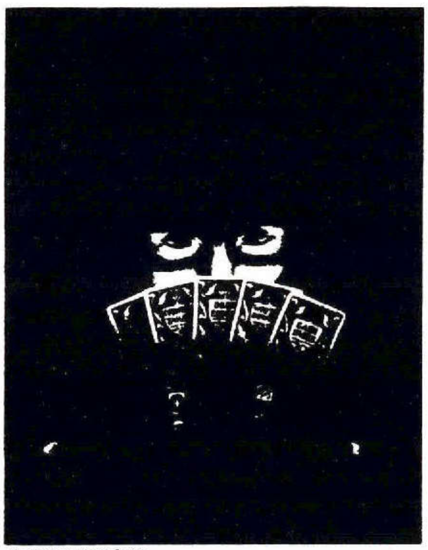
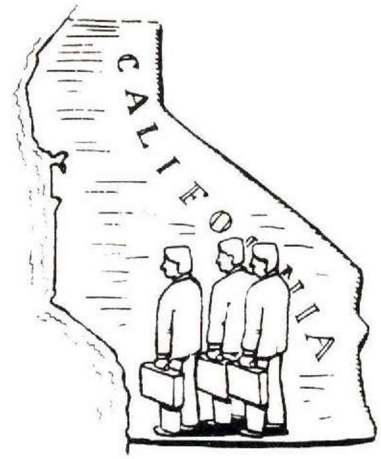


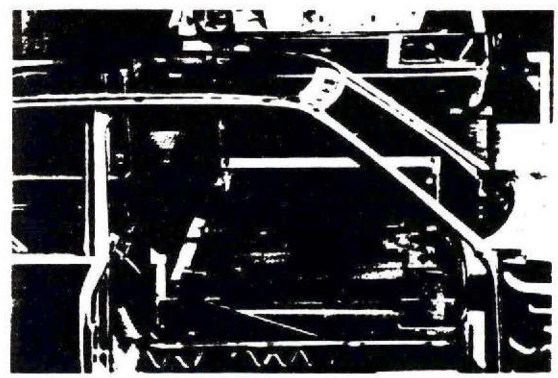
Illustration: Mario Baert

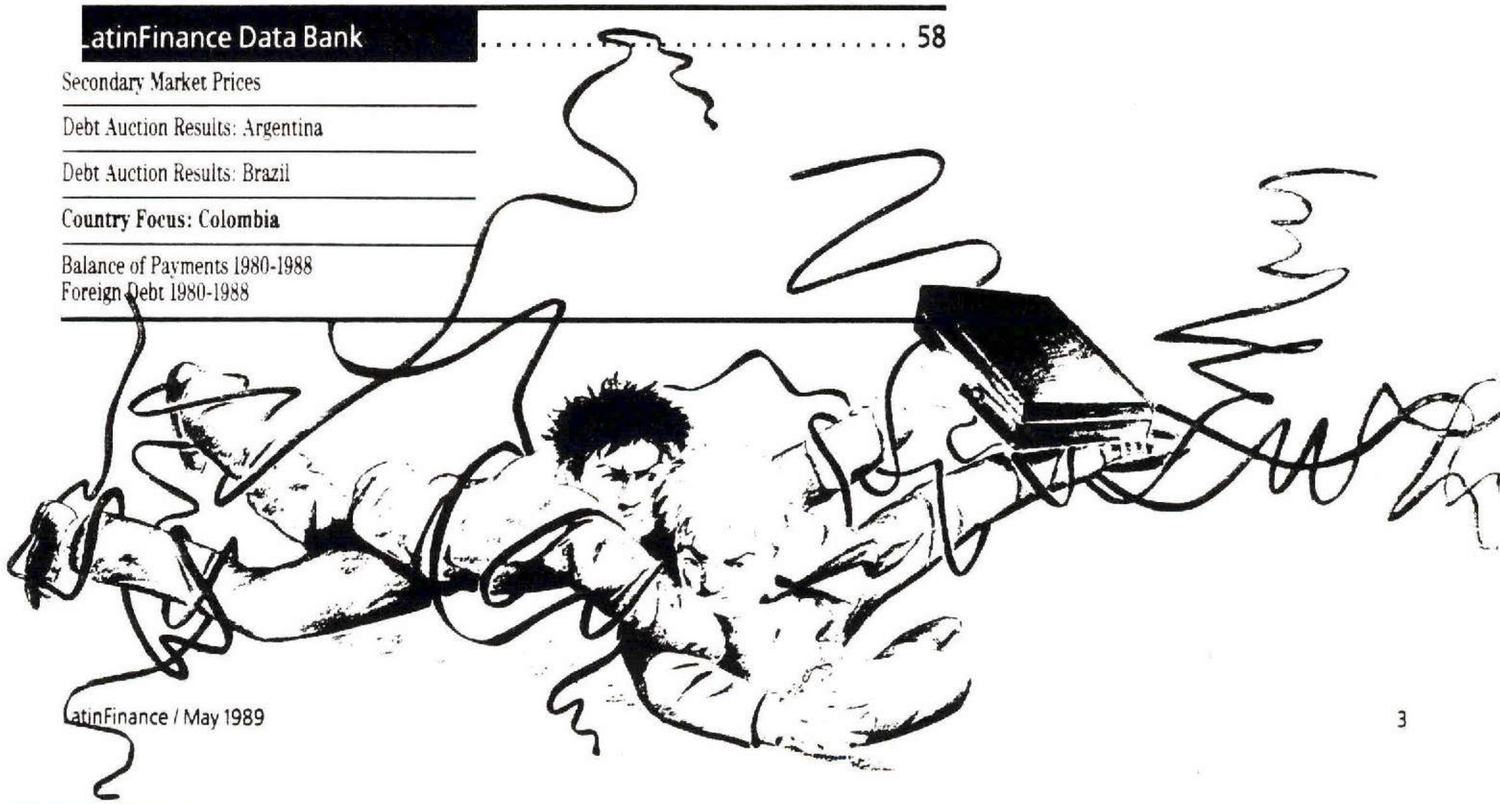
Debt Reduction: 1988

	$ billion	% of bank debt outstanding
Argentina	1.1	3.0
Brazil	6.9	8.5
Chile	2.9	21.2
Mexico	5.9	7.9
Venezuela	0.3	1.0

Source: Libra Bank


CALIFORNIA





Colombia prepares its first big privatizations

Chasing Paper in Paris

By Andrew C. Quale, Jr.

Andrew C. Quale, Jr., a partner at Sidley & Austin in New York, advised Colombia's Instituto de Fomento Industrial during recent financial preparations for the country's first major privatization deals. At LatinFinance's request he wrote the following insider's account of the negotiations.

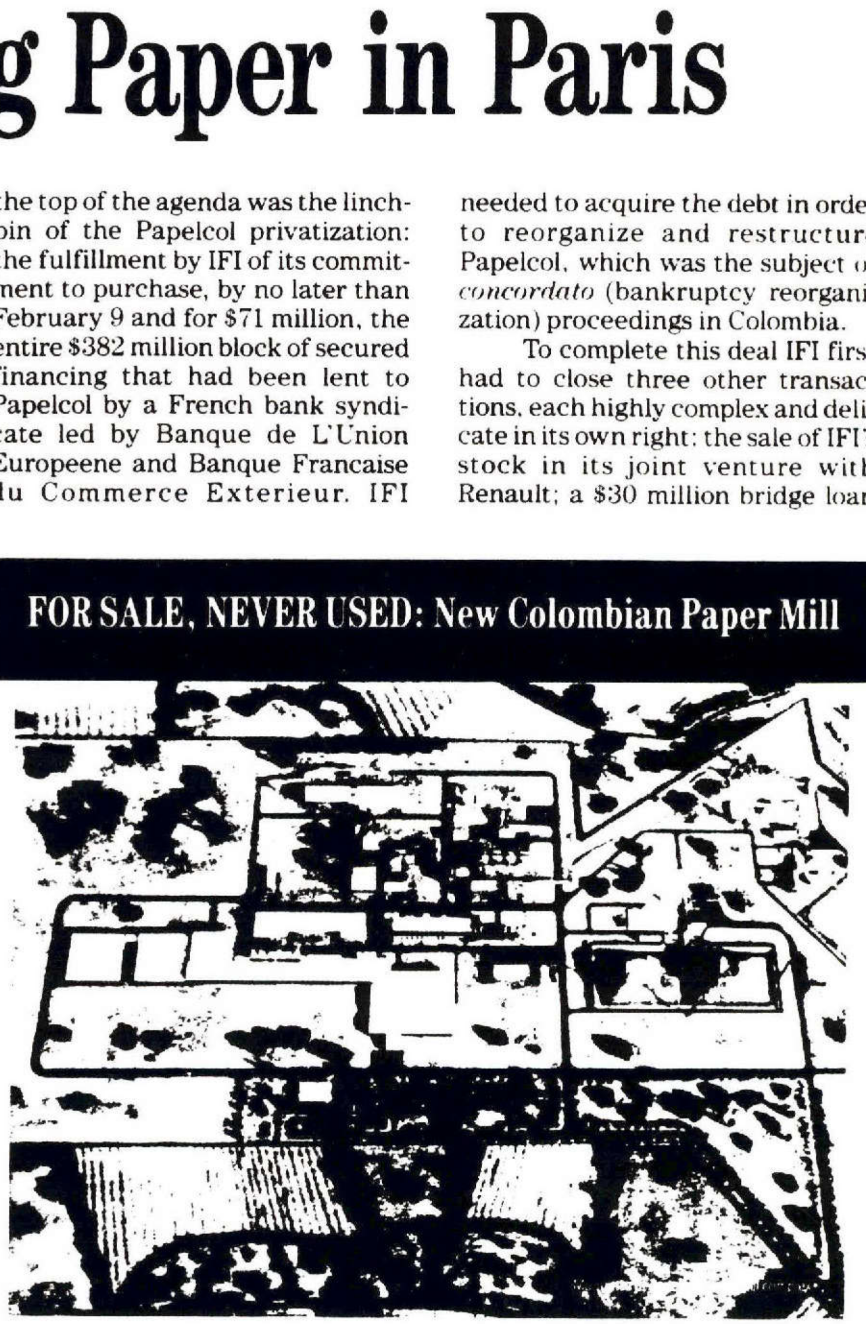
A week of intense negotiations centered in Paris, but radiating out to New York, Bogota, Panama City and Caracas, has set the stage for the first major privatizations ever undertaken by Colombia. The outcome of the talks in February underscored foreign confidence in the Colombian economy: for Renault, which bought out a Colombian state development agency's half-interest in a joint venture auto plant, the transaction was its largest overseas investment of the 1980s.

The negotiations, held in early February, also prepared the way for a second, larger privatization deal: the sale of one of Colombia's biggest industrial complexes, Papelera Colombiana S.A. (Papelcol), a high-tech, bagasse-based paper and pulp mill in the Cauca Valley. The Colombian development agency, the Instituto de Fomento Industrial (IFI), which owns Papelco, is now prepared to offer the company to the highest bidder.

The meetings were orchestrated by Colombia's Minister of Economic Development, Carlos Arturo Marulanda, and IFI's General Manager, Eduardo Robayo. At the top of the agenda was the linchpin of the Papelcol privatization: the fulfillment by IFI of its commitment to purchase, by no later than February 9 and for $71 million, the entire $382 million block of secured financing that had been lent to Papelcol by a French bank syndicate led by Banque de L'Union Europeene and Banque Francaise du Commerce Exterieur. IFI needed to acquire the debt in order to reorganize and restructure Papelcol, which was the subject of *concordato* (bankruptcy reorganization) proceedings in Colombia.

To complete this deal IFI first had to close three other transactions, each highly complex and delicate in its own right: the sale of IFI's stock in its joint venture with Renault; a $30 million bridge loan

FOR SALE, NEVER USED: New Colombian Paper Mill



IFI's financial advisor, Morgan Guaranty, has sent out a descriptive memorandum on Papelcol to prospective purchasers, and expects keen interest both from foreign multinationals and Colombian companies. Papelcol's assets include:

- A nearly completed integrated pulp and paper mill that could be placed in production within a few months
- A strong and growing domestic market in which current demand for paper products substantially exceeds supply, plus opportunities for export to the rest of Latin America and beyond
- A good location with respect to its customers and suppliers, particularly suppliers of bagasse, which is derived from sugar cane and is the primary fiber source for the plant's paper production.

from Morgan Guaranty; and \$29 million in loans from Colombia's Banco Cafetero and the Corporacion Andina de Fomento based in Caracas.

The most sensitive of these was the sale to Renault of IFI's 49.7% interest in SOFASA, a car production joint venture with Renault. The purchase price of approximately \$52.8 million was to be paid \$15 million in cash, \$15 million in short-term notes, and the remainder over several years. Because it was impossible to close this transaction by February 9, Morgan Guaranty, which also has been serving as IFI's financial advisor on the sale of Papelcol, agreed to provide a \$29 million bridge loan on the condition that the Renault/IFI sale contract had been signed and Morgan had a security interest in the anticipated sales proceeds.

IFI's Auction Block

Colombia's privatization efforts are just beginning, and the Instituto de Fomento Industrial — the government's wholly owned industrial development agency — is at the vanguard. The IFI holds shares in dozens of Colombian companies, some acquired in efforts to avert bankruptcies and others through initiatives catalyzing profitable new private investments. In contrast to many other large Latin American countries, Colombia does not tend to take a highly nationalistic, politically charged view of state enterprise. Government investment has been relatively modest in scope, determined by pragmatic financial considerations, and privatization is unlikely to provoke a populist backlash.

Among IFI's immediate plans are the sale of its stake in the Cerromatoso nickel project, a joint venture with Billiton Overseas, a Shell affiliate. Although Cerromatoso has had its problems in the past, its 1988 profits were the highest of any company in Colombia, thanks to a resurgence in nickel prices.

IFI is also preparing to divest more than 20 other investments, including Conastil, a shipyard in Cartagena, Copescol, a fish processing operation in Buenaventura; and Alcalis de Colombia, a producer of sulfuric acid and other industrial chemicals derived from salt. Other Colombian government holdings outside the purview of IFI may also be candidates for privatization, including several financial institutions that were saved from collapse by state intervention. Among these are the Banco de Comercio, Banco del Estado, Banco de Colombia, Banco de los Trabajadores, and Banco Tequendama. In a related initiative, the government is seeking to facilitate foreign ownership of financial institutions, and has supported legislation before the Colombian Congress which would liberalize the current maximum 49% limit on foreign ownership.

—AQ

During the early morning of February 8 and into the dawn of February 9 the hopes of signing the Renault contract and closing the Morgan loan seemed slim at best. The day before the scheduled signing, Renault requested new assurances concerning the treatment of its purchase price as registered foreign investment. These assurances could only be provided by a resolution of the Colombian Monetary Board, which met only once a week. Fortunately, the next scheduled meeting was the following day. After a flurry of urgent phone calls to Bogota, Minister Marulanda and General Manager Robayo obtained the necessary ruling from the Board.

That evening Marulanda and Robayo flew to Geneva (which Renault requested as the signing situs) to negotiate the final details and execute the contract. In the early hours of February 9, the contract was signed.

The ability of Colombia's team to respond to Renault's seemingly impossible requirements prompted one Renault executive to say: "The Colombian negotiators seem to have ice in their veins, but they have open and agile minds."

Only after the Renault contract was executed and faxed to Paris, and only after the last-minute resolution of critical legal and financial issues, was Morgan Guaranty willing to execute the bridge-loan agreement allowing the funds to repurchase the Papelcol loans from the French banks to begin flowing into Paris. Morgan gave its approval on the morning of February 9.

The remainder of the funds needed to make up the \$71 million was provided by Banco Cafetero de Panama and Corporación Andina de Fomento, in transactions negotiated simultaneously in Bogota, Panama City and Caracas, and by IFI, using \$14 million of its own internal resources. Once these funds were wired into Paris on the 9th, the only remaining hurdle was the delivery of the funds-transfer confirmation slips from Morgan's Paris office to the Bank of Paris.

Carlos Arturo Marulanda

The messenger somehow got delayed on the way to the Bank of Paris; when she finally arrived, she apparently lacked sufficient identification to gain entry. So although the funds had been wired to the French banks, there was no confirmation of payment. When confirmation was finally secured, the French banks assigned their Papelcol loans to IFI.

IFI in this way acquired approximately 93% of Papelcol's loans and became, as its dominant creditor, equipped to reorganize Papelcol. Perhaps equally important, Marulanda and Robayo had managed to ensure that Colombia fulfill its commitment to the French banks on time. This was critical if Colombia was to maintain its credibility with the international banking community while seeking substantial new financing.

Although the sale of IFI's interest in SOFASA to Renault was ancillary to the Papelcol effort, this transaction was highly significant itself as Colombia's first major privatization. And as noted by officials at Renault, it was the largest foreign investment of the decade for the French carmaker.

Having completed the purchase from the French banks of Papelcol's outstanding secured debt, IFI acquired all the remaining indebtedness of Papelcol. As a result, IFI is now in the position to sell Papelcol's assets, free and clear of liens and of the financial problems that plagued it in the past. If the Papelcol divestiture is concluded as professionally as its initial financial engineering was started, it should bode well for the rest of Colombia's privatization program.

Stuart FYI

FINANCIAL TIMES Wednesday April 10 1991

ıve
ıes

ning, jumping a
$10½ in brisk
past two days
more than dou-
vs that the com-
tent for an eco-
d for producing
ow-calorie sugar

$¾ to $5¼ as
st over the take-
y manufacturer
Hasbro, which
that Tonka was
g". Hasbro's
American Stock
ed $⅝ to $23¾.

sed on a mildly
ter a fair turn-
osite index shed
and declining
s by 294 to 260
of 26.7m shares,
nday's 16.9m.
ks led the fall
loss of 1.2 per
he 14 sub-groups
inancial services
re little changed,
se 1.45 per cent
a $3 gain in the
lion price.
up, off C$⅛ at
greed to sell 2m
res at C$26.875
lerwriting group.

Mexico climbs as economic hopes grow

Foreign demand and privatisations have also boosted shares, writes **Damian Fraser**

MEXICO'S turbulent stock market, which has risen in dollar terms by 98 per cent, 68 per cent and 37 per cent over the past three calendar years, is advancing once again. Its total return in sterling in the first three months of this year, based on the FT-Actuaries World Index, was almost 50 per cent.

Encouraged by a wave of foreign investment, the imminent privatisation of the banks and the selling of remaining government shares in Telmex, the telephone monopoly, the stock market index gained 22 per cent in dollar terms in March, to give a rise in the first quarter of 26 per cent. In April the index has gained a further 7 per cent; in late morning yesterday, it stood at 857,144.

Unlike the mid-1980s, when the market rallied while Mexico's economy lay in tatters, the latest rise reflects optimism about Mexico's economic prospects, both within and outside the country.

Economic growth in 1990 was 3.9 per cent, the fastest since 1981, and way above both government and private sector forecasts. Company results for 1990 have generally been much better than forecast. Telmex, which accounts for around one fifth of the market capitalisation of the Mexican *bolsa*, saw its profits double in inflation-adjusted terms last year.

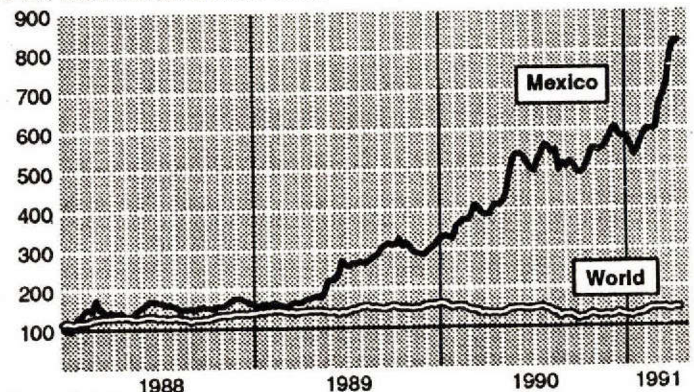
At the end of April or the beginning of May, the government will put its remaining stake of 26 per cent in Telmex up for sale in an international offering. At current prices, this would be worth $2.9bn.

The underlying reason why Mexico's stock market has proved so attractive to foreign investors is that, while the profits from big businesses have generally grown as fast or faster than the country's inflation rate (at 30 per cent last year), the peso-dollar targeted rate of devaluation has been cut to about 5 per cent a year, from roughly 14 per cent at the beginning of 1990.

As long as the exchange rate holds, foreigners are buying companies the value of which, in dollar terms, is likely to appreciate by at least 20-25 per cent a year.

The big danger is that the government will not be able to hold to its strong exchange rate policy for much longer; the merest whisker of a devaluation would send the market reeling. However, most stock market analysts reckon that the government can keep its exchange rate for the next couple of years. Thanks to big increases in foreign capital flows, the central bank now has $13bn in foreign reserves

FT-A World Indices in dollar terms



Source: Datastream

with which to defend the currency. Short-term interest rates, usually a leading indicator of imminent devaluation, are now at 22 per cent, the lowest level in a decade.

Foreigners, historically, have bought into major Mexican companies such as Telmex, Tamsa and Cifra through ADRs (American Depositary Receipts), which are listed in New York; at the end of February this form of investment accounted for $2.1bn, 86 per cent of which was in Telmex. A further $500m was probably invested in the four Mexico country funds, and $1.2bn in non-voting "B" shares listed in the Mexican bolsa.

Foreigners are not allowed to buy shares with voting rights, but since October 1989 they have been able to invest in Mexican companies which do not have non-voting shares through a trust run by National Financiera, the government development bank, which holds on to the voting rights. The trust has increased from $35m at the beginning of 1990 to $877m at the last count.

In all, foreign investment may be almost $4.7bn, against a stock market capitalisation of $39bn excluding government holdings. However, since a large proportion is owned by families who rarely trade their shares, only an estimated 20 per cent or $7.8bn of the market is actually traded; in effect, foreigners control about 60 per cent of the market's free float.

According to Baring Securities, which has recently opened a research office in Mexico City, foreign interest has centred on companies which sell in the domestic market, with a narrow product focus, low debt/equity ratios and shares that are relatively liquid. Of these the most actively sought after, and best performing, have been Telmex, up 54 per cent in the first quarter of this year, and Cemex, the cement company, up 74 per cent.

Foreigners, and domestic investors to a lesser extent, have tended to shy away from exporting companies for fears that the US recession would hurt their earnings. But now that the US recession looks to be almost over, at least by some accounts, investor attention may soon shift to the exporters.

The biggest short-term risk is that the US Congress will deny the US administration approval on what is called the fast track to negotiate the proposed free trade agreement between the two countries.

In the opinion of one foreign banker, the result of that would be disastrous for Mexico. And given the *bolsa's* lack of liquidity, if the market starts to crack, foreigners could be the last ones out.

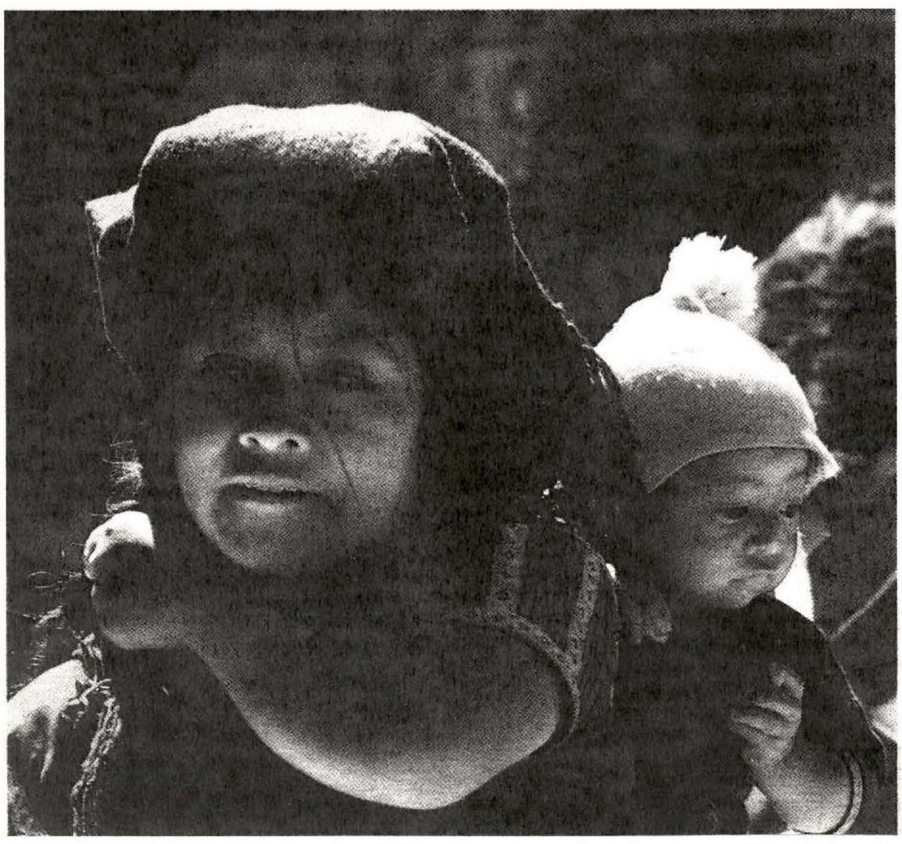
ASIA PACIFIC

red

Nikkei closes at day's low on reduced volume

Mexico's uneasy alliance of socialism and privatisation

Around 20 foreign banks want to buy into Mexico's antiquated and publicly owned banking system. But their enthusiasm could be dampened by the ruling PRI party's reaffirmation of its socialist principles; and the limits the government has placed on foreign ownership.



FRANCESCA CARNEVALE

No sooner has President Carlos Salinas established suitable political and economic preconditions for a series of reprivatisations of the banking system and selected publicly owned utilities, than dissenting socialist factions in the ruling Partido Revolucionario Institucional (PRI) party threaten to undermine his proposals. And as if that wasn't enough, portents of imminent financial crisis in potential investor countries also promises to undermine his investment drawing strategy.

Twenty or so foreign banks, from Canada, Japan, the US, Spain and France, have expressed an interest in buying their way into a Mexican operation, apparently induced by the improvement in the country's main economic indicators; by imminent free trade agreements with the US and Canada; and by a partial reduction in the banks' foreign debt obligations through an upcoming debt for equity swap auction, planned for October (see box).

But fundamental problems in Mexico's political fabric could dampen some of the anticipated enthusiasm of potential investors.

For instance, the self-styled "reforming" 14th assembly of the PRI in mid-September reaffirmed, rather than modified, the party's socialist stance. Foreign bankers reckon the "reforms" are a potential brake on Salinas's attempts to modernise the country, eventually hampering the bank privatisation programme.

Ironically, perhaps, Salinas is in full agreement with the thrust of the reforms, if not with some of their finer points. How the ruling party can reconcile its commitment to the privatisation programme, while actively pursuing a socialist economic strategy is anyone's guess; "and is certain to cause friction in the long run, when some important state enterprises are sold," says a New York banker.

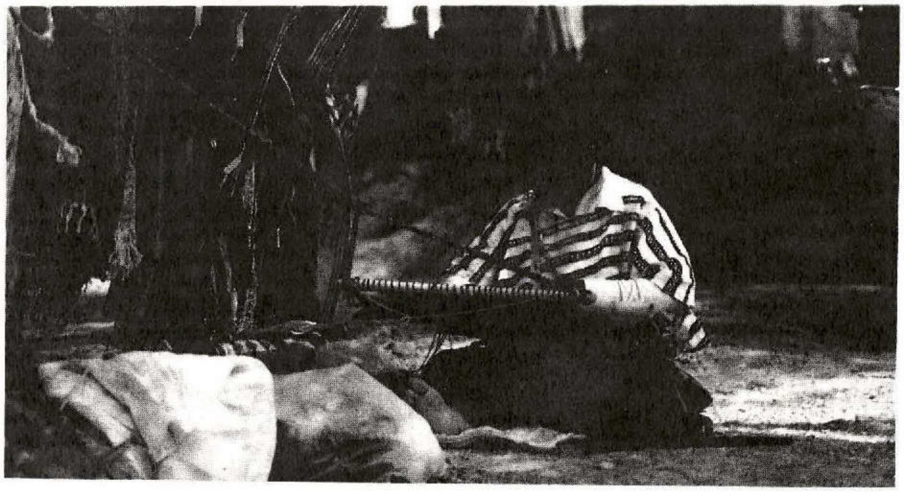
"The possibility of re-nationalisation of strategic sectors would not be a welcome move three years down the line – and any hint of backsliding will encourage potential investors to cut and run. We are looking for a solid commitment to less socialist policies. It indicates that all is not going his way in the government; although I guess it is not easy for him. Salinas is playing soft ball on a hard ball pitch," he adds.

Re-nationalisation at some future unspecified date is a distant spectre. Mexico's political structure, with the president retaining almost dictatorial control, should maintain the privatisation programme's pace "for at least as long as Salinas survives," says a banker in Rome.

"But you should not underestimate the growing demands for a more democratic political structure in the country, which could eventually undermine Salinas's plans. At the moment, it is hard to exactly determine how much support his privatisation schemes attract in the grassroots of the PRI."

Salinas justifies his stance with the straightforward statement that income from the privatisation of banks and utilities will be spent on social programmes. This, he adds, is as far as socialism extends into bank privatisation – a sop, undoubtedly, to all factions.

Bankers counter, however, that Salinas has also repeatedly stated that liberalisation in the ownership of banks does not necessarily imply liberalisation in financial regulation. "Salinas's original proposal clearly says that the government intends to retain a participation in commercial banking activities, with a specific interest in strengthening institutions directed towards specific activities. Until the phrase "specific activities" is clearly defined, you could find some investor resistance," continues the US banker.



The government has so far indicated, in its working programme on bank privatisation, that the designated development banks such as Nafinsa, Banobras and Banrural will continue under majority state ownership. But problems could arise from growing dissent in the PRI, which declares that the sale of banks is unnecessary given their profitability, and that privatisation will not necessarily result in a "democratisation of capital".

But foreign bankers do not look at the democratic or social consequences of privatisation; preferring to refer instead to the limit placed on foreign ownership in the impending privatised banks. "What Salinas does with his money once he's sold off the banks is his business," says the New York banker. "What he allows us to do with our money is the crux."

Foreign banks will be allowed to hold up to 30 per cent equity in a bank, but the special shares issued to foreign investors will have no voting rights. Individual and

debt swap auction

Having identified around 150 eligible infrastructure projects suitable for debt equity conversions, the government is now considering another auction some time in October. The auctions should help reduce the liabilities of the country's top six commercial banks, as well as decreasing the now residual private sector debts. The forthcoming sale of state-owned steel plants, Altos Hornos and Sicartsa (part of the Sidermex group), are also likely to attract bids.

Bids will be accepted in Mexico until October 8, and four days earlier in New York. The minimum discount is apparently set at 35 per cent (too low for some analysts), and the minimum bid is $1m.

The auction will sell off some $1.5bn worth of debt, in return for pesos, at a discount of somewhere in the region of 51 or 52 cent. Successful bidders will have to put up a deposit of at least 5 per cent of the rights they have won.

The government is said to have around $3.5bn worth of swaps in mind over the next three years (see *Asset Trading*, p.14). Some sources suggest that the October auction could be bigger than originally planned.

This is now unlikely, given the shaky local stock exchange, and could undermine investor confidence in the swap programme, at least in the short term.

"It is unlucky timing for the Mexicans," says one banker in London. "All the objective economic indicators say that now is a good time to invest in the country, with debt for equity swaps a handy option. But the financial crisis in many markets will undoubtedly dampen demand, at a time when the Mexicans expected a surge of investor interest."

A successful auction in July reduced some $1bn worth of public sector debt, when 27 bids (out of more than 300) were accepted at a discount of 50.2 per cent. The swaps covered over 20 projects, ranging from tourism to agriculture.

The discount was set at a little below the secondary market discount of Mexico's par bonds, which after the auction settled at 43 cents. Funds were used to help purchase companies being privatised, or were acceptable investments in government approved infrastructure projects.

Until the July auction, Mexican debt had been trading at around 48 per cent of part, but analysts do not think that the forthcoming auction will push up discount rates significantly. Particularly as the Mexican stock exchange has performed as badly during the last two months of the Gulf crisis and accelerating oil prices.

The Gulf crisis and the threat of incipient global recession has cut a swathe through the Mexican bourse (the Bolsa), with potentially disastrous effects on the government's planned privatisation programme which includes banks and public owned companies, such as the telephone company Telmex, (which is expected to be sold off for between $7bn and $8bn), and the state steel consortium, Sidermex.

The combined value of these public owned assets has plummeted by over $2.8bn, which could prompt the government to delay privatisation until next year – which in turn could dampen any enthusiasm for the upcoming debt for equity swap auction bidding.

The government acknowledges that it fears the significant flight of investment capital, particularly from foreign investors which may be anxious to turn holdings into cash in OECD money markets for a better return in the medium term (up to and beyond six months).

The downturn in the Bolsa has stunned local analysts who were buoyed by a 115 per cent growth in share purchases during the first eight months of the year.

It is ironic that the Bolsa is weak while the value of oil remains high. A big increase in the price of Mexico's oil through until year end could wipe out the country's trade deficit by the end of January. Good news for bankers who are interested in export finance; but for the time being, investors in Mexico will be looking for a greater interest in the second debt for equity swap auction than was reached in July.

Analysts reckon that the July auction produced bids worth between $17bn and $27bn – accounts vary between press and government reports. The October auction will have to produce bids over the $20bn mark for confidence to return; for the privatisation programme to remain on schedule; and perhaps, as a knock-on effect, for the Bolsa to revive.

corporate investors will be limited to a 5 per cent holding under the same conditions. Still, foreign banks should be content with even this modicum of freedom in a country which has prevented them from establishing commercial operations. No one can doubt the government's commitment to privatisation, at least for the present.

In early September, the finance ministry announced that it has established a special body, *the comite de desincorporacion bancaria*, to work out the rules and oversee the sale of state-owned banks to the private sector. The ministry added that the banks will not be sold off at the same time, but will be placed gradually on the market.

The banks had a combined market value of around $8bn in late July, but their stock has now been reduced by around 20 per cent. Even so, the government is unlikely to accept offers at the present market value, and will be looking for prices based on potential rather than current assets.

Mexican financial group investors will be allowed to own up to 51 per cent of any bank; but shares will have to be distributed

1991 is an election year and Salinas requires an economic surge

in such a way that no individual owns more than 10 per cent. This ruling is aimed at avoiding situations where a privatised bank exclusively finances its shareholders.

City analysts say that the most probable bidders for bank equity among Mexican corporates include Alfa, Cifra and Desc, the tourism and industrial conglomerate. An important question in the search for local shareholders is where the money will come from to buy bank shares. These three companies are among the few with significant reserves of cash.

The government no doubt hopes that the promise of privatisation will lure back capital from foreign-held accounts. This is unlikely on two counts. First of all, the weak performance of the Bolsa during the final months of 1990 could discourage local investors from buying up shares in secondary offerings in the stock exchange; and second, that not all Mexican banks are an attractive investment.

The speed and effectiveness of the bank privatisation programme is crucial for Salinas. 1991 is election year in Mexico, and the president requires some cash in hand to provide an economic surge in the run-up to the ballot box. Realistically, however, Salinas cannot expect much movement in today's financial climate. The struggle for democracy, socialism and privatisation looks likely to continue in Mexico for the next 18 months, at least.

Pemex leads Mexico back to capital

Mexican corporates are trumpeting their return to the international capital markets after an eight-year absence, led by the most active issuer, Petroleos Mexicanos (Pemex), the state-owned oil company. This year it has raised money on the German, Austrian and US capital markets: its latest offering being a $150m, three-year bullet Eurobond priced to yield 11.42 on a semiannual basis. The issue will bring the total raised in 1990 by Pemex to roughly $358m, reports Paul Hannon.

Despite all this activity, the 1990 borrowing programme is insignificant compared to Pemex's planned $15bn funding requirement over the next five years – half of which will be raised offshore. Tentative efforts this year suggest that Pemex needs to re-establish itself as a name that investors will recognise, and overcome residual fears about lending to or investing in Mexico, which is still recovering from the post-1982 debt crisis.

In terms of its overall borrowing needs, its 1990 issues are minor, but as an indication of what is to come they are of crucial importance. This explains why, for such a small total amount, the company has tapped four different markets.

Pemex is anxious to establish its credentials as a world ranking corporate borrower in an effort to convince investors that what they are dealing with is not Mexican risk, but Pemex risk. So far it has enjoyed some success, and creditors are sympathetic. But the real test will come in 1991, when Pemex begins to look for the large amounts of money it needs. Any change in Mexico's economic environment that could be interpreted as a return to the bad old days could still hurt companies such as Pemex and Telemex when they come to the markets again.

Pemex is a fully integrated oil company, including in its activities the extraction, refining and sale of oil and its derivative products, including basic petrochemicals. Rankings are important to Pemex; with spokesmen repeatedly declaring that in asset terms, it is the 10th largest industrial firm in the world; and the fourth largest oil company, boasting total assets (excluding oil reserves) of almost $45bn. Sales volumes rank it among the top 40 non-US firms in the world; and compared with US firms it is in the top 25.

In 1989, Pemex enjoyed a net export income worth $7bn, most of which came from sales to the US, Spain, Japan and France. Its pre-tax profit almost topped $8bn, although most of this was transferred to the government through taxes. Pemex is Mexico's cornucopia; accounting for roughly a third of the country's export revenues, 20 per cent of its foreign exchange income and 30 per cent of the government's total tax receipts. So important is the company to the Mexican economy, the argument goes, that the government would never dare to do anything to hinder its further growth.

This is the company that Pemex would like investors to recognise, not the old image of a state-owned oil company keeping a debt-ridden economy afloat.

The company now carries $15bn in external debt, down from a peak of $20bn in 1983. Much of this debt is now owed directly to the Mexican government as a result of its agreement with the country's commercial bank creditors. It has never defaulted on a fixed rate debt obligation. Excluding this, Pemex's domestic debt stands at the equivalent of $600m, most of which it expects to pay off by the end of the year. It has committed itself to borrowing only for new investment, and will establish a separate account for each new project in order to monitor the application of funds.

Although most of its new investments will be funded through bond issues, other means of financing projects will be used where appropriate. The planned expansion of its petrochemical processing capacity, for example, will be structured around a buildlease-transfer mechanism. The contractor will be expected to arrange finance for the project, take the construction risk, and then lease the facility to Pemex. Morgan Grenfell is among the banks looking for mandates for upcoming projects.

The lead for Pemex's most recent issue is Swiss Bank Corporation (SBC), which also led a DM100m ($63m) issue for Bancomext in June of this year. The oil company's private placement of $100m in the US in August was lead managed by Paine Weber and priced at 11.43 per cent. The company also became the first Mexican issuer of Austrian schilling-denominated debt to raise Asch500m ($45m). The issue was lead managed by Creditanstalt Bankverein. WestLB lead managed a further DM100m ($63m) issue for Pemex in March.

In addition to Pemex and Bancomext, other Mexican borrowers tapping the bond markets again include Telemex, Comision Federal de Electricidad, Nafinsa and Cemex. Again the main aim has been to establish the borrowers as recognised names in the international markets, and determine some rough guidelines for pricing and maturity on future, larger issues. If all goes well, 1991 should be an active year for Mexican issuance.

Borrowers all

TOKYO

JAPANESE consumers are supposed to be a penny-pinching lot, addicted to saving for a pensionless old age. So a new report from the official Economic Planning Agency has raised eyebrows. It shows that Japan's consumers now owe more than Americans. In 1989 consumer debt (excluding mortgages) grew by 23% to ¥53 trillion ($370 billion): 20% of annual disposable income, against 19% in America. Per head, the figure was $2,985, against $2,915 in America.

True, the exclusion of mortgages distorts the comparison. Japan's mortgage debt, some ¥83 trillion at the end of 1989, was equivalent to 21% of GDP; in America—where mortgage interest is now the only tax-deductible sort for consumers—the figure is twice as high. Still, the Japanese, only recently taught to spend, have clearly also learned to borrow; thanks perhaps to the 1980s boom in the value of their household assets, be it shares, property or golf-club memberships. All of which—just a thought—can go down as well as up.

cially about overseas markets, to manage its huge cash hoard. Known within Japan as "Toyota Bank", Toyota Motor, the Japanese parent company, had ¥2.2 trillion ($16 billion) of cash at the end of December and no bank debt. Add in other group companies and the amount of cash that Toyota needs to manage exceeds ¥3 trillion.

For a start, two trainees will be seconded from Toyota to Merrill. Amazingly, Toyota has only ten people responsible for investment at its Nagoya headquarters. The company gets away with such a skeleton investment team because it has always been ultra-conservative. Equity investment has been kept to a bare minimum, and currency risk avoided. About 70% of the parent company's funds are currently held in bank deposits and short-term paper, with nearly all the rest in government bonds and Euroyen bonds. Toyota was never drawn into the *zaitech* (financial engineering) game popular in recent years, when all sorts of Japanese companies borrowed money to bet in the stockmarket. And when it has bought foreign bonds, say to lock in a higher yield than it could get in yen, the company has always hedged its currency exposure.

Apart from gaining skills and information, Toyota seems to have two business goals in mind. First, it would like to manage its own pension fund. This was worth ¥248 billion ($1.8 billion) at the end of March 1990, and is growing at more than 10% a year. Such expertise could later be developed into a specialised investment-management business managing other companies' pension funds, much as General Electric Credit Corporation does in America.

Second, Toyota wants to build a more general financial-services business, rather like General Motors Acceptance Corporation. That is why in 1989 it set up a separate subsidiary, Toyota Finance. Its main role at present is to finance car purchases, which used to be done in-house by the finance department. It is Toyota Finance that has bought the Merrill stake.

How far the relationship develops will depend on what Toyota gets out of it. As a start, Merrill's Tokyo subsidiary, which manages only about $1 billion, says Toyota has given it a small sum to manage in a balanced portfolio of shares and bonds. From this small acorn much may grow.

Mexican bank privatisation

Ready to go

MEXICO

FOR the best part of a year, Mexico's financial community, frenetic and rumour-driven at the best of times, has been gripped by bank fever. In May 1990 President Carlos Salinas decided to privatise the country's 18 state-owned banks; now all Mexico, it seems, wants to know when they will be sold, to whom and for how much.

The banks were nationalised at the start of the 1980s. Partial privatisations began in 1987, with sales of some minority, non-voting stakes. Now the state is to sell 51% of each bank's equity with full voting rights. The government plans to complete the sale before the end of this year and on February 19th named the first three banks to be sold, Banpais, Multibanco Mercantil and Cremi.

Despite Mexico's tradition of corruption, the government seems to have confounded its critics by devising a system of selling the banks that will largely prevent string-pulling, favour-swapping and pre-arranged deals. Every bidder must first qualify as eligible on admittedly subjective criteria, such as moral character, financial soundness and experience with finance. That done, banks will go to the highest bidder, though if the top two bids differ only a little, room may be left—it is not yet decided—for other considerations such as dividend policy or regional balance to be taken into account.

The finance ministry has gone to great pains to avoid accusations of selling the banks too cheap. McKinsey and Booz Allen & Hamilton have just finished valuing nine banks apiece. Each bank also has to value itself. Most have hired foreign investment bankers such as S.G.Warburg and Salomon Brothers. All these valuations are then mulled over by the national banking commission, aided by yet more foreigners.

Most would-be buyers have already registered their interest. They fall into three groups—the Mexico City brokerages, the Monterrey financial and/or industrial conglomerates, and the banks' former institutional shareholders. Foreign banks, barred from owning more than 30% of a Mexican bank, do not look interested, with the notable exceptions of Société Générale and BNP of France, and Banco Santander of Spain.

The biggest prize will be Banco Nacional de Mexico. Though small by world standards—with $18½ billion of assets last summer it was less than one-tenth the size of Citicorp, Barclays or Deutsche—Banamex is Mexico's classiest bank. In its case, about 20% of the equity will be offered to members of its regional boards. The battle for the further 31% will probably be between Roberto Hernandez, head of Accival, Mexico's most successful brokerage, and Fernando Senderos, boss of Desc, a foods-to-chemicals conglomerate. If Mr Hernandez wins, his new group will dominate the Mexican capital and money markets.

Except for Bancomer, each of the 18 banks has already attracted at least two potential bidders. Who gets what will largely determine whether Mexico moves toward universal banking, with banks and brokerages under one roof, or maintains the traditional rivalry between the two.

The banks may not be great bargains. Most analysts think margins will be squeezed as competition grows Mr Hernandez agrees. He says the spread be-

Now, chiquita, you can buy a bank

tween lending and borrowing rates, about 5% in the past five years, will rapidly fall to 1½%. Besides, much of the banks' profits—a combined $1.2 billion in 1990—came from financing the government's deficit over the past decade. This too appears to be something of the past: the government this year may be in surplus.

Brokers hope that cost-cutting, higher private-sector lending and busier investment banking will make up for lower interest margins and the retreat of the government from money markets. There is plenty of room for cost-cutting; Mexico's bank branches are overstaffed and poorly located. But competition for new lending is likely to be fierce. Some of the smaller multi-regional banks may well not survive.

Derivatives trading in America

Discovering the world

CHICAGO

AMERICAN investment in foreign equities has been growing steadily over the past decade. Yet only in the past year have foreign-equity derivatives made a splash in the American marketplace.

On February 27th the Chicago Board Options Exchange (CBOE) announced that it was to start trading options on the FT-SE 100 index, the London equity benchmark, and the FT-SE Eurotrack 100 and 200 indices, which measure, respectively, equity performance in mainland Europe and in the mainland plus Britain.

The CBOE's news follows by a month its move into warrants on the FT-SE 100 index. It also recently began trading options on American depositary receipts of a handful of foreign shares. Yet the CBOE is trailing in the race to put new equity derivatives, in particular foreign-based ones, on the American investor's menu. In only a year the American Stock Exchange, its nearest rival in options, has become the leading American market for equity derivatives; thanks, notably, to Jim Jones, who took over as Amex chairman in November 1989.

At the start of 1990 Mr Jones quickly brought to the market a series of put and call warrants on Japan's Nikkei 225-stock average, and of put warrants on the FT-SE 100 and the French CAC-40. These contracts together with some other novel derivative products such as Salomon's oil trust units and contingent value rights, which resemble stock options, accounted for no less than 16% of Amex's aggregate trading volume in 1990. Stock-index warrants alone mushroomed to 13%. This year, given approval by regulators, Mr Jones plans to launch three more foreign-based warrants: on Germany's DAX index; on the FT-Actuaries Europe index; and on the Euro Top 100 index, which comes from the European Options Exchange in Amsterdam and is based on the share prices of Europe's 100 largest companies.

In recent months the two main Chicago futures exchanges, the Chicago Board of Trade and the Chicago Mercantile Exchange, also have jumped on the bandwagon. The CME began trading Nikkei stock-index futures and options on futures last September. These contracts have been popular, with average daily trading volume in the Nikkei futures reaching 1,375 last month. The CBOT has done less well with its new Tokyo Stock Exchange, or Topix, index futures. Also launched last September, this contract has failed to attract customers, in part because the Topix index is less well-known than the Nikkei.

Trading in the new equity derivatives seems bound for a boom, given the vast expansion in the trading by American investors of foreign shares. The Federal Reserve reckons this sextupled, to a yearly $270 billion, between 1985 and 1990. Large institutional investors told a survey by Greenwich Associates, a Connecticut research firm, that they intend to devote a larger chunk of their $1.9 trillion portfolios to foreign equities over the next three years.

The mere need to hedge these investments suggests that Amex, the CBOE and their rivals are on the right track. Why, one can wonder, were they so slow to take it?

Input your own tax return

NEW YORK

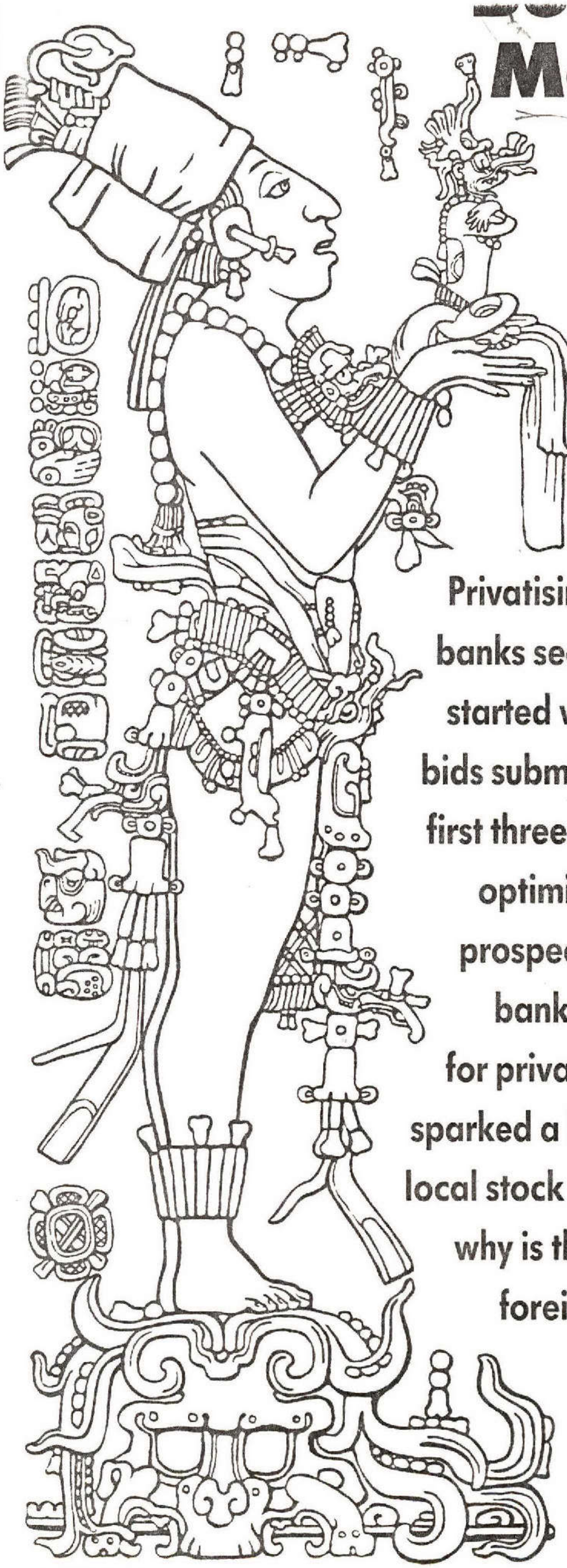
WITH America's April deadline for filing tax returns looming, tax software is selling as fast as the mail-order houses can ship it out. Some 650,000 Americans are likely to prepare their tax forms this year using programs such as TurboTax or MacInTax, nearly half as many again as in 1990. The potential market is vastly more than that: America has 120m taxpayers. An added joy for the software companies is that most Americans have both federal and state tax forms to file—and users have to update their software for both each year, to take account of new tax rules.

Tax software usually sells for around $50 for the initial program. Chipsoft's TurboTax and MECA Software's PC Tax Cut lead a crowded market for machines running DOS and Windows operating systems. Softview's elegant MacInTax dominates the smaller Macintosh market. All these programs gently guide users through the maze of questions that the taxman asks. Just type in the facts and figures. Help and advice (in English, not taxmanese) are available on-screen from an expert system. The more sophisticated programs warn the taxpayer when his deductions are likely to arouse the close attention of the taxman.

The program does the calculations and then prints out the forms at the end. The tax return can then be sent electronically to an accountant, if the taxpayer wants professional vetting, or to the Internal Revenue Service (IRS). The taxmen are keen to encourage electronic returns, because these cut administrative costs. However the taxpayer still has to take a disc to an IRS-authorised electronic filing bureau and also to supply a paper copy of his return, because the taxmen require a physical signature.

Tax programs are only the hottest part of the fastest growing area of retail software in America, that for personal finance. This has grown from nothing to a market of around $100m in barely six years. The buyers are typically 35-45-year-olds, earning upwards of $100,000 a year. That may explain why programs for tracking stockmarket investments, such as Dow Jones's Market Manager Plus and Realty Technologies' Wealthbuilder, are almost as popular as tax software.

Programs range from the straightforward to the extensive. Intuit's Quicken is designed to make easy that most fiendish of 20th-century tasks, keeping tabs on your cheque book. MECA's Managing Your Money lets you keep track of your household budget, your net worth and your investment portfolio, as well as offering rudimentary tax- and investment-planning advice. The only problem is to remember to keep your data up-to-date. So far anyway, that still requires human intervention.



Mexico's banks

FRANCESCA CARNEVALE

[redacted]

Privatising Mexico's banks seems to have started well, with 17 bids submitted for the first three banks. And optimism over the prospects for all 18 banks scheduled for privatisation has sparked a boom in the local stock market. But why is there so little foreign interest?

The initial response to the first of Mexico's bank privatisations looks set to breathe some life back into its overall privatisation programme. The first three banks for sale attracted 17 bids by close of registration: seven for Multibanco Mercantil de Mexico, and five each for Banpais and Banca Cremi. "The registration period closed on March 11," says Thomas Keesee, director, investment banking, at First Boston in New York, which is advising the Mexican government on the bank privatisation programme.

However, like the government, Keesee is not forthcoming about the identities of the bidders. Mexican bankers say it is because most of the bidders are themselves Mexican; and that foreign interest in the Mexican bank privatisation is limited because of the stringent limits put on foreign equity. John Harter, vice president of Citibank's Latin American trade finance group says the question is "whether Mexican control is compatible with foreign investment." Keesee is somewhat evasive: "Interest is specific and localised. We haven't really begun to raise foreign awareness – so it is hard to gauge. Comments in the press that there is not much interest is not really the case."

If the sell-off of Mercantil, Banpais and Cremi is a test of interest, the real action will begin in the autumn, when the next candidates are reckoned to be the six major Mexican banks, including Banca Serfin, Banamex and Bancomer. Surprisingly, in the run-up to privatisation, fewer groups have shown initial interest in the larger banks than in the smaller institutions. The international debt profile of many of the larger banks may be something of a disincentive, but in terms of infrastructure and modernity, they are streets ahead of the super-regionals. The most popular attraction among the larger Mexican banks is likely to be Banamex, with \$18.5bn in assets. Some 20 per cent of its equity will be offered to members of its regional boards, with other bidders including the Accival group and Desc.

"The government now has evaluations for all 18 privatisation candidates under preparation by McKinsey and Booz Allen and Hamilton (which are valuing nine banks apiece)," says Keesee. "Individual accounts are being examined by the banks themselves, which have brought in investment advisers such as Warburgs and Salomons. Then these evaluations are examined by the national banking commission. We too will look at the evaluations and the offers and

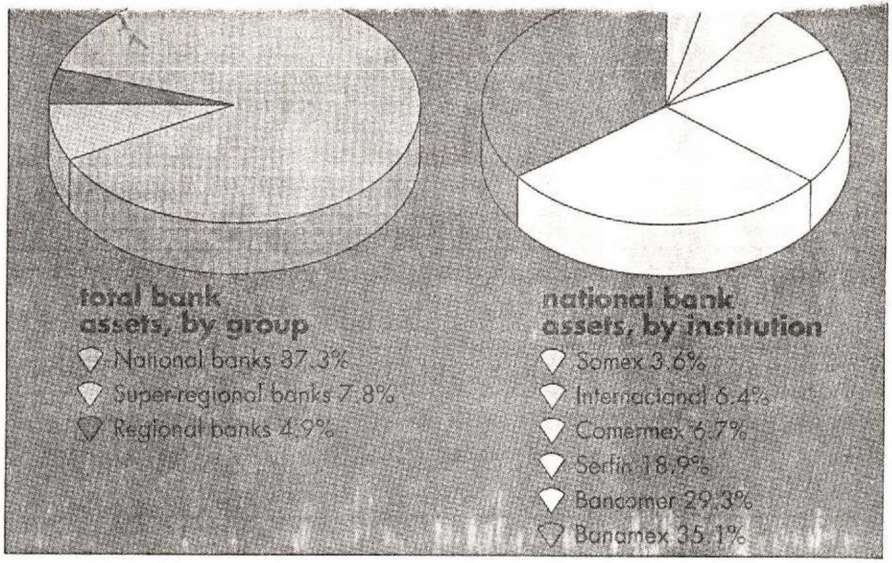
German, Canadian and Japanese banks have declared an interest. But US bank participation is an open question: a number of local bankers frankly declare that they do not expect much interest from the American majors.

From Europe, interest has been shown by Societe Generale and Banque Nationale de Paris. The most active foreign investors, however, are likely to be the Spanish. Teams from Banco Santander, Banesto, Banco Exterior and Banco Hispano Americano have already been to Mexico to discuss a possible role in the privatisation programme.

Apart from their obvious cultural links, the Spanish are keen to expand their overseas operations, and Mexico is an obvious entry into both the North American free trade area, and a spin off point to financing trade in the central and southern continent. "Foreign banks have a number of options," explains Fernando Quiroz Robles, senior vice president at Banamex. "Either they go it alone or they build up strategic alliances, or they arrange marketing agreements."

It is doubtful whether the privatisation scheme will attract the uninitiated. It is an obvious market for active players in Mexican risk. According to Jorge Anwandter, vice president and representative for NMB Bank in Mexico City: "We are not involved yet, but we would like to be. The debt problem provides us with an opportunity that we would like to take advantage of. Individual holdings are limited to 5 per cent, institutional to 30 per cent. We are trying to find vehicles to own more – up to 51 per cent. The problem is to find the right Mexican partner, that is the truly difficult decision."

Keesee at First Boston is optimistic that widespread investor interest is only a heartbeat away. "The banks enjoy good profit margins, and there is a strong need for banking services. The level and quantity of information produced by the banks is more extensive than ever before. Local groups think the system will work and are putting together diverse numbers of investors. We have heard talk of as many as 200-300 investors. We will wait and see what happens: after all there are 18 banks to privatise. I do not think that much will happen until we see the outcome of the privatisation of the first three."



Mexico's finance minister, Pedro Aspe, estimates that the government's stake in commercial banks is worth between $4.4bn and $6bn, although local bankers allow that this second valuation is rather generous. However, the government has retained the right to hold on to its controlling stake in a bank if it considers the bid price to be too low. The government is unlikely to play this card too often: it needs an injection of capital into the national treasury to meet the inevitable costs of rising imports and a growing public sector spending requirement – even if it means losing some of the banks rather cheaply.

Mexican bank valuations

US$ million†

	market capitalisation	net worth	total assets	12-mth profits
Banamex	2,015	1,136	16,784	165
Bancomer	1,639	1,132	13,917	232
Serfin	696	398	9,018	126
Comermex	357	185	3,202	50
Internacional	269	152	3,036	39
Somex	160	130	1,739	n/a
Atlantico	83	65	1,381	15
Mercantil	83	62	1,089	14
Cremi	101	62	1,029	15
Confia	98	57	781	13
Banorte	259	98	784	29
Promex	130	70	705	28
Banco Centro	139	67	686	19
Banoro	125	89	327	25
Banco Oriente	42	20	123	7
total	6,195	3,723	54,652	777

† exchange rate of M$2,808:US$1 market capitalisation as of May 4; asset valuations and profits from bank reports through Q1 1990.

The announcement that Mercantil, Banpais and Cremi were first on the list for sale took the financing community by surprise. In late September, 1990, a carefully timed government leak rumoured that the bank privatisation programme would start off with the sale of four regional banks: Banca Promex, Banoro Bank, Banco del Centro, and Banco Mercantil del Norte.

"The announcement was precipitate," admits one banker in Mexico City. "When all the worrying was about the worsening situation in the Gulf, the government carefully reminded everyone that business was going on normally in Mexico. To most of us, in hindsight of course, it was a feint. The clue? At the time of the leak, there was some surprise that the list of regionals omitted an obvious candidate – Banco de Oriente. I think that everyone knew that these were not the obvious banks with which to begin a sell off."

Moreover, the choice of the first banks strikes bankers as a mixed bag. Although Mercantil and Cremi are profitable, Banpais, a so-called super-regional bank, only returned to profitability early this year. Banpais is based in Monterrey; Mercantil, the 13th largest in Mexico ranked by deposits, and Cremi, ranked 11th by deposits, are based in Mexico City. The three banks have a combined working capital of $200m, and widespread retail outlet networks.

The government is concerned to reduce the power of industrial concerns which historically have had close ties with the commercial banks. "One reason for nationalisation," explains a Mexican banker, "is that the companies which owned the banks also borrowed heavily from them, which meant that when the companies found themselves in difficulty, so did the banks. That is a situation that no one wants to return to."

According to Robles: "The new law provides a legal framework to divide industrial risks and banking activities. So in that sense, that mistake will not be made again." Most Mexico watchers believe that the various industrial concerns will stick close to their financial heritage: the Alfa group as major bidders for Banpais shares, and silver mining group Industrias Penoles seeking to buy back into Cremi. A group of businessmen, led by Boris Sigal, is among the favoured bidders for Mercantil, according to analysts' reports.

More importantly, the bank privatisation, if successful, will provide a necessary fillip for the government's otherwise stalling overall privatisation programme. The success of the privatisation of Telmex, the communications concern, has been overshadowed by controversy over its private sector pricing policy. Telmex has had to make a series of pricing concessions, after accusations that the concern was becoming too greedy. There is growing popular feeling that the costs of privatisation may eat too deep into the pockets of the Mexican consumer, with inevitable consequences for elected politicians.

The bank privatisation programme is part of a new set of laws which encompass a total reform of the Mexican financial system – of which the privatisation of the banks is one part. Companies sold, or partially sold to the private sector include Telmex, Mexicana de Aviacion, Compania Minera de Cananea, Construtora Diesel Nacional, Turalmex, and Grupo Industrial NKS.

Forthcoming sales include the iron and steel conglomerate Sidermex (including 25 associated companies), and a partial sell off of Instituto Mexicana de Television. Pemex, the giant oil parastatal is not for sale, but the government has made it clear that Pemex will engage private sector companies to conduct oil exploration and exploitation on a risk contract basis.

The government is now considering whether to sell off its remaining 26 per cent stake in Telmex. Banco Internacional has

been asked to assemble the offering. The timing of the issue is yet to be finalised. "The government does not want it to interfere with investor interest in the banks," says a New York banker. "I wonder if they are floating too much, too quickly."

Mexico's banks were nationalised in 1982 and exchange controls introduced, ostensibly to halt capital flight and regain control over the peso in the wake of mounting inflation and a series of financial and industrial crises. That move followed a series of measures to counteract the collapse of short-term credit to Mexico, and volatility in oil prices. That, at least, was the official version. Most Mexicans now acknowledge that the then president, Lopez Portillo, nationalised the banks in a desperate attempt to muster popular support for his ailing administration.

The subsequent administration of de la Madrid, took steps to return some bank assets to the private sector in early 1987, with the launch of minority, non-voting stakes, called *certificados de aportacion* (CAPs) or B shares, in the nationalised banks. Legislation, introduced by de la Madrid, divided the capital of banks into A, B, and C stocks. The A stocks accounted for 66 per cent of ordinary capital, which could only be owned by the federal government. B stocks accounted for the remaining 34 per cent of ordinary capital, and could be owned only by Mexicans, with individual holdings allowed up to 5 per cent of a bank's ordinary capital, but not exceeding 1 per cent of total capitalisation.

C shares represented additional capital, and foreign investors were allowed to own up to 34 per cent of these shares.

Banamex and Bancomer were the first to take advantage of this bank stock programme, and a total of 13 bank CAP issues were sold in the stock market during 1987. Today, the stocks of 15 of the country's 18 commercial banks are quoted on the Bolsa, with the average price of the stocks rising by more than 147 per cent during 1990.

The new banking law, introduced in May 1990 by the Salinas administration, stipulates that the capital of commercial banks, with equity conferring full voting rights, consists of:

- A stocks – making up 51 per cent of the total. These stocks are for sale only to Mexican citizens, the federal government, Mexican development banks, the Bank Fund for Savings Protection and financial groups.
- B stocks – making up to 49 per cent of the total. These can be bought by all investors eligible for A stocks, Mexican companies that are not controlled by foreigners, domestic bonding and insurance companies, pension funds, investment societies, and other Mexican institutional investors, which have obtained approval from the finance ministry.
- C stocks – making up to 30 per cent of the capital of the bank. Possible buyers include all those qualifying for A and B stocks as well as all other Mexican and foreign non-governmental institutions.

Despite the optimism surrounding the

key bank statistics (valuations in Mex$ millions)

	market capitalisation	net worth	total assets	12-mth profits	profit/net worth %	profit/ assets %
NATIONAL						
Banamex	5,659,449	3,191,122	47,130,465	463,391	17	0.98
Bancomer	4,601,348	3,177,407	39,077,603	650,694	26	1.76
Serfin	1,953,936	1,117,545	25,322,060	354,779	47	1.40
Comermex	1,001,248	520,632	8,990,281	140,366	37	1.56
Internacional	755,197	426,243	8,526,297	109,139	34	1.28
Somex	449,514	364,439	4,883,109	n/a	n/a	n/a
sub-total	14,420,692	8,797,388	133,929,815	1,718,369	24	1.28
SUPER-REGIONAL						
Atlantico	231,826	182,353	3,878,821	42,109	30	1.09
Mercantil	233,645	172,944	3,059,015	40,392	30	1.32
Cremi	284,173	174,584	2,890,356	41,507	31	1.44
Confia	275,083	160,671	2,194,138	35,896	29	1.64
sub-total	1,024,727	690,552	12,022,330	159,904	30	1.33
REGIONAL						
Banorte	728,615	274,290	2,201,558	80,516	42	3.66
Promex	363,887	196,889	1,979,278	78,766	67	3.98
Banco Centro	389,351	188,497	1,926,037	53,924	40	2.80
Banoro	350,295	249,485	918,175	71,125	40	7.75
Banco Oriente	118,354	7,085	484,954	18,510	48	3.82
sub-total	1,950,502	966,246	7,510,002	302,841	46	4.03
total	17,395,921	10,454,186	153,462,147	2,181,124	26	1.42

market capitalisation as of May 4; asset valuations and profits from bank reports through Q1 1990.

privatisation programme in Mexico, there are significant hindrances to the successful marketing of the banks' shares. First, is the inevitable politicisation of the top banking posts which has occurred in the wake of nationalisation. Most top banking positions have been issued as political prizes to former government officials and their proteges. This has meant that Mexico's financial system is still governed by bureaucrats, rather than bankers – a fact which sometimes clouds their financial judgements, say analysts.

Second is the uneven situation of Mexican commercial banks. A number of banks require investment in computers, rationalisation of operations, and performance controls. "That will cost a lot of money," says Jose Antonio Rodriguez, sub-director of the international promotion division of Bancomer. "There will be a fight for market between automated and non-automated banks. That will affect investor interest." Some of the smaller regional banks, may not survive, he adds.

Third is the strict limitation on shares allowed to each investor. It is an issue which the local banks resent. "You don't need 70 per cent of a bank to get control," says Olaf Collado, divisional director, at Bancomer. "Allowing foreigners to have control will cancel negotiation powers overseas. But other issues have to be considered here. I think many more foreign banks will come into Mexico independently, rather than buying into existing Mexican institutions."

One favourable aspect of nationalisation is that commercial banks gain effective control of the Mexican money markets, which continue to be dominated by government instruments, such as *Cetes* (short-term treasury bills, with terms between 7 and 364 days, issued through a weekly auction by the central bank at a discount to par value of Peso10,000), and *Bondes* (development bonds, with a term of 364 days, with yields revised and payable every 28 days).

The 1990 bank legislation enlarged on the reforms of 1989, encouraging the formation of new financial groups, and now allows them majority ownership of commercial banks. With brokerages outnumbering banks; re-privatisation could eventually result in a rationalisation in their number, resulting in a leaner financial system.

For Banamex's Robles, however, privatisation will not make a lot of difference: "Most banks, during public ownership, acted as corporate companies. Profitability was a big objective, that is why there is so much interest from Mexican private investors. Added to this is the fact that financial intermediation is set to be profitable in Mexico for years to come. With all this in hand, there is no sense for government to participate in banking."

How long the 1989-90 profit margins will last is debatable. Rodriguez says: "Spreads between lending and borrowing have been good, up to 5 per cent in some cases. But increased competition will reduce margins considerably, even though rationalisation of bank operations could save money." ■

l--..l : t. uriti

FRANCESCA CARNEVALE

Given the wariness of US banks towards Latin American risk, why not finance exports out of Latin America, rather than imports in? US banks prefer to employ a bundle of securitising strategies. This leaves the traditional export credit route to the Europeans, which are redefining export financing strategies of their own. Mexico is at the forefront of change once again.

Securitising trade-related receivables is a big and growing business in financing trade with Latin America, particularly with Mexico. Securitisation is used for both import and export finance, and encompasses a variety of new and old financing techniques. In essence, securitisation involves the repackaging of receivables into securities or other tradeable instruments, for distribution in the capital markets to private investors. The securitisation of trade-related assets is not a new technique. Big US majors such as Chase Manhattan Bank have been repackaging medium-term export credits for distribution in the capital markets for many years. The difference is that banks such as Chase usually repackaged deals that were concluded on an à forfait basis – non-recourse financing, without export credit insurance. In the Latin American context, import financing without export credit agency (ECA) involvement is not always a viable option.

US banks, which are showing signs of becoming increasingly risk averse, now prefer to finance exports out of Latin American countries, rather than imports. This has led to the development of a variety of techniques according to the preferences displayed by individual banks.

Citicorp, for example, assigns hard currency receivables (backed by the credit of, typically, an OECD importer) for goods received from a Latin American exporter to a trust or special purpose vehicle. Because the receivables are collateralised, they can be turned into low coupon securities which can then be sold. The exporter receives funds either on shipment or when the receivables are assigned to the bank.

Investors in the securities receive payment of principal and interest when the receivables have been collected. If the Latin American producer does not supply, then the importer does not pay. This means that in Latin America Citicorp is taking supply risk rather than credit risk. Citicorp makes fee income on structuring the deal, which includes a premium on account of non-performance risk.

The advantages to the Latin American supplier are twofold: the finance is between 2 and 4 per cent cheaper than the normal market rates (typically 5 or 6 per cent above Libor, to take account of the foreign exchange risk), and the assets no longer have to be pledged to secure the finance. This type of financing is available only to high-grade companies in Latin America, which meet contract obligations punctually.

For import financing, US banks are again at the forefront of the move towards securitisation. Bankers Trust's approach emphasises flexibility. The bank is arranging a facility for NAFIN "worth not less than $100m," says Terina Golfinos, vice president at Bankers Trust. She explains that the deal is unusual in that it is a series of import financings, rather than a fixed value transaction. Although the bank would not be drawn on the exact structure of the deal, Golfinos says that the transaction is securitised, and that the facility is directed towards larger transactions. "It is not a discreet facility, but one for big ticket transactions with tenors not under five years – which makes the capital market involvement possible."

The signal advantage of the deal is that it affords flexibility in pricing – "From floating to fixed over the life of any transaction," says Golfinos. "It started out as a project facility, which includes deal by deal approval – the kind that Eximbank wants to see. The nature of the project will determine final terms, and we can go out as long as 10 years. In Mexico, there are only a handful of borrowers for which this type of financing makes sense."

Neil Allen, managing director of Bankers Trust Latin America merchant banking group, adds: "It is taking a traditional technique, and seeing how we can alter it, while keeping the Eximbank guarantee, and being able to structure the financing so that it is placeable. Clearly there will be lots of structured finance potential over the next three years. But we work as arrangers, and take an overall advisory role instead of taking possession of the deal itself."

Securitisation is gaining most ground using the US Eximbank-backed bundling programme. First Interstate, the Los Angeles-based bank bounced back into Latin American trade finance when it launched a programme in early 1990 to securitise medium term export credits to Mexico.

The difference is that in this case securitisation was done with US Eximbank support (see box), targeting small to medium-sized importing companies, rather than the large conglomerates. So far, First Interstate claims to have extended some $205m worth of export credits to Mexico, mainly to Banco National de Comercio Exterior (Bancomext). Of this, some $70-80m worth of credits have been securitised, and sold on to private investors, through a process known as bundling.

Bundling works like this: First Interstate extends a US Eximbank guaranteed loan (which provides cover up to 85 per cent of the value of the export credit) to a Mexican bank, which then on-lends in small amounts to a Mexican importer. When a specified amount has been disbursed by the Mexican provider, the loans are bundled into promissory notes, which are then placed with private investors by First Interstate.

The advantages to First Interstate are that it derives fee income from structuring the transactions, and it can increase its lending capacity to Mexico without actually increasing its exposure to Mexican risk in its book.

The benefits to the Mexican borrower are that it increases its credit lines, and allows smaller companies to take advantage of increased credit availability.

The attraction to investors is that they are essentially buying US government risk, as the paper carries an Eximbank guarantee.

First Interstate is pursuing the bundling route with vigour, although bankers acknowledge that investor interest has been only moderate. Even so, the bank has announced that it intends to try and increase its bundling programme four-fold over the next 12 months; and there are rumours that it intends to work with the UK clearing bank Barclays on marketing the programme to US exporters.

A number of other banks are now also involved in the bundling programme. Swiss Bank Corporation has just announced that it will provide a $112m credit to Bancomext for US capital goods exports under the bundling programme. US Eximbank is to guarantee $95.2m of the credits. Merrill Lynch will float the bundle in the capital markets. According to Peter Griffiths (ex-Chase) and now at Swiss Bank Corporation's London branch: "Securitisation is not a game for banks without a significant distribution capacity. If you cannot distribute the risk, there is little point in doing it. Added to this, you have to have a good treasury operation to add value to the financial instruments."

For the time being, ECA involvement is still a prerequisite for much day to day trade finance business. ECA perception of Mexican risk is improving daily, even in America. Contrary to expectations, US Eximbank is bullish on Mexico; and peachy

a bundle of benefits

The goal of US president Bush's Enterprise for the Americas initiative is to strengthen economic ties and encourage economic growth throughout the western hemisphere. The Latin American private sector is the linchpin in that effort, but it will lead the region to real economic growth through trade and investment only if it has adequate financing.

Eximbank has developed a bundling programme to make this financing available. Bundling will help to rebuild the commercial banking network, which ties the region's local banks to international banks, and the local private sector to private sectors around the world.

For the six largest borrowers in Latin America – Argentina, Brazil, Chile, Colombia, Mexico and Venezuela – new debt flows, net of repayments, dropped from $33.9bn in 1981 to $3.1bn in 1988. Drastic as this aggregate decline is, the picture for the private sector is even worse. Foreign debt flows to the private sector went from a net inflow of $15.3bn in 1981 to a net outflow of $3.2bn during the same period.

The small amount of international bank lending to Latin America which did take place during the 1980s was largely tied to debt-restructuring packages negotiated between the borrowing country's government and creditor banks.

The banks, under severe regulatory and financial pressure to avoid exposure in developing countries, found it internally indefensible to lend to private borrowers which not only carried the country exposure of their residence but also lacked the debt restructuring mechanism to justify even nominal lending. The experiences of the early 1980s, when commercial banks saw many short-term credits to the private sector turned into long-term public sector debt, also loomed large in their memories.

Multilateral and bilateral lending institutions have compensated for some of the decrease in commercial bank lending, but most official lending has been to the public sector, and for large projects.

Little has gone to the private sector for productive industrial projects. To succeed in reaching private sector investors, in the depth and breadth necessary, requires the engagement of the traditional banking system.

First, the local banking sector must review and streamline the legal and regulatory framework within which it channels funds to the private sector – to facilitate risk evaluation and efficient allocation of funds. The financial sector reforms underway in many Latin American countries is essential in this regard. Banks also may need to offer new training programmes to enable their staff to handle foreign loans again.

Second, to atract international banks back to lending in the region, transactions must be structured to minimise cross-border risk and to generate for the lender a greater yield on assets than in the past. Eximbank's bundling programme satisfies both requirements.

Through bundling, Eximbank guarantees the repayment of many small and diverse private sector loans bundled into one large transaction. Eximbank's guarantee meets cross-border risk concerns and the bundling process provides the opportunity for a high yield on assets at two levels. At the operational level, bundling creates economies of scale. At the financing level, the bundled transaction can be funded by investors in the capital markets, reducing bank asset requirements and increasing the possibility of further profits.

Perhaps most importantly, bundling encourages the re-establishment of international banking relationships. It helps local commercial banks resume the marketing of foreign financing to their industrial clients. It helps foreign banks resume traditional commercial business with local banks.

In less than a year, Eximbank has authorised over $400m in new business under the bundling programme, and has made offers on another $400m, bringing financing within reach of the private sector in Latin America.

Rita Rodriguez is a director at the Export-Import Bank of the United States

keen on the bundling process in particular. At the beginning of the year, the agency announced that it would step up guarantees for exports to Mexico, to the tune of $5bn over the next five years.

Since the bundling programme was introduced in March 1990, Eximbank has authorised more than $500m in new business, with an additional $600m still pending. "We've never closed on Mexico," explains Rita Rodriguez, director at US Eximbank. "In Mexico you have an example of what can be done when parties work together."

Christian Rigby, vice president and group head of commodity and trade finance at Generale Bank's New York branch says an advantage enjoyed by Mexico is that Eximbank reps are clear on policy. "It does not come from daily routine. There is a clear mandate to expand business. We see a lot of transactions where the Mexican borrower will go to one of the banks – usually Bancomext – and they will provide a guarantee. Eximbank looks to that, rather than the quality of the underlying borrower. Everyone is willing to look at a private borrower, but there are limits to the amounts anyone is comfortable with. If it is a company one is familiar with, which has had three years of good financials, the Mexican company can go to Eximbank a standalone transaction."

According to Olaf Collado, divisional director, international, at Bancomer, the refinement of securitisation in the Mexican context is a reflection of increasing interest in the market, rather than simply a risk-averse method of financing trade. "We certainly see an increasing willingness to accept Mexican risk – particularly from the Europeans. The US banks certainly have more problems; but now they are starting to adapt to capital adequacy, they are coming up, although not as much as one would like."

Despite continuing dependence on traditional trade financing routes, trade with Mexico is increasingly a European rather than a US option. "It is mainly Germany and Switzerland," says Jose Antonio Rodriguez, subdirector in the international promotion division of Bancomer. "They are in a league of their own. Then we see France and Spain; then a little UK. Italy is slow, even with SACE credits."

Another indication of change is the broadening scope of banks able to raise credit. "After 1982, the only lines we could get were through the development banks, such as NAFIN; now there are lines with everyone," adds Collado. "Italy is looking to establish lines outside the development banks. But Hermes was first."

Although few bankers will work outside ECA-backed financing, the problem doesn't end there for Mexican banks looking to extend credits. The real problem lies in the add-on costs passed to the Mexican importer. Although credits are charged at category two consensus rates to the Mexican bank borrower, the Mexican importer pays significantly more: usually between 2 and 4 per cent above cost of funds. "The ECAs themselves are always looking for a ministry of finance guarantee. The ministry is willing to give it, thereby reducing the country risk cost," explains Ernesto Martinez Gutierrez, manager of foreign trade in Banca Serfin's international division. "But we have to pay a fee to the ministry, which inevitably means add-on costs to the importer." In addition, the banks ask for a margin on top to take account of the foreign exchange risk.

This translates into a lot of interest among Mexican banks for trade finance, where the returns match the risk and profits are plentiful. The international division of Banca Serfin, which enjoys around 22 per cent of the Mexican trade finance market, made a $30m profit last year – it is this sort of result which attracts envious glances from profitstretched OECD banks. Even so, foreign banks are wary of extending credits beyond 180 days for short-term Mexican trade risk – or even of entering the market themselves as direct lenders.

Serfin is hoping to increase market share by 10 percentage points during the next 12 months. This will not be done by extending its range of financing services: "We will not be offering new products, because we have access to NFCE lines, and because it imposes its own limits. We already have 10 to 12 programmes to manage. Second, additional financing techniques, such as factoring, are handled by subsidiary operations," explains Gutierrez at Banca Serfin. "Rates are getting lower, which means we can offer the clients better credits."

Bancomer, on the other hand prefers to develop new instruments to capture market share. Domestic factoring is a booming business, and Bancomer "is anxious to develop an international factoring service; though we are just starting out in this area," explains Collado. "Meanwhile in trade finance, we are trying to develop internal suppliers for maquilladores."

Even so, banks such as Serfin are looking for better terms. "We don't work with Eximbank," explains Gutierrez. "Our kind of importing is done with the backing of the US Commodity Credit Corporation (CCC). But even with favourable CCC terms, we need to gain access to lines of credits to contract with foreign banks. Cheaper credit and a wider range of credit is essential if we are to compete effectively within the upcoming free trade area."

Fernando Quiroz Robles, senior vice president of Banamex's economic studies department is relatively sanguine: "It is a good thing to be considered a private sector risk, although borrowing will obviously be more expensive in the short term."

This very fact may encourage foreign banks to enter the Mexican market on the back of straight corporate financing, rather than working through Mexican credit providers. It takes nerve, but the returns are attractive. According to Jorge Anwandter, vice president and representative of NMB Bank in Mexico: "The distinction between corporate and export finance is a little fudged here in Mexico. Much of the export financing provision is on a preshipment basis, which calls for a proper assessment of corporate risk. Our philosophy is to go beyond the perceived risk, lending directly to the Mexican corporate. If we can finance at Libor plus 5 or 6, it is a very good return. And it undercuts what the corporates are asked for ECA-backed credits."

A spokesman at a leading US bank in Mexico City agrees: "It is a good time to lend directly on short-term basis: the security is commercial paper indexed to a free US dollar. It is good for the foreigner who wants to be fully hedged. But there are obvious corporate limits. What the corporate does with the funds, whether preshipment financing or working capital, whatever you call it, it is a good deal for them." ■

Privatization Heats Up in Mexico

Government sales of Mexico's banks will unleash a round of fund-raising for domestic companies and buying by foreign investors.

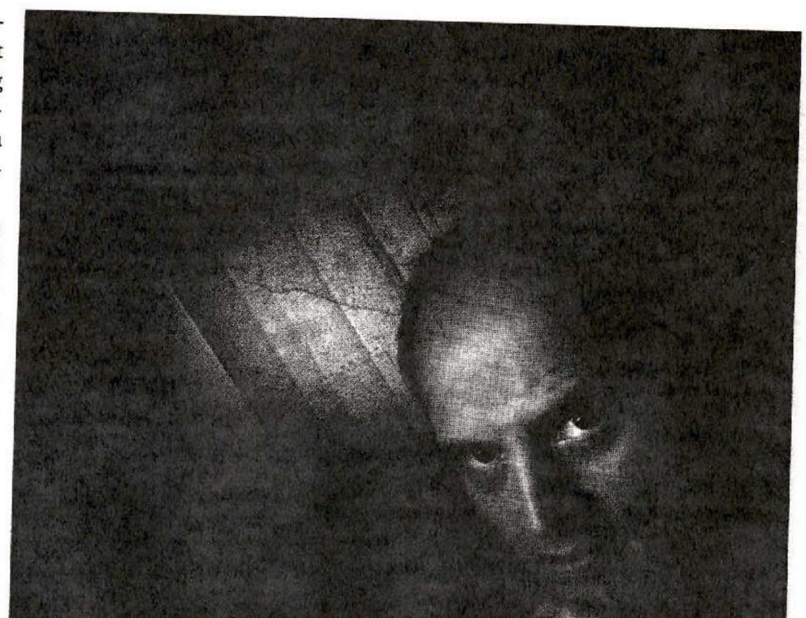
By Ernest S. McCrary

Mexico is plunging ahead with financial reforms which will put most of the country's banking system back in the hands of private owners this year, opening the door for a sweeping modernization of the domestic financial sector.

Along the way, a swarm of opportunities is emerging for foreign bankers, investors and financial advisers who until now have had only limited access to—or interest in—the Mexican market.

As the economic reforms of the past two years take hold, a dramatic surge in foreign interest in Mexico is taking place. New international funding by both state and private companies is being welcomed by the market, the stock exchange is thriving, and prospects for a free trade agreement with the United States and Canada by 1993 are increasingly bullish.

"The year has started out quite aggressively for Mexico," says Orlando Sacasa, managing director in the International Capital Markets area at Citibank. "Even the Mexican government has come back to the Eurobond market, for the first time in nine years."



ROBIN THOMAS

For example, this past February's DM300 million issue of five-year Mexican government notes managed by Deutsche Bank was a real flagship deal, Sacasa notes. Other deals are in the works too, such as Pemex, which is seeking to raise $1 billion this year.

"We see a lot of demand for Mexican paper, and equities will play a big role in financing deals this year too," says Sacasa. "As Mexican banks are privatized, they will be issuing short-term paper. We see a lot of appetite from investors for that, because the banks are viewed as well run, with decent balance sheets."

ORLANDO SACASA, MANAGING DIRECTOR OF INTERNATIONAL CAPITAL MARKETS AT CITIBANK, SEES A HARDY INVESTOR APPETITE FOR MEXICAN SECURITIES.

According to Finance Ministry figures, the 18 state-owned Mexican commercial banks, nationalized in 1982 and now slated for privatization, earned combined profits of $1 billion in the first 10 months of last year. Average return on assets for the group was 1.4%, with an average 60% return on capital.

The auction process, through which the government will sell its controlling stake in all 18 banks, officially began in mid-February when the Finance Ministry announced the first three banks to go on the block. They are regional banks Banpais, Banca Cremi and Multibanco Mercantil de Mexico.

Though another two banks, Banco del Norte and Banco Internacional, are expected to follow shortly, the government has refused to provide a precise schedule for the entire privatization process thus far.

"We want to go as fast as we can, while still maintaining careful controls to do the job right," says Javier Lozano Alarcón, a member of the government's 10-person Bank Privatization Committee and director of authorization and control of foreign credit for the Finance Ministry. "After all, we don't have any previous experience in selling banks. We just have to see how things go as we reach each stage of the process."

THE GOVERNMENT ISN'T COMPLICATING PRIVATIZATION WITH TOO MANY RULES, AND WE SEE LOTS OF INTEREST IN EVERY BANK.

A Careful Balance

The government is proceeding cautiously because bank privatization is an emotional, politically charged issue. Any miscue by President Carlos Salinas de Gortari's administration could prompt a backlash from opposition politicians who could try to derail the entire privatization and free market economic reform program.

Also, huge amounts of capital are at stake. Mexican banking sources estimate the 18 institutions to be worth a combined total of $5–6 billion. The government must pace the sales to get top prices, yet avoid overwhelming the resources of national capital markets.

Though open to foreign bidders, basically, the sales are tailored for to Mexico's largest stock brokerage firms and industrial conglomerates, which are expected to buy up the banks and build them into powerful, diversified financial groups able to compete internationally. At least a dozen of Mexico's 25 brokerage firms are expected to vie for ownership of the banks.

Already, Casa de Bolsa Inverlat, an eight-year-old brokerage firm with $6 billion in assets under management and net worth of $170 million, has confirmed its intention to enter the fray. The same group owns Seguros América, Mexico's second-largest insurance company, in a joint venture with Italy's Assicurazioni Generali.

Carlos Muriel, president of Inverlat International in New York, explains the group's strategy. Inverlat definitely wants to buy a bank and is registering to qualify for bidding. "Banca Confia is really the bank we're after, but it wasn't in this first group of three to be offered," says Muriel. "We might go ahead and bid for Banca Cremi now, or we might wait for Confia later."

Such decisions will have to be made rapidly. Within a month of the March 11 registration deadline, the Bank Privatization Committee will ask for bids to be presented. The first sales could take place quickly, perhaps as early as May.

But, insists Lozano Alarcón, the Committee's secretary, there is no absolute timetable. "There is no commitment to try to sell all 18 banks in 1991," he says, "but we could offer the next group of banks before we close deals on these first three to keep the process moving."

So far the government is earning high marks from international financial advisers for its handling of the bidding process. "The way they're handling it is smart," says Jesús Zamora León, an associate in Salomon Brothers' International Corporate Finance Department. Salomon is advising Bancomer and Banco del Centro on valuation during the privatization process. "The government isn't complicating privatization with too many rules, and we see many parties interested in every bank. It's going to be a real bidding process."

Prospects for bank restructuring as a result of privatization already have driven up bank share prices on the Mexican stock exchange, where shareholders own substantial minority blocks for most of the 18. (The government owns at least 66% of each bank, but minority shares are traded publicly.) Price/earnings ratios are climbing but are still considered to be in a reasonable range.

Inverlat's Muriel notes that recent 12-month trailing p/e's range from a high of 9 for Banamex, the largest bank, to 4.5–5 for Banca Serfin and Banco Mercantil. A huge surge in prices occurred early last year, when most bank stocks doubled or tripled from February to June. Today most are trading at close to, or just under, their May/June 1990 highs.

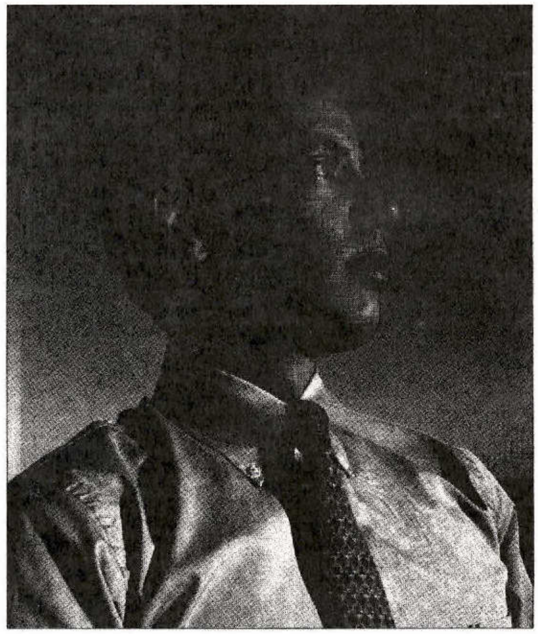
Each bank will be evaluated three times before privatization—once by the government using external auditors, once by the current administration of each bank and once by each bidding group. The government hopes to receive substantial premiums over current market capitalization values, which are estimated at $2.2 billion, $1.7 billion and $1.3 billion, respectively, for the three largest banks, Banamex, Bancomer and Banca Serfin.

Foreign Interest

Foreigners are free to bid but must do so in conjunction with Mexican investors since they cannot hold more than 30% in any bank. "Some foreign groups have expressed an interest," says the Privatization Committee's Lozano Alarcón. Offers will have to identify foreigners who might be involved. They can also buy shares later by forming a joint venture with Mexican buyers who increase the bank's capital, he adds.

So far only European banks are rumored to be interested in entering Mexico's commercial banking field as minority partners. The most persistently mentioned names are Spain's Banco Santander and France's Banque Nationale de Paris and Société Générale.

US banks are conspicuously absent from the list of interested parties. Citibank, which has been in Mexico since the early 1920s already has a substantial presence. Citibank was not nationalized when the domestic banks were taken over in 1982, and it is expected to receive an expanded franchise for activities as the whole sector undergoes restructuring.



CARLOS MURIEL, PRESIDENT OF INVERLAT INTERNATIONAL IN NEW YORK, A MEXICAN BROKERAGE FIRM SEEKING TO BUY ONE OF MEXICO'S BANKS.

THOMAS IANUZZI

Of enormous interest to US banks is how the Mexican government will resolve the issue of some $5.2 billion in short-term interbank foreign credit lines, in limbo since the debt crisis and nationalization.

"These are obligations of the Mexican banks to foreign banks," says MG-First Boston vice president Michael Pettis. Interest payments are being made under a gentlemen's agreement, extended until December 31 1992, but creditor banks want a definitive solution, and so do the Mexican banks. "For them this is a short-term liability, and they don't have short-term assets to match it. " explains Pettis. "There is a secondary market where this paper is traded for about 75 cents on the dollar, but these loans are basically illiquid and prices would crash if anyone tried to sell a lot of it. So, these banks are stuck with what is counted as Latin American debt exposure."

An Old Problem

Salomon's Zamora León agrees. "The interbank liability issue is a real problem," he says. "The government has to define how those lines will be restructured as part of the privatization package."

The largest banks are estimated to owe $800 million to $1 billion each in interbank credits, or amounts equal to about half their market capitalization value. "Obviously, nobody is going to be anxious to buy a bank without having that liability cleared up," says another US investment banker working in Mexico.

Such problems haven't shaken overall investor confidence in Mexico, though that confidence is not unconditional.

One example of this is the handling of the February issue of five-year Mexican government Deutschemark notes yielding 10.37%. It was expanded to DM300 million ($198 million) from the originally planned DM200 million and placed mainly at the retail level with individual German investors by Deutsche Bank.

"We'll continue to see more of these deals but mostly in the euromarket, " says Citibank's Sacasa. Though the yield is high by German standards and it's an attractive rate for Mexico, the US market would be more demanding, he says. "It would be harder to do this type of deal in the US, and the Mexican government doesn't want to push this kind of deal there, because it doesn't want to be forced to get a rating."

Private Mexican companies are more willing to come into the US market because dollar deals are still cheaper than the 16–18% domestic cost of funds. Indeed, the newly privatized Mexican banks are expected to seek $300–$400 million in short-term funds in the United States later this year.

A distinct shift toward equity funding is taking place among these Mexican companies.

For example, Telmex, the Mexican telephone company, will stage the equity megadeal of the year, with its mammoth offering of limited-voting-rights shares, or L-shares, on several international stock exchanges before the end of 1991. The L-shares are a form of dividend payment and represent about 60% of Telmex's market capitalization of $7.5 billion. The government's portion of these dividends is estimated at $2.3 billion.

According to a Mexican banker who was involved in the Telmex sale, the L-shares are priced the same as existing A and AA Telmex shares. However, the shares carry voting rights that can be used only in special circumstances, such as in voting to approve Telmex's entry into new business fields or to de-list shares.

The stockholders will receive 1.5 L-shares for every Telmex A and/or AA share that they already hold. The shares will be sold in Mexico and abroad. The new Telmex shares are to be offered in Japan (where Nomura Securities will run the Japanese portion of the offering) and simultaneously in New York and Europe, where lead agents are to be named soon. The shares will be listed on the New York Stock Exchange as American Depositary Receipts (ADRs). "It will be one of the three largest ADR issues ever done," says the Banco Internacional official in Mexico City.

Goldman Sachs advised the government on the sale of Telmex shares last December to private investors, and the firm is expected to play a major role in the US offering. Specialists who follow Telmex say the offering is not expected to affect the existing over-the-counter market for the earlier shares. In late February Telmex was trading at $1.73, or an 88.1% increase compared with its January 1990 price.

NOW MEXICAN COMPANIES ARE READY TO USE ADRS AS A TOOL FOR CAPITALIZING THEIR OPERATIONS.

A combination of rapid appreciation and hefty dividends has made Mexican stocks real winners for the small group of country fund managers who jumped into the Mexican market early on in the game.

Audley Twiston-Davies, managing director of Latin American Securities Limited in London, runs the open-end Mexican Investment Company Fund, which has grown to about $50 million in assets since its founding in November 1989. "For 1990, we were up 44.2% against the Mexican stock exchange index, which had risen by 36.6%," says Twiston-Davies. "Our share price at launch was $10.00, and today it's $14.94."

BRIGHT STARS

The fund holds numerous big winners, he says. "The stars have been in the food, retail and banking sectors. We more than doubled our money in Cifra and nearly tripled it with El Puerto de Liverpool, both retail companies. Our bank stocks doubled, and Telmex more than doubled."

The Luxembourg-registered fund's stocks are picked in London, with trading executed by Acciones y Valores, a major Mexican brokerage house, which also provides stock selection advice. The fund's parent company, Latin American Securities, is a 50-50 joint venture between Foreign & Colonial Management of London and Brazil's Banco Garantia.

"We originally offered a Brazil Fund in December 1987," says Twiston-Davies, "but Mexico offers more opportunities right now. Most of our investors are blue-chip European institutions, though there are a few from the US and the Far East."

Currently, fund activity is a mix of profit-taking by investors, who are happy with 50% runups, and other investors entering the Mexican Fund for the first time, he says.

Twiston-Davies continues to see bullish fundamentals in the Mexican economy. "GNP should be up by more than 3% this year, interest rates are coming down and inflation should drop to about 15%," he says. "Even if there is a severe recession in the United States this year, we don't expect it to affect Mexico very much." The government already has taken into account lower oil prices, and President Salinas is still solid as a rock politically. "Overall, we like what we see."

In anticipation of this surge in equities Mexico is expanding its custody operations. The central depository in Mexico is S.D. Indeval, originally established 12 years ago as a state entity and privatized in July 1987.

Today Indeval is owned by Mexico's 25 brokerage houses, seven banks, six insurance companies and the stock exchange, or Bolsa Mexicana de Valores.

"Everything quoted on the Bolsa goes through us," says Indeval's International Division subdirector Rosamary Underwood. "We don't participate in any buy-sell transactions, but we provide clearance, settlement and custodial services for all securities. We now have approval from the US Securities and Exchange Commission to serve as the depository for US investors too."

Indeval provides daily fax reports to foreign investors, advising them about proxy actions, dividends, splits, swaps, and similar matters. "Within six months we will join the SWIFT system, allowing us to credit dividends, interest and amortizations to foreign investors on a same-day basis, instead of the next-day system we have now," says Underwood. Indeval also handles all domestic market transactions, except for a few special types of securities kept by the Banco Central de Mexico.

Some commercial banks offer their own custody service in Mexico, but their customers' securities still must be deposited with Indeval, which tracks account information for the custodial banks. Indeval charges 0.003% per month, based on the market value of the holdings in its keeping, for stock custody service.

A new Hewlett-Packard Spectrum 3000 computer system, using Indeval-designed software, will go into service by May, which should boost Indeval's capacity to process both domestic and international transactions.

YEAR OF THE ADR

Such modernization has begun to reinforce US investor confidence that Mexico's stock market is now moving into the big leagues. Miguel "Mike" Martinez, Bank of New York's vice president for Latin America, sees that this confidence is being translated into much stronger ADR activity this year for Mexican stocks.

"This is the year the Mexican ADR market will mature," says Martinez. "Until now, Mexican companies have concentrated on developing their market presence in the United States. Now they are ready to use the ADR as a tool for capitalizing their operations."

Martinez sees a progression similar to what occurred in Spain when industrial companies and banks were privatized. "It took about two years for the Spaniards to come into the ADR market," he says. "We started our Mexico ADR campaign in 1988, mainly by putting out information. At the time, most people were involved only in debt trading and weren't paying attention to equities."

Until now, most overseas demand for Mexican stock has come from Mexicans themselves, using capital held outside the country, and from "forefront" institutional investors such as Scudder, Stevens & Clark, Fidelity Brokerage Services, Templeton International and the major US insurance companies. Now, Martinez says, investor interest is trickling into several equity alternatives, such as ADR's, Mexico country funds and direct purchases by sophisticated investors.

FINANCIAL REFORMS IN MEXICO SHOW THE LEVEL OF GOVERNMENT COMMITMENT TO RESTORING THE PRIVATE SECTOR.

New offerings will also add some action to the market during the rest of this year.

"We're talking to two companies in Mexico now that want to do new, primary issues in New York, as the Chilean telephone company CTC did last year," says Martinez. These deals will be in the $50–$100 million range, which is small in comparison to the big Telmex issue. But, they prove that Mexican companies are moving toward overseas equity issues as the next natural stage in capitalizing themselves, and that the market will accept them.

Altogether, Bank of New York expects that there will be about six such deals, totaling $400–$600 million, materializing in mid-year, in addition to the Telmex issue.

PENSION REFORM

Another force likely to affect Mexico's capital market this year is the first movement toward privatization of Mexico's pension system. The model for that program is Chile, where some private pension funds are now so strong that they are shopping to purchase large overseas companies.

Bankers Trust is among US institutions that are following the scent of pension reform in Mexico. "We've played a large role in Chile's system and would like to help Mexico too," says a Bankers Trust executive. Though countries need these large pools of liquid savings, it isn't easy to set up a system, he adds. Privatization is a great concept, but planning and implementation take a long time.

With such developments ahead, scores of foreign institutions are competing to carve out new niches in the Mexican market. Continental Bank, for example, is forming an investment banking company in Mexico with more than $30 million in capital, earmarked for small and medium-sized projects. "There are many great opportunities in Mexico," says Alberto Luzarraga, Continental's managing director and Western Hemisphere Division head. But all eyes are on the trade account, he says. It is currently balanced, rather than at a surplus, as it should be, and the country's capital account is in

THE FIRST THREE BANKS ON THE BLOCK

The first three banks targeted for privatization in Mexico are small regional institutions that will, in essence, serve as trial runs for the larger banks to be auctioned later this year.

These first banks in the bidding process are:

Banpais, which operates 100 branches in 27 cities with 3,100 employees, has capital of $45.5 million. Its main areas of operation are Nuevo León and Mexico City.

Banca Cremi, with key operations in Jalisco and Mexico City, has 116 branches and 5,000 employees. Capital totals $78.2 million.

Multibanco Mercantil de México, with 92 branches and 3,500 employees, has its largest operations in Nuevo León and Mexico City. Multibanco has capital totaling more than $77.0 million.

Combined, the three institutions represent 6.8% of the country's branch bank network and 5.94% of national bank deposits.

INVERLAT GEARS UP TO GET AN EDGE

Mexican financial institutions want to be bigger players in the international market, and the most aggressive of them, such as brokerage house Casa de Bolsa Inverlat, have already started moving into the United States.

Established in 1983 by executives who left Mexico's largest bank, Banamex, after its nationalization, Inverlat opened a New York subsidiary last April and now is looking to open offices in Los Angeles and London.

Carlos Muriel, president of Inverlat International in New York, says the firm always has looked beyond traditional brokerage services, for business niches not covered by banks.

One example of this can be seen in the dollar-indexed commercial instrument Inverlat created for short-term working capital loans to top-rated Mexican companies, most of which are exporters.

"These are for up to 90-day terms, whereas our competition offers them for longer periods," says Muriel.

To the corporate borrower, the cost of these funds is 16%, plus about 5% in dollar inflation. The cost of current peso loans, including inflation, is 27–28%.

Since these companies are exporters and have dollar income, they prefer a dollar-indexed deal. For buyers of Inverlat's own commercial paper, which funds such deals, the yield is 14–14.5%.

Eventually, all services now offered by Inverlat in Mexico, including investment banking and M&A advisory, will be offered out of the New York office, which now has seven employees.

These moves, Muriel says, are in line with preparations for the opening of Mexico's financial services sector under the North American Free Trade Agreement plan.

"Privatization in Mexico will help us get ready for the FTA," he says. "It will help Mexican financial groups consolidate and be ready when US and Canadian banks and brokers begin pushing into Mexico."

deficit. "If that continues," adds Luzarraga, "sooner or later it will put pressure on the exchange rate."

The Downside

Such risks are concrete, while others are less tangible, though equally disturbing to experienced Mexican investors. "The worst thing working against Mexico is its history," says a veteran European investment adviser. "Several times history has suggested that Mexico looked very promising, and then things went wrong.

"Although there is always that concern, he says, the big difference this time is that relations with the US have never been as strong. "That can make up for a lot of problems."

Thomas W. Studwell, partner in the Chicago office of law firm Baker & McKenzie, who specializes in Mexico and Venezuela, sees growing client interest in both countries. "Financial reforms under way in Mexico are extremely important. They show the level of government commitment to restoring the role of the private sector in the country," he says. "The Free Trade Agreement is also a very positive development, which would have been unthinkable only a year or so ago."

The worrisome thing is that so many of the liberalization measures have come through Presidential decrees and the implementation of regulations, posits Studwell. The foreign investment law has been modified so as to make it as liberal as possible, but it is still the same law that was interpreted strictly against foreign investment in 1974 and 1982.

Key changes still have to go through the Congress which could prove to be more unpredictable, says Studwell. "Other countries such as Chile, Venezuela, Argentina and Uruguay all have more liberal legislation for foreign investment, but they just don't have the market that Mexico does."

EVEN THE MEXICAN GOVERNMENT HAS COME BACK TO THE EUROBOND MARKET, FOR THE FIRST TIME IN NINE YEARS.

VOL. CCXIX NO. 34 ★★★ EASTERN EDITION

Rewiring a Nation

Telefonos de Mexico Makes Promising Start On a Daunting Task

Privatized Monopoly Shows First Signs of Rewarding Its Enthusiastic Investors

The One-Exit Truck Garage

By MATT MOFFETT
Staff Reporter of THE WALL STREET JOURNAL

MEXICO CITY – In Mexico, even $1.76 billion may not buy you a quick dial tone.

That was the price Mexican magnate Carlos Slim and his U.S. and French partners paid for control of the spectacularly inefficient telephone monopoly Telefonos de Mexico S.A. Yet on a recent afternoon the receptionist at Mr. Slim's headquarters had to endure an aggravation common to millions of their countrymen: a phone line on the blink.

All right, so there are still kinks to be worked out before Telmex becomes a world-class telecommunications company.

Mr. Slim and his partners, Southwestern Bell Corp. and France Telecom Inc., knew to expect a bit of a struggle when they bought into Telmex in December 1990. Though Mexico is the world's 13th largest economy, it ranks 83rd in the world in phone lines per capita. The average wait for a new line is three years. The typical lag for repairs is several months. And even figures like these don't convey the depth of the problems. Most Telmex pay phones operate for free because repair crews can't keep up with vandals. Lines are so often crossed that befuddled dialers commonly open a conversation by asking *Adonde hablo?* – Where am I speaking?

Fond Followers

But even as Mexican consumers have been complaining bitterly about Telmex, investors have been loving it. While complaints against Telmex were soaring 230% last year, its stock price was climbing 237%. Some conservative U.S. mutual funds were among the big buyers.

Maybe they knew something. For despite the immensity of the challenge, Mr. Slim's Telmex turnaround appears to be off to a promising start, telecommunications specialists say. Even though 1991 was considered a transitional year, the new owners managed to reduce costs by hundreds of millions of dollars. They installed a record number of new lines.

And they improved at least some of the service. Mr. Slim, finally finding a line in his office that works, dials the number for reporting service problems and—after a moment of suspense—the call goes through. "Our operator picked up in eight seconds," he says, checking his watch. "That wouldn't have happened a year ago." When asked to fill out Mr. Slim's first-year report card, an analyst at Nomura Securities, Joanne Smith, gives him an A.

For investors, Telmex is a play on a country that's coming on strong. "Buying Telmex is very much buying Mexico," says Raul Solis, director general of Mexico's Banco International, which helped plan the 1990 Telmex privatization. And buying Mexico, a nation of 80 million rebounding after a decade of economic stagnation, is very much in fashion. A record $5 billion in foreign capital flowed into Mexican stocks last year, more than half of that money into Telmex.

Room to Stretch

Robert Lamons, a retired military officer from Lawton, Okla., took note of Telmex after hearing that there were only five phone lines for every 100 Mexicans, half the phone density of the former Soviet Union. "I thought, 'Now there's a company that's going to grow,'" he says. Indeed it has: Telmex is expected to report that 1991 profit rose about 60% to around $1.8 billion as revenue grew about 30% to $5 billion. The stock Mr. Lamons bought last summer has more than doubled. (There are two ways to trade Telmex in the U.S.: The New York Stock exchange lists American depositary shares that each represent 20 "L" shares with limited voting rights; quoted on the Nasdaq are Telmex ADRs that each represent one full voting "A" share.)

Many telecommunications analysts think there's more to come. Telmex outshines the U.S. Bell holding companies in nearly every measure of growth potential, says analyst Jack Grubman, who wrote a glowing Telmex report for PaineWebber Inc. in November ("the right company in the right country at the right time"). He sees earnings growing 25% annually for five years, far faster than at the regional Bells. The Mexican government concession requires Telmex to increase lines by 12% a year through 1994, Mr. Grubman notes, adding that favorable regulation preserves the company's monopoly through 1996 and allows it flexibility on rate increases.

Counting Every Peso

If the government has been kind to Telmex, it's paid off. Through the sale of the Telmex stake to Mr. Slim's group and a later public offering of Telmex shares, Mexico has earned a total of $4.8 billion. The government still holds a 9.5% interest, worth $2.5 billion.

Southwestern Bell also has a warm place in its heart for Telmex. Its $953 million investment in 10% of Telmex has a current market value of $2.85 billion.

For Mr. Slim, sturdy as a lineman and rarely without a big cigar, the task is to make service soar the way the stock price has. The 51-year-old entrepreneur learned his first lessons in business from his father, a Lebanese immigrant who ran a general store in Mexico City. The father taught his eight-year-old son to use an accounting ledger to keep track of every peso of his allowance. Maybe that explains the keen eye for a good buy that Mr. Slim displayed during the Mexican debt crisis of the 1980s. While most businessmen were bailing out of Mexico, Mr. Slim built what's now Mexico's biggest business empire, ranging from mines to tire factories to cafeterias.

"Companies were absurdly undervalued," he says. "This country has endured worse crises than that of the 1980s, and it has always survived." Mexican history is a passion for Mr. Slim, who has a valuable collection of books on the Spanish Conquest and the Mexican Revolution.

He and his U.S. and French partners are hoping that Telmex's customers will take the long view when considering the company's service problems. Notes John H. Atterbury, president of Southwestern Bell's Mexican operations: "Telmex didn't get this bad overnight, and it's not going to get better tomorrow."

Telmex was a more or less typically ineffective Third World utility until the 1980s, when it was racked by a natural disaster and a manmade one. The 1985 Mexico City earthquake severely damaged the Telmex network. Meanwhile, Mexico's debt depression kept the government from making the huge investments needed to upgrade Telmex. In 1989, President Carlos Salinas de Gortari said the only way to make Telmex work was to privatize it.

In winning the controlling interest in Telmex, Mr. Slim's group narrowly outbid a consortium that included GTE Corp. Mr. Slim pledged to invest $13 billion over six years to double the number of phone lines. But he warned: "One must have patience."

He didn't realize how much patience would be needed until he got a good look inside. The first order of business was replacing Telmex's outdated analog technology with digital, which carries vastly more information. But the new managers encountered a mind-bending problem: For about a third of the lines in the system, Telmex lacked accurate information about how they were connected to the main network. "Before you can change lines you have to know where they run," says Mr. Atterbury. So Telmex is undertaking the laborious process of checking every line.

The new owners discovered that purchasing had been conducted in a similarly haphazard fashion. An audit found $300 million of equipment scattered in 105 Telmex warehouses throughout the country. The warehouses are being consolidated into just six equipment storage centers.

Mr. Slim's group had the opposite problem with maintenance centers: They were too centralized. All of the repair crews in Mexico City, which has 20 million residents, were crammed into 11 buildings. In one center there were 300 repair trucks—and one exit. It took an hour and a half each morning simply to roll all of the trucks onto the street. The new management built four maintenance centers last year and will add 14 more this year. They will have multiple exits.

Playing Hardball

One of the most burdensome legacies was an agreement to buy hundreds of millions of dollars worth of equipment over five years from local affiliates of Stockholm-based Telefon AB L.M. Ericsson and Paris-based Alcatel N.V. According to PaineWebber's Mr. Grubman, Telmex's suppliers were charging the company three times what the Bell companies pay for switches and other basic equipment. When Mr. Slim sought to renegotiate the agreement, he ignited a battle that dragged on all last year. "They were tough, tough, negotiations," says Rodrigo Calderon, an executive at Alcatel. "The new Telmex is not an easy client."

Unable to get the suppliers to budge after months of bargaining, Mr. Slim played hardball: He threatened to defer all of the purchases Telmex was obligated to make under the five-year agreement until the final year. Facing the prospect of four lean years, the suppliers agreed to lower Telmex's equipment rates by $250 million in 1992. To ensure that Ericsson's and Alcatel's prices stay competitive, Telmex has brought in American Telephone & Telegraph Co. as a third supplier.

"In a remarkably brief time, Slim has succeeded in giving Telmex a much more business-like management culture," says Jorge Arredondo, an Ericsson executive.

Having spent last year doing that, Mr. Slim now hopes to concentrate on building up the network. Juan Antonio Perez Simon, director general, says line growth for 1992 should reach 14%, well above the government's mandate. Telmex is expanding pay phone service by putting lines in mom and pop stores, where the presence of the store owners discourages vandals. Construction of an 8,000-mile fiber optic line connecting 54 cities is ahead of schedule.

Operators, who for years labored at 1940s vintage switchboards, are switching to computerized systems that enable them to handle 50 calls an hour, instead of the current 15. "We're shipping these to a museum," says Emma Rosa Hernandez, a supervisor, pointing to the old ones.

Technology won't solve all of Telmex's service problems. Even after it replaced the switchboards, management had to haggle with the balky telephone workers' union to reassign the people needed to run the new computers. That points to the biggest potential problem with the Telmex privatization: The owners and equipment may be new, but the workers are all too familiar. To prevent the powerful 45,000-member phone workers' union from blocking the privatization, the government specified in its concession that Telmex's new owner couldn't make layoffs.

Telmex has nearly twice as many employees per line as the average Bell company. Productivity has always been substandard. Repair crews have traditionally sold their services to the highest bidder. Telmex linemen for years refused to use cable protected with rain-proof jelly, because it was slippery to handle.

Wall Street Journal – 2/19

File mexico

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 9, 1987

TO: Mr. Luis Landau, Senior Economist, LC1DR

FROM: Jeno Malatinszky, Economist, LC1MX
(Through: Pieter Bottelier, Division Chief, LC1MX) P.B.

EXTENSION: 72561

SUBJECT: MEXICO - Financial Times on SIDERMEX Expansion

I refer to your query about the accuracy of the information in the attached article. The article is factually not precise. SIDERMEX's rated (theoretical) capacity in 1985 was equal to 6.75 million tons, although the actual production never surpassed 4.3 million tons. In 1986, with the closure of Fundidora, 1.5 million tons rated capacity (0.94 million tons actual production) ceased to exist. In addition to that, 1.1 million tons out of the 4 million tons rated capacity of AHMSA should be closed or replaced in the relatively near future, since it is based on obsolete Siemens-Martin technology. Half of it will be closed as part of Phase I of our project. In this way, parallel to the creation of 2.5 million tons of new capacity in SICARTSA II (not 2.7 as the article states) 2 million tons obsolete capacity will be closed and the net increase will be 0.5 million tons, i.e. 7.4% of SIDERMEX's rated capacity or 4.7% of the country's capacity.

It is questionable, even with these corrections, whether Mexico will need the new capacity in SICARTSA (given the necessity to do something with the facilities of AHMSA). Therefore, the Bank has recommended and will finance a comprehensive study of the whole steel market and facilities in Mexico. There is a preliminary agreement between the Bank and the Government that final decision on the use of SICARTSA II and ultimate modernization of steelmaking in AHMSA will be made based on the results of the study. It would be too early to speculate about the outcome of the study, but there may be such options as (i) to complete the SICARTSA II steel shop to (or operate at) less than full planned capacity; (ii) to modify and further reduce the steelmaking capacities in AHMSA.

cc: Messrs. Steckhan, LC1DR
Bottelier, LC1MX
Rowat, INDD3
Venkateswaran, INDD3

JMalatinszky:mac

Industrial output was estimated to have fallen 4.3 per cent in January, compared to the same month last year, and preliminary indications for February show no improvement. A very symbolic (limited to the decimals) cut in some interest rates was attempted in mid-March, after 20 weeks of stability at record high levels, but with both inflation and the government's borrowing needs expected to be running at a high level, at least for another few weeks, the authorities cannot afford to discourage the investor. The stock market has been jittery with erratic movements in the index of as much as 3 to 5 per cent on single day.

It therefore looks as if President de la Madrid will finish his term of office, having achieved zero growth over the six-year period. And worse may lay ahead. The difficulties of putting together this year's financial package with the foreign creditors do not augur well for the period later this year when the needs for 1988 have to be assessed.

The growing economic difficulties are occurring against a political background of heavy politicking for the presidential succession, unprecedented open dissent within the PRI, and renewed militancy even among official trade unionists. Those who think Mexico is on the mend could be in for some unpleasant surprises.

SIDERMEX STICKS TO ITS EXPANSION PLANS

Mexico's state-owned steel business is getting new foreign loans and customers. However, its domestic markets remain depressed and dumping accusations are hampering its export drive.

Sidermex, the government conglomerate that produces most of Mexico's steel, implemented deep production cuts last year and suffered a 50 per cent drop in federal subsidies. Its oldest steel mill, the money-losing Fundidora de Monterrey, was finally closed, while domestic steel demand fell to its lowest level in a decade.

Demand is not expected to rise substantially this year, yet Sidermex is proceeding with a multi-billion dollar plan to boost production. Its capacity to produce liquid steel should increase by 2.7m tonnes in 1988, a big jump from its present installed capacity of 6m tonnes.

A major part of this expansion — the conclusion of the long-delayed second phase of Sidermex's Sicartsa plant at the Pacific coast port of Lázaro Cárdenas — is being financed by a recently approved $260m loan from Japan's Eximbank. The government also plans to spend some $85m this year on the modernisation and expansion of Altos Hornos, the biggest Sidermex steel mill located near Monterrey.

The industry's boom ended some time ago. Steel mills expanded rapidly in the 1970s to serve an exploding domestic market fuelled by the funds and needs of the oil business. In 1981 Mexico's steel consumption reached a record 12.5m tonnes and Sidermex was forecasting 15.7m tonnes of domestic demand for 1985. But demand for steel collapsed along with the rest of the economy in the 1982 debt crisis; now, with Mexico's consumption down to 7m tonnes yearly, steelmakers are forced to sell surplus output abroad.

EEC trade officials are now investigating charges filed by European producers which claim that Sidermex sold some 70,000 tonnes of hot rolled steel plate in 1986 at below market prices. Sidermex has called the accusation "unfounded and unfair." Pleas from US manufacturers for countervailing duties against Sidermex products were largely withdrawn three years ago, when Mexico restricted its sales under a "voluntary" US import quota that keeps cross border exports below 400,000 tonnes annually.

In response, Sidermex is increasingly turning to more receptive markets in Indo-China, the Middle East and elsewhere in the developing world. Its best new customer is the Peoples Republic of China which last month took delivery of a massive 217,000-tonne order. Sidermex is also quietly getting into the barter business, trading steel plates for capital goods, and discussing the exchange of steel for Chinese coal.

■ American Express Bank, the banking subsidiary of the US financial and travel concern, has signed a deal to convert into equity in hotel projects $100m of its Mexican loans. It is the first time that a US bank has negotiated a debt-equity swap of such size and it is likely to raise several important regulatory issues.

Brazil

SAYAD BOWS OUT

After attempting — and failing — in an eleventh hour attempt to regain some say in economic policy-making, planning minister Joao Sayad resigned on March 17. Sayad was clearly out-manoeuvred, for a draft of his new economic stabilisation plan (with some

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: August 3, 1987

TO: Distribution

FROM: John J. Johnson, Senior Economist, LA2CO

EXTENSION: 73468

SUBJECT: MEXICO - Steel Sector Loan Yellow Cover Report

1. This note is being drafted as I am about to depart on mission, so it may not be as precise as I would prefer.

2. I wish to follow up on a point raised by Vittorio Corbo at our recent meeting on the Yellow Cover Report. It concerns the contention that the publicly-owned steel companies actually produce a range of basic flat steel products profitably at prices below international levels, including a fair allowance for financing overhead. This observation has always seemed at variance with the views of respected Mexican economists[1] as well as experience with parastatals in other countries. Moreover, it has seemed difficult to understand why the Government would want to hold the prices of these products below international levels, and, thus, incur large budgetary losses for a product which, after all, cannot be considered a basic consumer good like food or medicine.

3. It is my understanding that much of the statistical basis for this conclusion derives from data of December 1986. This was, of course, a month when the real exchange had fallen 55% below the level of July 1985. Such a sharp decline in so short a time could easily explain why international prices could appear to be higher than domestic prices, since, no doubt, adjustments of controlled prices would have lagged well behind. Indeed, calculations done for TPL II suggest that nearly all observed prices of tradeable goods, controlled and non-controlled, are below international prices at the current exchange rate.

4. The issues are: (a) whether, historically, domestic steel prices for these publicly-produced non-specialty steels have been below international levels, and, if not, what this says about the viability of continuing to use these enterprises as the major source of future supplies; and (b) whether there is any good reason to believe that, now that the adjustment to the oil shock and the lack of external finance in 1986 is advancing, the real exchange rate will be sustained over the project life at a level near that observed in December 1986.[2]

1/ Indeed, Francisco Dil Diaz, Director of Economic Research in the Central Bank, recently singled out the SICARTSA II project, along with the Laguna Verde nuclear reactor station, as the two major public sector investment projects of the 1980s which have experienced unreasonably high costs. See the forthcoming Mexico's Experience with Foreign Aid, Conference on Aid and Development, Talloires, France.

2/ There are many ramifications to this question which we have addressed elsewhere, for example, in the CEM and in the recent CPIR paper on the macroeconomic outlook.

5. I believe the comparisons of the prices would be more meaningful if a longer, more representative historical period were used (or, perhaps, if the December 1986 real exchange rate were replaced with a long-term average real exchange rate).

Distribution:

Messrs. Corbo (LA2CO)
Knotter (LA2TF)
Simon (EDI)
Venkateswaran (AS3IF)
Malatinszky (LA2CO)
Rivera (LATTF)

JHJohnson:jh

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

LAC

Mex - Steel Sector Restruc.

DATE: September 29, 1987

TO: Mr. S. Shahid Husain, LACVP

THROUGH: Rainer B. Steckhan, LA2DR

FROM: Paul Knotter, LA2TF

EXT.: 61271

SUBJECT: MEXICO - Proposed US$400 Million Steel Sector Restructuring Loan

1. I attach for your approval and subsequent distribution to the Operations Committee (OC), drafts of the Memorandum and Recommendation of the President, the Staff Appraisal Report, and the Loan, Guarantee and Project Agreements and the Invitation to Negotiate for a proposed Steel Sector Restructuring Loan to Nacional Financiera, S.N.C. (NAFIN), with the guarantee of the United Mexican States. The documents have been cleared with Environment, Procurement, Legal and Controller's units and relevant comments have been incorporated therein. Also attached is a copy of the current lending program for Mexico. This operation is one of three industrial restructuring operations that would qualify as link loans for Mexico's multi-facility financial agreement. Consequently the Government attaches high priority to these operations which are in an advanced stage of preparation.

2. The reason I propose to submit the package to the OC is that: (i) the proposed project is a hybrid operation with a policy-based component, that falls within the competence of the OC; (ii) a decision on the inclusion of this component is being sought from the OC; and (iii) in view of the sensitive issues that are raised by any operation in the steel sector, it appears prudent to seek final guidance from the OC and seek management approval for negotiations. The major policy issue related to decontrol of steel prices appears to have been resolved by a recent Government decision to eliminate all price controls on steel products in steps between January and June 1988. We received a telex from the Government on September 23 (copy attached) informing us of this decision and we expect to receive the detailed program in the next few days. If the proposed program is satisfactory, as expected, we recommend submitting this project to the OC. The following paragraphs address the price control and other issues that were either raised in the Loan Committee meeting on February 17, 1987 (minutes attached) or are the result of later developments. As discussed at that meeting, a SAR was prepared for this blend operation with a predominant investment component.

Project Design and Loan Amount

3. While the Government's original project request was to assist only the restructuring of the public steel sector, the Bank project preparation team recommended to include: (i) various policy measures that would help both the public and private sectors; (ii) elaboration of a

global steel strategy to define the development of both sectors, (iii) financial assistance to private steel producers under existing Bank credit lines and/or through the Industrial Restructuring Loan under preparation; and (iv) technical assistance to the private steel sector financed under the proposed Loan. The Government accepted most of these proposals, but the Loan Committee felt that some imbalance still remained between the assistance offered to the two sectors.

4. Following the recommendations of the Loan Committee, the appraisal mission reviewed closely the problems of the two major private steel companies: HYLSA and TAMSA. In parallel, HYLSA (i) developed a sound physical rehabilitation plan with the help of Nippon Kokan (Japanese consultant); (ii) worked out a debt restructuring plan with its creditor banks; and (iii) agreed on a preliminary term sheet that would allow the company to retain sufficient funds for the implementation of the rehabilitation plan. The appraisal mission found Hylsa's rehabilitation plan suitable for Bank financing, and it is proposed that a US$75 million component be included to support the rehabilitation of the HYLSA Monterrey plant. The disbursement of the HYLSA component would be contingent upon the signing of a satisfactory debt restructuring agreement between HYLSA and the creditor banks.

5. The mission could not develop a similar component for TAMSA because of (i) the severely depressed market situation for seamless tube, TAMSA's main product; and (ii) the lack of any serious restructuring plan of the company and no immediate prospects for agreement between TAMSA and its creditor banks. Since TAMSA has a very specialized production profile and serves a specific market (mainly PEMEX), its restructuring would only constitute a small part of the whole steel sector restructuring. Therefore, in this stage we propose no provision for financial assistance to TAMSA under the Bank loan. The technical assistance component of the Bank loan would be available for assistance in preparation of physical-financial restructuring studies to any steel related companies, including TAMSA.

6. A further issue relates to the policy-based component of the Loan. The Loan Committee approved the Region's proposal for a US$150 million fast disbursing policy-based component aimed at supporting the Governments comprehensive adjustment program for the steel industry. With regard to the entire steel industry, this program includes the liberalization of imports of steel products, elaboration of a national steel strategy, removal of domestic price controls and improvement of operating and investment conditions for the private sector. It also includes appointment of new management for SIDERMEX, rationalization of its corporate structure, delegation of decision making authority, closure of non-viable plants, massive divestiture and financial restructuring of the company. All these measures have been or are being implemented.

7. Since last February the foreign exchange reserve position of Mexico has improved dramatically and a fast disbursing component would no longer appear to be justifiable on BOP grounds. We are concerned, however, that, given the advanced stage of processing, transformation of the project into an investment project with policy conditionality could be understood by the Mexicans as a withdrawal of Bank support for the

Mr. Mangan
LAC Files

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

ME 2916

DATE: July 13, 1988

TO: Mr. Rainer B. Steckhan, Director, LA2

THROUGH: Paul F. Knotter, Chief, LA2TF

FROM: Neil C. Hughes, LA2TF

EXTENSION: 38771

SUBJECT: Mexico - Steel Sector Restructuring Project
Disbursement Request Under the First Loan Tranche

1. On June 3 and July 1, 1988 LOAEL received two disbursement applications totalling US$ 17.1 million under the US$ 50 million first tranche of the policy based component of the loan. This memorandum analyzes whether the conditions for first tranche release have been met, and recommends appropriate action.

Conditions for Disbursement

2. Under Schedule 1, Paragraph 4(d) of the Loan Agreement, as condition for disbursement for imports in support of the reform program under category (1), the Government is required to eliminate all official steel reference prices. This requirement was met prior to the end of 1987. In addition, Section 3.06 of the Guarantee Agreement links disbursements to progress achieved in carrying out the Steel Sector Reform Program as spelled out in a policy letter dated January 15, 1988 (annex 4-2 in the SAR), which included a timetable for decontrol of domestic steel prices by June 30, 1988.

3. After taking into consideration the provisions of the "Pacto Economico" introduced in December 1987, it was agreed at negotiations that changes in steel prices would intially be limited to graduated adjustments in accordance with projected monthly inflation starting from a base date of March 1, 1988. This agreement was reflected in Supplementary Minutes of Negotiations which stipulated that (i) the decontrol measures originally scheduled for January, March and June 1988 would no longer be conditions for disbursement, (ii) complete elimination of price controls would take place no later than December 31, 1988 rather than June 30, 1988, and would remain as a condition of disbursement of Tranche 2 of part A of the project, and (iii) based on prices prevailing on March 31, 1988 and beginning April 1, 1988 steel prices would be adjusted on a monthly basis to maintain them in real terms. However, in late February 1988 a price ceiling was put into effect under the "Pacto", and none of the monthly price adjustments envisaged above were carried out.

4. The main purpose of the project has been to increase the efficiency and competitiveness of the steel industry. Recent data on the performance of the sector under the "Pacto" appear to indicate that the sector's output and export performance is showing a steady improvement. In the year ended March 31, 1988, real output increased 16.5% over the prior year. Recent exports of base metals (largely steel) have increased at an even faster rate. They increased 45.1% in January-April, 1988 as compared to the same period last year. At the same time, costs in the steel sector

rose only 12% during the first four months of 1988 (the CPI rose 35% over the same period), while the effects of a 30% annual wage increase negotiated with the steel workers union in March, were partly mitigated by price increases in December 1987 and January 1988 that provide a buffer against price increases during the early months of 1988. Regretably, no recent market share information is available, which might indicate the degree to which foreign imports have been able to compete with domestically produced steel.

5. A comparison of Mexican domestic prices in June 1988 with c.i.f. (including a 10% tariff and 15% shipping and port costs) prices from Japan, Netherlands and Germany, indicates that Mexican domestic steel prices are generally competitive with international prices. For hot rolled coil, the Mexican price was 9-15% less than the three international prices. For cold rolled coil, the Mexican price was just 1% above the Japanese price, and it was 2% less than the Netherlands price and 4% below the German price. In the case of wire rod, the Mexican price was 5% higher than the Dutch and the German prices (no Japanese price quoted). Only in the case of reinforcing bars was there any significant difference between Mexican and international prices. The Mexican price was 11% above the Netherlands price, 19% above the Japanese price and 28% above the German.

6. The output, export and price data presented above, indicate that the price ceilings adopted under the "Pacto" have, overall, permitted the steel sector to compete efficiently with other international producers. Indications are that the profitability of the steel companies continues to be highly satisfactory. We consider, therefore, that a justification exists for temporarily suspending the price adjustments spelled out in the Supplementary Minutes of Negotiations which replaced the decontrol actions as preconditions for disbursement under category (1) for the duration of the price ceiling under the "Pacto". We should still insist, however, that full decontrol be carried out as soon as possible after the "Pacto" expires, or at the latest by December 31, 1988, as originally planned. In the interim, we will continue to monitor closely changes in both domestic and international steel prices, as well as to assess their effects on the sector's performance.

<u>SIDERMEX Strategic Plan and Global Steel Sector Policy</u>

7. SIDERMEX was required under its Project Agreement (Section 2.06 (a)) with the Bank, to furnish the Bank with a satisfactory five-year strategic plan no later than March 31, 1988. A supervision mission which visited Mexico during April-May 1988 reviewed the SIDERMEX plan and concluded that it required significant changes because it did not entirely conform to key elements of the strategy adopted for the Steel Sector Restructuring Project. British Steel Corp., which had done an earlier study for SIDERMEX, was engaged to do the new study, which is expected to be completed by August 1988 and discussed with the Bank in September.

8. According to Section 2.07 of the Project Agreement with SIDERMEX, the restructuring of SIDERMEX was supposed to have been carried out by June 15, 1988 , that is, 90 days after the signing of the loan documents. The restructuring has not been completed; however, the major portion of the

restructuring, which involves establishing the five independent companies under SIDERMEX, is expected to be completed by the end of August.

9. The failure to comply with the dated covenants indicated above, have delayed our policy discussion with the Government and left the strategy for SIDERMEX's future unclear. However, we have recently received a draft of the Government's Global Steel Sector Policy and, in a meeting on July 12, 1988 with Mr. Escofet, Subsecretary for Energy and Mines, we were asked to comment as soon as possible on the document and to be ready to discuss both the global policy and SIDERMEX strategy by the end of July. Under the circumstances, if compliance with the two SIDERMEX covenants is not achieved by say, the end of September, we should consider suspending disbursements under the investment component of the project (Part B). However, disbursements for general steel sector imports (Part A) should not be affected.

I thought we were not disbursing for that

10. If you agree, we recommend that LOAEL be instructed to process the two pending disbursement applications under category (1).

cw & cc: Mr. Hill

cleared in substance: Mr. Varallyay.

cc: Messrs. Steckhan and Lee (LA2DR); Martinez and Johnson (LA2CO); Iskander, Mangan, Meuniere, Goswani, (LATTF); Sugar, (LOAEL)

NCHughes

I concur
Please instruct LOAEL
to process the 2 pending applications
under category (1)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Mex-2916

DATE: 15 February, 1989

TO: Mr. Paul F. Knotter, Chief, LA2TF

FROM: R. Venkateswaran, AS3IF

EXTENSION: 7-4624

SUBJECT: MEXICO: Steel Sector Restructuring Strategy Some Additional Thoughts.

---

1. You asked me to jot down some of my thoughts on the strategy for restructuring of the Mexican steel sector, particularly, in light of possible alternatives that should be considered in evaluating the recent proposals from SIDERMEX to reopen the Aceros Planos facility at Monterrey.

2. The proposal to reopen the Aceros Planos facility and present dubious market justification is motivated by SIDERMEX' overwhelming need to justify the production of slabs at the SICARTSA II facility and to find a ready market for the slab output. At the same time, the pressure to make a political gesture in the industrial heartland of Monterrey is too great for the Government to ignore the demands for reopening of the Aceros Planos facility. The analyses that were carried out by the appraisal team and subsequently endorsed by the work of the British Steel consultants largely supported the view that Mexico could not justify the operation of three flat product facilities at this stage. The shipping of slabs from SICARTSA II to Monterrey could not be considered to be an economic proposition given the substantial transport inconvenience and inadequate infrastructure.

3. The HYLSA facility at Monterrey, on the other hand needs to be modernized; the current plan to invest in a major rehabilitation of the hot strip mill and then install a new cold mill (that is still in crates, having been acquired by HYLSA as part of a now defunct expansion program) would be substantially strengthened if HYLSA were to take over the operation of the Aceros Planos facility, substituting the relatively modern facility for its own run down plant, and selling its uninstalled cold mill to a steel mill overseas. HYLSA would then be able to modernize its plant at relatively low cost, reduce the time factor in achieving rehabilitation of its production line, and reduce its overall debt requirements for modernization; this is an important consideration given its recent restructuring, the continued presence of price controls preventing it from earning adequate returns on its non-flat production, and the yet unfinished financial needs for modernization. HYLSA would also find a ready buyer of its new cold mill in China, where at least one producer had already sought bids for such a mill and HYLSA had made an offer to sell albeit a bit late in the bidding process. As there are other Chines producers planning expansions of their existing

Hylsa is private? Aceros Plano part of SIDERMEX capacities, HYLSA should be able to find a buyer with relative ease in that country.

4. The problem of SICARTSA II would then remain to be dealt with. Again, the growing needs of the Chinese market, the practical limitations on building enough new steel capacity to satisfy those needs through the end of the next decade, and the attractiveness of the SICARTSA location on the Pacific coast afford a potential opportunity. A mutually satisfactory arrangement could be worked out whereby, the Chinese needs could be temporarily met by the slab production at SICARTSA II, thus reducing the investment needs and the time delays in China to set up an equivalent level of slab production, and the Mexican desire to operate the SICARTSA II facility in order to cover at least a part of the debt service needs on its financing could also be satisfied. The possibility of such tri-lateral arrangement, ie. sale of Aceros Planos to HYLSA, disposal of the HYLSA owned cold mill to China, and the development of a commercial arrangement between China and Mexico on the use of the SICARTSA II slab output, should be explored by the Bank with the Mexican authorities and eventually with the Chinese authorities as well. There have already been some preliminary inquiries that some consultants have made acting for and on behalf of Chinese enterprises. The Chinese investment priorities in the next two or three years are on the development of the basic industries that supply the inputs to downstream processing and to eliminate the continued major supply constraints in such basic sectors as steel, cement, petrochemicals, etc. The Bank and possibly IFC, could play a major catalytical role in attempting to marry the obvious needs of Chinese industry with the pressing need of the Mexican steel sector to modernize, raise its output and shut down obsolete facilities.

5.. In order to explore these ideas further, a consultant with world-wide experience in the steel industry should be engaged by the Mexican authorities, and acting under terms of reference to be agreed between the Bank and Mexico, should develop the needed analysis of the options, seek potential buyers, determine the most effective arrangement for a commercial agreement between Mexico and one or two Chinese producers, work out the financing plan and the other details of setting up and implementing a complex deal.

cc. Messrs. Stern, AS3IF, Mangan, ASTTF

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

2919-ME
2916-ME
2918-ME

Yellow

OFFICE MEMORANDUM

DATE: February 23, 1989

TO: Those Listed Below

FROM: Paul F. Knotter, Division Chief, LA2TF

EXTENSION: 38771

SUBJECT: MEXICO: Bank Position on the Three Existing Adjustment Loans for the Forthcoming CSIR

During a meeting on February 21, 1989 chaired (for most of the time) by Mr. Lee to discuss the status of the Fertilizer Sector Adjustment (FSAL) and Steel Sector Restructuring Loan (SSRL), it was decided that (i) the negative effects of the PACTO/PECE on the three existing adjustment operations (in fertilizers, steel and agriculture) in the areas of pricing and investment/operating budgets could not be tolerated any longer and (ii) this position should be conveyed at the CSIR with the intention of ultimately finding acceptable solutions for all three loans. In this context it was noted that the price freeze was becoming increasingly counter productive due to the resulting need for increasing budgetary transfers to cover operating and investment deficits.

In terms of the two loans discussed at the meeting, this means that: (i) we would not declare the FSAL effective unless all the conditions in the attached note prepared by Ms. Babelon have been met and (ii) we would indicate to the Mexicans that we would suspend the SSRL unless the pricing, budget and steel sector policy and strategy issues have been resolved to the Bank's satisfaction within a reasonable period of time (to be specified). Mr. Mangan is preparing a note on the SSRL. It was suggested during the meeting that a similar issues note with specific recommendations should be prepared for the AGSAL and that the three notes together with a covering memo would be sent to Mr. Husain early next week, i.e., in time for his decision prior to the CSIR. It was felt that taking a clear position concerning the unmet commitments under the three existing adjustment operations should also enhance the Bank's position for negotiating the package of the proposed three adjustment loans.

Attachment

Distribution: Messrs./Mmes. Lee (LA2DR); Martinez, von Wijnbergen, Croce, Varallyay (LA2CO); Binswanger, Nercissiantz, Garcia-Garcia (LA2AG); Halperin (LA2IE); Hughes (o/r), Musalem (LA2TF); Iskander, Mendez (LATTF); Babelon, Mangan, Venkateswaran (ASTIF); Collell, Manley, Ahmed (LEG); Sugar (LOA); Voljc (Res. Rep.)

PFKnotter:mlg

2916 ME
2-23-89

Mexico - Steel Sector Restructuring Project (Loan 2916-ME)

1. The Loan, of US$400 Million equivalent, was approved by the board in March 1988, signed and made effective immediately. There has been about US$30 Million in disbursements against Part A, the policy based component and US$20 Million to set up the revolving account for the investments in Parts B&C. Considerable delays and problems have developed particularly in the Steel Sector Reform Program and in adequate funding for investments, with the result that the Government was formally notified by letter in November 1988 that there had been no progress in fulfilling its obligations under the loan. A recent disappointing reply advised that information would be forthcoming, but it appears that no progress is being made. Details are included in the following paragraphs.

2. The Steel Sector Reform Program includes dated covenants requiring actions on; (i) trade policy; (ii) price policy; (iii) public enterprise restructuring and strategy and; (iv) steel sector policy. Item (i) was satisfied prior to Board presentation, all other items have passed the dates for action without satisfactory progress. Because of the acceptance of the PACTO, item (ii) was allowed to slide at least to the promised date for total price decontrol of December 31,1988. Items (iii) and (iv), which included presentation of the SIDERMEX Strategic Plan by March 31, 1988 and the Global Steel Sector Policy by July 31, 1988 received a great deal of unsuccessful attention. Satisfactory progress on the Steel Sector Reform Program is a condition for second tranche release of Part A and agreement on strategy and policy are necessary prerequisites for disbursement of investment funds for Parts B and C. The borrower however, does not seem to agree, since requests have been received to begin disbursements on the investment portions.

3. The Global Steel Sector Policy statement was presented to the Bank in draft form in July 1988 and jointly reworked into an agreed document by October 1988. The statement commits the Government to; (a) improving quality and efficiency throughout the subsector; (b) maintaining the current trade policy and competitive environment; (c) decontrolling prices and allowing internal market forces to prevail; (d) defining the SIDERMEX Holding Company organization; (e) continuing the funding of the Project covered by the subject loan; (f) making transparent the financial situation of the public sector companies including budget transfer, subsidies and capital investment; and (g) encouraging further investment beyond existing capacity (including SICARTSA II) to come in the private sector. Unfortunately, this work has never been finalized, nor agreed within the Government.

4. The SIDERMEX Strategic Plan has been in preparation since September 1987 with repeated help from British Steel Consultants. There are many problems with the drafts reviewed by Bank Missions to date. Most serious is the fact that the new Plan presented in May 1988 was, and continues to be, totally different from the agreed plan that was embodied in the Project that was presented to the board in March 1988. The major issue is the insistence on reopening an apparently uneconomic facility in the public sector to compete with the two loan beneficiaries in a very limited market. This threat has contributed to the decision by HYLSA, the private sector beneficiary of Part C

of the loan, to indefinitely delay their portion of the Project. The new Plan is in conflict with the loan agreements and with the draft Global Steel Sector Policy. Outside the Bank, there has apparently been no effort to reconcile these conflicts, nor any attempt within Government to critically review the Plan being put forward in the light of earlier commitments. No financial or economic supporting data has been presented, and it is doubtful that it exists since the only data in hand comes from British Steel work done in September 1988 which showed that the the reopening of Aceros Planos is not financially or economically viable under the current and projected market conditions. At this time, it seems unlikely that the Bank can accept this new Plan.

5. Price Decontrol is a critical part of the policy agenda but has been delayed under the PACTO, which in 1988 actually reduced domestic controlled steel prices about 8% on average, rather than raising them to keep up with inflation as agreed at negotiations. As a dated covenant to the loan, prices were to be totally freed by December 31, 1988. This has not taken place and the freeze is expected to continue through July 1989. This results in a major disadvantage to the private sector producers who have had to accept cost increases in labor, energy and materials and whose prices on about 70% of the production are well below international levels. On the other hand the public sector producers enjoy a major advantage since raw materials in the form of iron ore, and energy in the form of coal, are provided by the SIDERMEX Division, CMC, at a transfer price which is based on the selling value of the steel. Therefore, no matter what happens to steel prices the two largest input costs for the public sector remain under control.

6. The Investment Budget for the Project was cancelled by the Government in July 1988. This mainly affected AHMSA, where the delays in implementation are expected to reduce the projected cash flow over the life of the Project by over US$800 Million. The budget for 1989 causes a further problem since it does not provide sufficient funds for the Project, but instead diverts scarce industry and Government resources to the start-up of Aceros Planos. This further extends Project implementation which results in market erosion, higher capital and operating costs, delays in obtaining expected benefits and economic loss due to competition from higher quality imported steel.

7. In Conclusion, the intricate interactions, between the policy agenda and enterprise operations and investments, and between public and private sector steel producers and consumers, seem to have been forgotten, along with the real benefits to improving quality and the capability of the downstream industry to improve its competitiveness in world markets. The Project and loan were conceived as a total program supporting not only steel subsector reform, but also overall industrial sector improvement. To proceed, the original commitments must be reconfirmed, the lapse of memory overcome, and a consensus rebuilt within the Government and its enterprises. The recommended method for accomplishing this is to use the leverage of other operations to focus attention, and at the same time take on the role of consensus builder, accepting all the costs, efforts and likely problems. The only alternative is suspension, since the Project cannot continue in its present state.

February 23, 1989

ME-2916

March 31, 1989

Mr. Steckhan,

MEXICO - Steel Sector Restructuring Loan 2916-ME:
SIDERMEX Strategy and Aceros Planos Issue

Filed: 3-31-89

Attached please find a note prepared by Mr. Mangan analyzing the summary of the SIDERMEX strategic report prepared by British Steel Consultant's Ltd. which covers the Aceros Planos opening in 1989 as one option. It is clear from Mr. Mangan's note that the opening of the plant in 1989 would not be economically desirable, in particular given its negative impact on the steel sector as a whole. I have also discussed with him the possibility of looking into a limited number of likely alternative options. However, this approach would involve an infinite number of possible options and it would be necessary to discuss with the Mexicans which option(s) they would like to pursue. According to Mr. Voljc' recent communication on the Mexican package, Mr. Aspe expects to present to the Bank a strategic plan for the steel sector shortly as well as a position on pricing in the sector.

As you know I recently offered to Mr. Cervera again the Bank's help in providing the strategic plan, but he did not see any benefits from the Bank's involvement at this stage. This was confirmed in a telephone conversation I had with Hacienda today. I do not think we should be pushing our assistance too hard. There are other arguments to support this suggestion too. As I indicated to you, the Mexicans are apparently negotiating with the Unions a reduction in AHMSA's current staff of 21,000 by some 8,000 and are considering at least a gradual privatization of AHMSA. While this would clearly be steps in the right direction (and the Aceros Planos issue quite likely would disappear in this context), the situation is politically highly charged. Under the circumstances I strongly recommend to await the submission of the SIDERMEX strategic plan from the Mexicans and be ready to analyze it immediately upon receipt.

Paul Knotter

cc: Messrs.
Segura, LACVP
Lee, LA2DR
Martinez, LA2CO
van Wijnbergen, LA2CO
Hughes, LA2TF
Musalem, LA2TF

2116 ME

3-31-89

Mr. Paul F. Knotter, Chief, LA2TF

MEXICO - Steel Sector Restructuring Loan 2916-ME
British Steel Strategy Report

#931220

1/19

1. Attached is a brief report prepared by British Steel Consultants summarizing the conclusions contained in the Strategy Report finalized with SIDERMEX in October 1988. They point out that the report in the Bank files is the "draft" version, prepared earlier and that the final report was apparently not forwarded by SIDERMEX. There are some minor differences between the reports with the "final" version containing the missing economic analysis. The conclusions of both versions are the same, as seen from Section 6 of the attached, repeated in the following paragraph.

2. The report concluded, with respect to the Aceros Planos hot and cold mills facility, that "it would seem to have a limited viable future within the Sidermex Group, given the demand forecasts made in the report. Strip mill capacity is simply too great until the mid-1990's. A decision is needed as to whether the mill should be disposed of or moth-balled in such a way that its maintenance costs are reduced to a minimum. Its stock of slabs should be sold."

3. The financial and economic returns are based on projections through the year 2000. Based on the "expected" market forecast, opening Aceros Planos in 1995 has a 24% financial and 21% economic rate of return. Opening in 1989 reduces this to 12% in both financial and economic terms, due to the negative return of approximately 18% corresponding to a minus US$20 Million in the period 1989 to 1994. The report also states that the results are similar even with an assumed 10% larger market.

4. As we have stated before, a strategy for SIDERMEX that includes the reopening of Aceros Planos in the short term does not appear to be a viable proposition. Exports included in the above analysis are the major contributor to the negative returns since "export prices achieved by Sidermex are very low and provide corresponding low margins" due mainly to high operating costs and low internationally competitive quality.

5. All of this was explained and discussed in detail with SIDERMEX top management, British Steel, NAFIN, SEMIP and other representatives of Government during the last Supervision Mission in October 1988. In addition we pointed out that the expected negative impacts and losses to the rest of the industry and in particular the project beneficiaries are significantly higher than the direct losses to Aceros Planos. As pointed out in the recent status note which I have also attached, I am willing to review this again in Mexico, but I feel the Mexican position is based on something other than financial or economic criteria and, until they are willing to share their real reasons, further analytical work is a waste of time. I strongly recommend that we continue to wait for the information requested in Mr. Steckhan's November 1988 letter.

Edmund L. Mangan, ASTIF

March 31, 1989

ME-2916

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 20, 1989

TO: Mr. Paul F. Knotter, Chief LA2TF

FROM: Edmund L. Mangan ASTIF ELM

EXTENSION: 78000

SUBJECT: MEXICO-Steel Sector Restructuring Project (Loan 2916-ME) Status Report

Project and Loan Status

1. The subject loan, of US$400 Million equivalent, to provide assistance in Steel Sector Restructuring, was approved by the Board in March 1988, signed and made effective immediately. There has been US$37.4 Million in disbursements against the US$50 Million first tranche of Part A, the policy based component and the initial deposit of US$20 Million was made to set up the special account for the investments in Parts B & C.

2. Delays and problems developed almost immediately after the loan was signed, particularly in Government funding for the agreed investments and in the implementation of the agreed Steel Sector Reform Program which is the policy basis for the loan. After multiple missions proved unsuccessful in resolving these issues, the Government was notified by letter in November 1988 of the Bank's serious concern over the lack of progress in fulfilling the loan obligations and commitments.

3. In late February 1989, a reply was received advising that funding decisions would be made after July 1989 but in the meantime additional information would be forthcoming. A revised version of the SIDERMEX Strategic Plan was received in early April 1989, which is only one element of the Steel Sector Reform Program and it is unclear when additional action will be taken to comply with the obligations and commitments under the loan agreements. Details are included in the following paragraphs.

Project Funding

Bdgt:
- Govt Contribution
- Bank Loan.

4. The investment budget for the Project was cancelled by the Government in July 1988. This stopped the investment program for AHMSA, Part B.1 of the Project. The 1989 budget causes further problems since it does not provide sufficient funds for the Project, but instead diverts scarce industry and Government resources to the mothballed plant, Aceros Planos. According to a February 1989 mission, SPP advised that the SIDERMEX 1989 budget includes Mex$60 Billion (US$26.4 Million) for Aceros Planos and only Mex$50 Billion (US$22 Million) to be made available for the

" revised to M$ 225,000 billion, incl. [illegible] investment program supported by the loan and even those funds will not be available until the second half of 1989. These figures are significantly lower than any previously discussed and AHMSA had previously estimated that a budget of over US$100 Million was needed in 1989 to continue with the agreed investments.

5. The delay in project implementation in 1988 and 1989, will result in higher capital and operating costs, delays in obtaining expected benefits and economic loss due to competition from higher quality imported steel. The October 1988 Supervision mission estimated that as a result of the budget freeze, the AHMSA cash flow would be reduced by over US$800 Million over the life of the Project. The new budget will have a substantial additional negative affect and will further reduce the project returns to the point where the entire effort may become marginal in financial and economic terms. The Government has given no indication that the issue of providing the necessary funding is being further reviewed and there has been no response to the November request for the development of an agreed action plan covering the scope and timing for a revised implementation program.

The Steel Sector Reform Program

6. The Program detailed in the loan agreements includes dated covenants requiring agreed actions on; (i) trade policy; (ii) price policy; (iii) public enterprise restructuring and strategy and; (iv) steel sector policy. Item (i) was satisfied prior to Board presentation through the elimination or reduction to 5% of import tariffs on all relevant steel products. Although considerable effort was made, agreement has not been reached on the other items and the specified dates have passed without satisfactory progress.

7. With the acceptance by the Bank of the economic measures embodied in the PACTO, item (ii) was allowed to slide at least to the promised date for total price decontrol of December 31,1988. This date has now passed with only a promise by Government to review the issue again after July 1989. Resolution of items (iii) and (iv), which included commitments for presentation of a SIDERMEX Strategic Plan by March 31, 1988 and elaboration of the Government Global Steel Sector Policy by July 31, 1988, received a great deal of unsuccessful attention. Details of these three items are included in the following paragraphs. Satisfactory progress on the total Steel Sector Reform Program is a condition for second tranche release of US$50 Million for Part A. An agreement on strategy and policy are necessary prerequisites for disbursement of investment funds for Parts B and C.

Price Policy

8. Domestic steel price decontrol is a critical part of the policy agenda for the subsector but has been severely delayed under the PACTO. As a dated covenant to the loan, prices were to be totally freed by December 31, 1988. This has not taken place and the freeze is now expected to continue through July 1989. Currently controlled steel prices range from near import parity to about 20% below international levels depending on product.

9. Prior to loan signing controlled prices were raised to approximate international levels. In September 1988 they were reduced by about 8% on average, rather than increased to keep up with inflation as agreed at negotiations. International demand and price have steadily increased in the same period, with the result that domestic prices are again well below international levels. Since the domestic producers cannot obtain the same price as higher quality imports, there is no incentive to compete at these higher quality levels, thereby returning the industry to a position of providing low quality and poor service to the downstream industrial consumers and defeating a basic objective of the project.

10. The continuation of price controls also impacts the major objective of increasing the incentives for private sector steel producers to invest in improving their facilities and expanding to satisfy domestic market requirements. Without a consistent price policy which provides adequate returns based on market prices which they are able to influence, the private sector has no incentive to invest. This gives SIDERMEX the public sector producer, the opportunity to falsely claim that industry development is their prerogative since they are the only ones willing and able, through Government subsidy, to make the necessary investments.

11. The cost/price squeeze affects all the producers in varying degrees due to increases in materials, energy, labor and other inputs, particularly imported spare parts. However, it is most disadvantageous to the private sector whose prices on about 70% of the production are those farthest below international levels. Price increases in raw materials and energy, which include scrap, purchased mainly from the United States and domestic natural gas and electricity must be absorbed totally by the private sector producers. The technical configuration of the public sector plants however, provide an advantage in raw material and energy costs. Iron ore and coal, the two major cost inputs to these integrated facilities, are provided by the SIDERMEX company CMC, the beneficiary of Part B.2 of the loan, at a contract price which is proportional to the selling value of the steel. As a result, no matter what happens to steel prices, the two largest input costs for the public sector remain under control.

12. In summary, continuation of price control defeats the major objectives of policy reform on which the project is based.

It discourages improvement in product mix, quality and international competitiveness in the steel consuming industrial sector, removes the incentives for investment by private sector steel producers and distorts the competitive positions of public and private producers.

Global Steel Sector Policy

13. A policy letter was provided by the Government prior to board presentation and included in the loan documents. It was agreed at negotiations that a final statement, based on the letter and acceptable to the Bank, would be elaborated to the industry in order to clearly state for all concerned the Government's role in the steel sector and the policy environment in which the private sector could do its operating and investment planning.

14. The policy statement received serious attention from SEMIP and a draft was prepared for Bank review in July 1988. Subsequent Bank missions worked with SEMIP on the preparation of an agreed draft by October 1988. The statement commits the Government to; (a) improving quality and efficiency throughout the subsector; (b) maintaining the agreed trade policy and competitive environment; (c) decontrolling prices and allowing internal market forces to prevail; (d) defining the SIDERMEX Holding Company organization; (e) continuing the funding of the Project covered by the subject loan; (f) making transparent the financial situation of the public sector companies including budget transfer, subsidies and capital investment; and (g) encouraging further investment beyond existing capacity (including SICARTSA II) to come in the private sector.

15. The agreed policy statement is in conflict with the SIDERMEX Strategy which has not been agreed with the Bank. The major conflicts are in regard to the redirection of funding for the investments at AHMSA, Part B.1 of the loan, to the expansion of SIDERMEX operations and investment in other facilities and the reduced opportunity for participation by the private sector, in particular HYLSA whose investment program is supported by Part C of the loan. The pivotal issue is the projected reopening of Aceros Planos by SIDERMEX to compete with AHMSA and HYLSA in the limited flat products market in the country. The policy statement, to our knowledge has not been finalized. However we assume that, since the "Plan Estrategico de SIDERMEX" just received, has not wavered on the conflicting issues, the internal conflict must have been settled in favor of SIDERMEX and that the agreed policy will probably be amended to the detriment of the industry as a whole.

The SIDERMEX Strategic Plan

16. A restructuring plan for the steel sector was developed by SIDERMEX and the Government and embodied in the SIDERMEX Convenio

which was supported by the Bank in both the steel subector study in 1986 and the appraisal of this project in early 1987. The SAR included a detailed operating and investment program developed by SIDERMEX and agreed by the Bank. In order to assist with long range planning and to provide the private sector with information on the Government intentions in both operations and investment it was agreed that SIDERMEX would prepare a long range plan based on assistance from recognized international consultants. This work was completed in September 1987 with assistance from British Steel Consultants.

17. It was expected that the resulting SIDERMEX Strategic Plan would be consistent in the short term with the agreed plan on which the project was based. The Bank Supervision mission in May 1988 reviewed the first draft of this plan and found that it had ignored the conclusions and recommendations of the consultants as well as the agreements with the Bank. The major issue is the financial and economic merit of reopening Aceros Planos, as a separate flat products facility in the public sector to utilize semifinished steel from the new SICARTSA II facility for export and to compete with the two loan beneficiaries in a very limited domestic market. This threat has contributed to the decision by HYLSA, the private sector beneficiary of Part C of the loan, to indefinitely delay their portion of the Project.

18. Agreement was reached during the May 1988 mission for SIDERMEX to again use the services of British Steel Consultants to assist in developing an analysis of the strategic options and to include with the technical recommendation the needed financial and economic analysis. Their report concluded, with respect to the Aceros Planos hot and cold mills facility, that "it would seem to have a limited viable future within the Sidermex Group, given the demand forecasts made in the report. Strip mill capacity is simply too great until the mid-1990's. A decision is needed as to whether the mill should be disposed of or moth-balled in such a way that its maintenance costs are reduced to a minimum. Its stock of slabs should be sold." In addition, based on projections through the year 2000 and the "expected market" forecast, opening Aceros Planos in 1995 has a 24% financial and 21% economic rate of return. Opening in 1989 changes this in both financial and economic terms, with a the negative return of approximately 18% in the period 1989 to 1994. The report also states that the results are similar even with an assumed 10% larger market.

19. Despite this conclusion, SIDERMEX submitted their Strategic Plan to the Government including the reopening of Aceros Planos, again ignoring the consultant report and analysis. The October 1988 mission again reminded SIDERMEX management that the strategy being discussed had to be supported by financial and economic analysis that included the main strategic options. These were spelled out in the mission's aide memoire and are included in the attachments to this memo.

20. As before, the new "Plan Estrategico de SIDERMEX" recently received, which was to contain the proper analysis in order to settle this key issue and allow the project to move ahead, is the same as all the ones previously presented. The attached report prepared in the Bank, includes comments on the plan's analytical methods and results and concludes that the strategy does not represent a viable operational or investment plan and is not technically acceptable. The Bank analysis is limited due to the lack of information presented, but demonstrates that even under the most favorable conditions the financial return associated with reopening Aceros Planos in 1989 is a negative 17.6% through the year 1994. This result closely parallels the British Steel work. It also indicates that on a very conservative basis, in economic terms the proposal has a negative present value of US$131 Million on the proposed investment of US$79 Million.

Conclusions and Recommendations

21. The "Plan Estrategico de SIDERMEX" is not acceptable as part of the Steel Sector Restructuring Project from a technical, financial or economic standpoint. It is also difficult to imagine how it can be accepted by the Government since it acts to defeat the sound measures taken within the subsector to date and will require additional subsidies for an industry which would not need them if the originally agreed reforms were allowed to take place.

22. A short term plan that focuses on the agreed restructuring steps of balancing and technically upgrading AHMSA, CMC and HYLSA appears to be a more viable option, leaving the reopening of Aceros Planos, as recommended by British Steel, to a time when it is financially and economically justified or selling the facility to the private sector. There does not seem to be a rational for directly linking the operation of SICARTSA II to Aceros Planos. The former should be able to operate independently as an exporter of high quality steel slabs in the growing international market for semifinished steels thereby contributing to its debt service.

23. The intricate interactions, between the policy agenda, enterprise operations and investments and between public and private sector steel producers and consumers seem to have been forgotten, along with the real benefits to improving quality and capability of the downstream industry to compete in world markets. The Project and loan were conceived as a total program in support of steel subsector reform and industrial sector improvement. Government actions to date, and in particular the apparent support of the SIDERMEX Strategic Plan, do not contribute to this objective nor to the implementation of the total program.

Attachment 1

MEXICO STEEL SECTOR RESTRUCTURING PROJECT

SIDERMEX STRATEGIC PLAN
APRIL 1989 REVIEW

1. A restructuring plan for the steel sector was developed by SIDERMEX and the Government and embodied in the SIDERMEX Convenio which was supported by the Bank in both the steel subector study in 1986 and the appraisal of this project in early 1987. The SAR included a detailed operating and investment program developed by SIDERMEX and agreed by the Bank. This is highlighted in attachment 3. The plans that have been presented since loan signing in March 1988 have been prepared on a different basis than that embodied in the loan and have consistently lacked sound financial and economic analysis and planning. It appears that once the loan was secured the original agreements were forgotten.

Summary

2. The SIDERMEX Strategic Plan, recently received, is different in content but the same in conclusion as the drafts reviewed in May and October 1988. The recommendation being made is to reopen the Aceros Planos rolling mills to convert high quality slabs from the new SICARTSA II facility to lower quality flat products to compete in a limited domestic market and for export. This is based on the false supposition that this is an effective method of adding value to SICARTSA II slabs rather than directly exporting that output. This recommendation, if carried out, would take investment funds and market share away from the producers already serving the flat products market. This would result in a subsidized operation in the form of investment, transportation and transfer prices competing with the loan beneficiaries with no apparent rational objective other than to consume SICARTSA II slabs and disrupt the market.

3. The attached analysis prepared in the Bank, compares the alternative recommended in the SIDERMEX Strategic Plan with the strategy included in the SAR. The Bank analysis is limited due to the lack of information presented, but demonstrates that even under the most favorable conditions the financial return associated with reopening Aceros Planos in 1989 is a negative 17.6% through the year 1994. This result closely parallels the British Steel work done in 1988 which showed a negative 18% associated with this option. It also indicates that on a very conservative basis, in economic terms the proposal has a negative net present value of US$131 Million on the proposed investment of US$79 Million.

at what discount rate? 10%

3. The loan documents require that SIDERMEX prepare a Strategic Plan satisfactory to the Bank. Previous Bank missions have pointed out that this requires a financial and economic analysis that shows the proposed investments in the plan make sense for SIDERMEX and Mexico. The Strategic Plan presented in April 1989 still does not satisfy those criteria.

Attachment 1

Background

4. In order to assist with long range planning and to provide the private sector with information on the Government intentions in both operations and investment it was agreed at appraisal that SIDERMEX would prepare a long range plan based on the program agreed in the restructuring project and with assistance from recognized international consultants. This work was completed in September 1987 with assistance from British Steel Consultants. The results formed the basis for the existing project and loan. During negotiations it was agreed that SIDERMEX would present a long term strategy acceptable to the Bank by March 31, 1988 as specified in the loan documents. Since the assistance provided by British Steel Consultants in September 1987 had verified the program being proposed to the Bank it was expected that the resulting SIDERMEX Strategic Plan would be consistent in the short term with the agreed plan on which the project was based. It was also expected that the Strategy would focus on the longer term issues and provide the needed financial and economic analysis relating to the SICARTSA II facility that at the time was being completed.

5. The Bank Supervision mission in May 1988 reviewed the first draft of this plan and found that it had ignored the conclusions and recommendations of the consultants as well as the agreements with the Bank. The major issue became the financial and economic merit of reopening Aceros Planos, as a separate flat products facility in the public sector to utilize semifinished steel from the new SICARTSA II facility for export and to compete with the two loan beneficiaries in the limited domestic market.

6. Agreement was reached during the May 1988 mission for SIDERMEX to again use the services of British Steel Consultants to assist in developing the methodology for analysis of the strategic options and to include with the technical recommendation the needed financial and economic analysis. This work was carried out during the summer and fall of 1988 and the final reports were presented by British Steel to SIDERMEX and the Bank in October 1988. Their report concluded, with respect to the Aceros Planos facility, that "it would seem to have a limited viable future within the Sidermex Group, given the demand forecasts made in the report. Strip mill capacity is simply too great until the mid-1990's. A decision is needed as to whether the mill should be disposed of or moth-balled in such a way that its maintenance costs are reduced to a minimum. Its stock of slabs should be sold." In addition, based on projections through the year 2000 and the "expected market" forecast, opening Aceros Planos in 1995 has a 24% financial and 21% economic rate of return. Opening in 1989 changes this in both financial and economic terms, with a negative return of approximately 18% in the period 1989 to 1994. The report also states that the results are similar even with an assumed 10% larger market.

7. Despite this conclusion, SIDERMEX submitted their Strategic Plan to the Government including the reopening of Aceros Planos, again ignoring the consultant report and analysis. The October 1988 mission again reminded SIDERMEX management that the strategy being discussed had to be supported by financial and economic analysis that included the main strategic options. These were spelled out in the mission's aide memoire and are included in paragraph 10.

Attachment 1

Alternatives Considered

8. The proposed Plan includes five alternatives with four based on the opening of Aceros Planos in 1989. The fifth alternative which includes disposing of both SICARTSA and Aceros Planos is not fully developed nor treated with any seriousness in the analysis. For example the $600 Million selling value for SICARTSA is not credited to the option. The alternatives presented in the proposed Plan are:

> Alternative 1. AHMSA completes its Phase 1 modernization and closes down the plate mill in 1995. Aceros Planos begins operations in 1989 recovering part of its former domestic market. SICARTSA II completes construction of the plate mill in 1993 and begins production of plate in the first quarter.
>
> Alternative 2. AHMSA delays start up of Phase 1 modernization one year. Operation of the plate mill is continued until 1996. Aceros Planos begins operations in 1989 recovering part of its domestic market, primarily displacing AHMSA from the market. Start up of the SICARTSA plate mill is delayed until 1994.
>
> Alternative 3. The operation of the SICARTSA II plate mill is permanently cancelled and AHMSA continues operation of its plate mill. Aceros Planos starts up operations in 1989.
>
> Alternative 4. This considers selling SICARTSA II and Aceros Planos.
>
> Alternative 5. This considers the simultaneous operation of the plate mills at both AHMSA and SICARTSA II with the later beginning production in 1994.

9. The selection of alternatives clearly shows that the issue of when to start or stop a plate mill is far more important than the basic decisions regarding whether to restart a whole facility. The October 1988 mission suggested that in order for the Bank to be able to evaluate the merits of various options that a summary document should be prepared in which the key assumptions and evaluations are presented along with the supporting financial and economic analysis. It was also suggested that the investment program for SIDERMEX be spelled out for the life of the project. The proposed plan does attempt to do this, although inconsistently. The investment requirements are partially given for Alternative 1 as are the financial results in cash flow terms. The investments are as follows (AHMSA and CMC are beneficiaries of Parts B.1 and B.2 of the Bank Loan):

> AHMSA - US$378 Million which coincides with the Bank Project.
>
> SICARTSA I - US$347 Million which is a new figure. Prior investment values discussed with the Bank were significantly lower.
>
> SICARTSA II - US$433 Million which does not include investments in

1158

raw material development.

1527 Aceros Planos - US$79 Million which includes start up and some new equipment.

CMC - US$290 Million which coincides with the Bank Project.

The funds for these investments would have to be budgeted in the period 1989 through 1994. The plan projects that AHMSA would supply the major cash within the group for these investments.

10. The October mission also suggested several alternatives be explored but their results are not included here and they may not have been run. These were:

> Base Case. The strategy on which the project and loan are based. This includes no investment in Aceros Planos and the facility not operating until 1994. This assumed all slabs produced by SICARTSA II in the Base Case are sold in the international market at (i) the export price included in the Base Case and (ii) the world price of US $270/tonne reduced by 10% to allow for discount in entering the international market.

Sidermex Price

> Alternative 1. The strategy selected by SIDERMEX with financial and economic detail along with a clear indication of assumptions.

> Alternative 2. Same calculations as the Base Case with Aceros Planos sold to HYLSA at a selling price based on the net present value of the cash generated by Aceros Planos in Alternative 1.

> Alternative 3. Same calculations as the Base Case and Alternatives 1 & 2 with no delay in completion of the SICARTSA II Plate Mill and it competing with the AHMSA mill in the domestic market and exporting the balance.

Why?

11. Although these other alternatives were not run the proposed plan appears to be better prepared than earlier versions. The results appear slanted to support the predetermined conclusion but at least some effort was made to construct a logical report supported with some analysis. This may provide a basis for future work.

Other Comments

12. The proposed plan recommends a program for operation and investment significantly different from that originally proposed by SIDERMEX and embodied in the Restructuring Project and loan. The projection of domestic market made at the time of appraisal indicated that the capacity of both companies was sufficient to support domestic demand with the small excess capacity exported. The proposed plan assumes a much larger market growth, which is questionable, and as a result attempts to make a case for the reopening of the third flat products producer.

13. Two of the years in which the market is projected to rise

dramatically, 1990 and 1991, coincide with the time for rebuild of AHMSA equipment. Although British Steel Consultants provided estimates of possible production during rebuild, the figures used in the plan are further reduced. Even so, imports during the period peak in 1991 at a total of only only 135,000 tonnes which is less than the level of flat product imports in the 1985-86 period and less than 3% of the apparent steel consumption.

14. The market growth rate for flat products used in the projection is 2.0% in 1989-90, jumping to 6.1% in 1990-91, 6.3% in 1991-92 and 6.6% in the years through 1994 after which it drops back to 6.0%. This compares to an annual growth rate used in the SAR of 4.4% for flat products. Historically, there has been little actual growth in steel consumption since the 1982 decline with the 1988 figure being less that that of 1984 and 1985 and about equal to 1986 and 1987. Although the sudden and sustained increases projected by SIDERMEX seem risky the Bank analysis attached uses the market figures as presented.

1989 – 1994 5.5%

15. The high market estimates do not provide sufficient market to justify a third facility due to the low capacity utilization that would result. Therefore the plan decreases the participation of AHMSA in the domestic market to allow room for a high percentage of Aceros Planos products and then assumes export of the remaining production of the two facilities at about 85% capacity utilization levels. This scenario reduces the cash flow at AHMSA and increases it at Aceros Planos. When viewed independently this apparently makes the case for the reopening of Aceros Planos. But in fact this results in practically no new cash being earned and cash sharing only distorts the real projected return on investment.

16. Comparison of present values in the summary table and the results of the proposed plan is based on a discount factor of 5%. The value appears to have been chosen to give more value to alternatives with a larger gestation period of benefits. This also penalizes the alternative dealing with sale of assets. Bank calculations used 10% which was thought to be more realistic for a planning exercise.

17. Railway transport of slabs between SICARTSA II and Aceros Planos is mentioned as a risk but the transport price per tonne of steel is given at US$20. This was not changed in the Bank calculations, however, it is expected that the economic value would be much higher since it is doubtful that the 350 unit trains and railway cars, along with the engines needed to move them, currently exist or could be transferred from present use to a new dedicated purpose. Additional railway transport would also be needed to move the exportable output from Aceros Planos to a port of embarkation. The cost for putting all of this into service including track and equipment maintenance is not mentioned in the report, but would seem to be of a significant magnitude. The Bank analysis does not penalize the economic return for these factors.

Prices

18. The proposed plan does not include details of prices used in the projections. In the Bank analysis prices were taken from the October aide memoire which reported prices used by SIDERMEX at mid-1988. The plan

states that it also uses prices from mid-1988 which should be the same. They are as follows:

FLAT PRODUCT STEEL PRICES
US$/ tonne

	Domestic	Export	Current World Price
Slab	230	210	270 a/
Plate	463	312	460 b/
Hot Rolled Sheet	405	276	430 b/
Cold Rolled Sheet	562	393	540 b/

a/ Brazil FOB export price, October 1988
b/ World Bank Commodity Price Data, December 1988

19. Export prices are assumed to be at these low levels due to quality differential in the world markets for Plate, Hot Rolled Sheet and Cold Rolled Sheet. This should not be the case for slabs which should compare favorably with the world's best quality from SICARTSA II.

Analysis of the Plan

20. The attached notes and tables provide the results of the Bank analysis of the proposed program. The analysis compares the proposed plan with the original plan on which the loan is based and concludes that:

1. The gross revenues from following a rational production strategy for AHMSA are moderately higher in the original plan each year, as should be expected if AHMSA were to reduce exporting at throw-away prices.

2. The additional savings from not operating the Aceros Planos plant, together with the increased revenues from AHMSA due to a rational strategy compensate for the loss in revenues in Alternative 1.

3. The net effect is that through 1994, implementation of the SIDERMEX alternative 1, would have an incremental net present value of negative \$28 Million and an incremental IRR of negative 17.6%

4. Beyond 1994, the increasing market demand results in a need for additional facilities, and alternative 1 yields a positive incremental NPV of \$-130 million, at the SIDERMEX assumed transfer price of Slab from SICARTSA II of \$ 230/ton.

5. If the transfer price of slab from SICARTSA II were to valued at current world market price of \$270/ton (now being achieved by the Brazilian producer TUBERAO), the results show a net present value of negative \$131 Million through 1994, and negative \$ 59 Million through 2000. Thus, if SIDERMEX were to price the slab transfer from SICARTSA II at its market value in international trade, alternative 1 would not show a positive return under any circumstances.

Attachment 1

6. If upward adjustments on railway transportation and other inputs were factored into this analysis, as to better reflect the economic cost of opening Aceros Planos, the already negative net present value would drop further.

Conclusion and Recommendation

21. The SIDERMEX Strategic Plan, based on the opening of Aceros Planos to utilize slab production from SICARTSA II, in the present market conditions, does not appear viable from a technical, financial or economic viewpoint. It ignores the higher the return to SIDERMEX and the country that could be obtained by completing the modernization of the AHMSA facility in the shortest possible time. The dilution of available investment funds and reduction of AHMSA market share will further delay the benefits of the agreed project and loan and produce a negative net present value for the proposed investments. In addition, Aceros Planos would operate as a subsidized facility in terms of, investment, transportation and transfer pricing. These are not acceptable criteria under the loan agreements nor should they be acceptable to the Bank, SIDERMEX or the Government.

22. With the current shortage of slab in world markets, it is completely irrational for SICARTSA II and Mexico to forego the opportunity of obtaining maximum benefits from the world's most modern Slab Mill by exporting all of the slab production into the international market. No credit was taken in this analysis for this option but at a US$40 differential on the domestic market and an estimated US$60 differential on export sales the additional revenue for export of 1.5 million tonnes per year would far exceed the contribution hoped for by opening the Aceros Planos facility to substitute for a few thousand tonnes of steel imports.

23. We recommend that the alternatives reviewed be expanded to include those recommended by the October 1988 mission and included in paragraph 10 above and that agreement be sought with SIDERMEX and the Government to develop a strategy that has a positive return on the funds to be invested and at the same time reduces or eliminates the requirements for transfers and subsidies from the Government.

April 20, 1989

		[illegible]	1992-2001
Capacity	HYLSA	1.0	1.1 ✓
excl. Plate mill.	AHMSA	1.5 (1.1C[illegible]) (0.5)	2.0 -2.25 → 1.3CRC (+0.9 [illegible])
Plate mill	AP	–	0.8 1.0 → 0.5[illegible]C
	SICARTSA	slabs	(1.5) Plate mill

M[illegible]

Attachment 3

MEXICO STEEL SECTOR RESTRUCTURING PROJECT

1. This attachment provides a recap taken from the SAR of the agreed programs for SIDERMEX that are embodied in the loan agreements of March 1988. This was the basis for the expected SIDERMEX Strategic Plan and are presented here for reference.

SIDERMEX Restructuring Program

2. The program for SIDERMEX includes: investments in the major flat product facility, AHMSA, aimed at improving the quality and competitiveness of its hot and cold rolling lines and improving the utilization of its heavy section mill through the addition of equipment for the production of rail; investments in the raw materials division, CMC, to ensure adequate coal and iron ore supplies for the steel plants; and assistance to SIDERMEX in strategic planning and other studies.

3. The AHMSA component concentrates on shifting the product mix to flat products, heavy structurals and rails with an overall reduction in steelmaking capacity and improvements in quality and lowering of costs of production, primarily in hot and cold rolled sheet and tin plate. The major technical thrust is to (i) rationalize the steelmaking and continuous casting facilities; (ii) rehabilitate and improve the quality and productivity of the hot strip mill; (iii) balance the cold rolling mills and improve the quality of cold rolled products; (iv) provide catch-up maintenance throughout plant operations and in the plantwide utilities and services; (v) expand the product line by using the underutilized heavy structural mill for the production of rail; and (vi) provide for enhancement of systems and training. The investments include equipment for improvement of the steel-making facilities, the hot and cold rolling mills, rail section mill and plantwide maintenance including utilities and services, as well as services of consultants for enhancement of management information systems, engineering and project management and development of training programs and expenditures for overseas training of operating personnel.

4. The CMC component concentrates on raising productivity in the coal mining operations and strengthening the Hercules iron-ore operation, bringing it to its intended level of operation, throughout a mixture of maintenance and equipment renewal, debottlenecking investments, systems and controls and technical assistance for project management, operational improvements and upgrading of technical skills. The proposed investments include replacement of mining, transport and conveyor equipment, purchase of new coal crushers, installation of an iron-ore concentrator facility and consultant services for implementation of accounting and management information systems, and for project management and training.

Attachment 2

state-of-the-art technology. In particular, the slabs from SICARTSA II, the world's newest and most modern steelmaking and slab casting facility, would command world market prices, and need not be given away as gifts from the Mexican people!

The results of the analysis in Table 11 are as follows:

1. The gross revenues from following a rational production strategy for AHMSA are moderately higher in each year, as should be expected if AHMSA were to reduce exporting at throw-away prices.

2. The additional savings from not operating the APSA plant, together with the increased revenues from AHMSA due to a rational strategy almost completely compensate for the loss of APSA revenues in alternative 1.

3. The net effect is that through 1994, the SIDERMEX alternative 1 compared with the alternative described above, results in an INCREMENTAL NET PRESENT VALUE OF NEGATIVE $28 MILLION AND AN INCREMENTAL IRR OF NEGATIVE 17.6%!!

4. Beyond 1994, the increasing market demand results in a need for additional facilities, and the alternative 1 yields a positive incremental NPV of $ 130 million, at the SIDERMEX assumed transfer price of Slab from SICARTSA II of $ 230/ton.

5. IF the transfer price of slab from SICARTSA II were to valued at current world market price of $270/ton (now being achieved by the Brazilian producer TUBERAO), the results show an INCREMENTAL NET PRESENT VALUE OF NEGATIVE $131 MILLION THROUGH 1994, AND NEGATIVE $ 59 MILLION THROUGH 2000!! Thus, if SIDERMEX were to price the Slab transfer from SICARTSA II at its market value in international trade, alternative 1 would NOT SHOW A POSITIVE RETURN UNDER ANY CIRCUMSTANCES! With the current shortage of slab in world markets, it is equally irrational for SICARTSA II and Mexico to forego the opportunity to obtain maximum benefits from the world's most modern Slab mill by exporting all of the slab production into the international market.

April 20, 1989

5. Strategic planning studies for SIDERMEX are aimed at assisting SIDERMEX management in: (i) carrying out a long-term strategic study including the necessary supporting technical studies; (ii) undertaking the corporate-wide asset revaluation exercise and translating the results into a suitable financial structure; (iii) implementing the organizational and financing restructuring measures that emerge after the completion of the long-term strategic studies; (iv) assisting in the detailed planning of the long-term strategic investments; and (v) providing assistance for implementation of corporate level management information systems.

Long-term Action

6. By the end of the proposed project, SIDERMEX is expected to be a group of solvent and viable companies with well maintained facilities, producing internationally competitive quality products at lower cost than now and with an adequate product mix to better serve the downstream steel-consuming industries. However, this immediate phase of the restructuring process does not include all the potentially needed modernization, balancing or the completion of the investments in progress. SIDERMEX is therefore carrying out a long-term strategy study to define the basis for its development through the 1990s. The Strategic Plan will be consistent with the guiding principles spelled out in the Policy Letter. Terms of reference for this work were reviewed and agreed by the Bank. British Steel Corporation Overseas Services (BSCOS) was selected and has carried out the task. SIDERMEX will present its long-term strategy proposal for Bank review by March 31, 1988. The market study has also provided a major planning input to the strategy study. The strategy developed for SIDERMEX will provide the basis for the Government's Global Steel Policy statement which will define the role of the public sector and along with the results of the market study the opportunities available for the private sector.

7. The integration of the proposed SICARTSA II investment program into the SIDERMEX complex is a critical element in the long-term strategy. The completion of this investment parallel with further facilities restructuring in the AHMSA plant may lead to excess capacities, particularly in plate production. Therefore, discussion with SIDERMEX and the Government has led to an understanding that alternatives to completion of SICARTSA II would be evaluated on their technical, economic and financial merits once the medium-term product and market studies are completed. Such an evaluation would be completed as part of the presentation of the SIDERMEX Long-term Strategic Plan and will include: (a) review and discussion with the Bank of the conclusions and recommendations of its long-term strategy study in particular, those with respect to major investments in facilities not included in the now agreed Restructuring Program and use of facilities not now in operation; (b) implementation of the agreed elements of the long-term strategy in accordance with investment criteria, financing plans and implementation schedules that are acceptable to the Bank; and (c) annual review of the plan and progress achieved.

Attachment 3

8. In reviewing the SIDERMEX financial restructuring already effected by the Government, and in particular, the financial prospects for its steel companies, it has become apparent that there is a need for further balance sheet restructuring, including revaluation of the fixed asset base in relation to the earnings potential and a corresponding writedown of the equity base, so that future SIDERMEX financial performance is measured against achievable financial return criteria and reflects the overall cost of equity and loan capital. It has been agreed that within six months after signing of the loan documents SIDERMEX will carry out, based on agreed Terms of Reference: (i) a complete analysis and revaluation of its fixed assets, including fixed assets of all of its subsidiaries, and (ii) an adjustment and updating of the relevant balance sheets based on these results.

April 20, 1989

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

ME-2916

DATE: August 17, 1989

TO: Mr. Paul F. Knotter, Chief, LA2TF

FROM: Edmund L. Mangan, ASTIF ELM

EXTENSION: 78000

SUBJECT: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)

1. Per your request, this updates the status of the subject Steel Sector work. Overall there has been no change in the status of the Project and Loan and although promises have been made with regard to the Steel Sector Reform Program, the agreed policy actions and budgeting of funds for investment, no positive steps have actually been taken by the Government.

2. The Steel Sector Reform Program contained in the loan agreements includes dated covenants requiring agreed actions on: (i) trade policy; (ii) price policy; (iii) completion of SIDERMEX restructuring and strategic planning and; (iv) steel sector policy. Item (i) was satisfied prior to Board presentation through the elimination or reduction of import tariffs on all relevant steel products. Although we and our Mexican counterparts continue to spend considerable effort, no progress has been made on the other items and the last of the specified dates passed on July 31, 1988.

3. Some of this delay may be understandable in the context of the economic change the new Government is attempting to carry out and in particular they are now said to be reviewing the issue of price decontrol for specific subsectors including steel. We were recently advised that some action may be forthcoming, but the most recent promised date of end July 1989 has passed with steel prices still under control.

4. A revised version of the SIDERMEX Strategic Plan was received in early April 1989 and was determined by Bank analysis to represent a program that was not financially nor economically viable and therefore not satisfactory to the Bank. A detailed review was carried out with Mexican counterparts and basic assumptions for the evaluation of a revised Plan were agreed jointly in June 1989. This revised Plan was to be developed along with an agreed analysis by SIDERMEX and reviewed in July 1989 in Washington. The agreed meetings have been continually postponed by the Mexicans and the latest schedule is to meet here on September 7 and 8. However this is only one element of the overall Steel Sector Reform Program and it is still unclear whether and when additional action will be taken to comply with all of the other obligations and commitments under the loan agreements.

5. The Global Policy Statement, for example, is said to be awaiting the completion of an agreed SIDERMEX Strategic Plan. And although we were advised in February 1989 that new budgetary funding decisions would be made after July 1989, there are still insufficient funds budgeted to carry out the investment portions of the project.

6. With regard to the enterprises, CMC has provided all of the information requested regarding conditions of disbursement for the Technical Assistance portion of Part B.2 and the completion of our review is expected shortly.

7. Conditions for disbursements for the investment portions of Part B of the project including both AHMSA, Part B.1 and CMC, Part B.2 have been reviewed. Disbursements cannot begin until a satisfactory SIDERMEX Strategic Plan is agreed that is consistent with the agreed Action Plans of each of the enterprises. In the meantime both enterprises are proceeding diligently with procurement and other matters pertaining to their parts of the project given the constraints imposed by the Government and the delays in SIDERMEX Plans. No work has been done by SIDERMEX on Part B.3, which includes studies and Technical Assistance at the Holding Company level. SIDERMEX withdrew their request to cancel this part of the loan after the study needs were reviewed.

8. The HYLSA portion, Part C is being delayed by the company until the SIDERMEX Strategy is clear and the Government elaborates it policy toward the Steel Sector.

9. A brief status summary is as follows:

> "No progress has been made by the Government in carrying out the commitments under the Steel Sector Reform Program, Part A of the loan. Loan Agreements with regard to; price policy, sector policy, SIDERMEX strategy and funding commitments for investments in Parts B and C have not been carried out. None of the conditions for second tranche release of Part A have been met. About US$45 Million has been disbursed against Part A and US$20 Million to set up the special account for Parts B and C. Discussions with the Government and SIDERMEX are underway in an attempt to settle issues relating to strategy and to secure commitments, however the project and loan remain in jeopardy."

cc: Messrs/Mmes: Steckhan LA2DR, Linder LACVP, Martinez LA2CO,
Iskander, Mendez LATTF, Manley, Collell LEGLA,
Sugar LOAEL, Raghavan, Sethi ASTIF, LAC Files
Marco Voljc, Resident Representative, Mexico

ME-2916

January 19, 1990

Mr. Knotter:

Re: MEXICO --Steel Sector Loan

As Mr. Mangan was unreachable in India, I spoke with Mr. Venkatswaran (Venka) in the China office regarding the reorganization of SIDERMEX as it had been contemplated at appraisal. As you know, he was a key member of the team that developed the project. In particular, I enquired about the importance which he attached to the conversion of SIDERMEX to a holding company. I discussed the current context, and explained that privatization was emerging as a possibility in the sector.

Venka indicated that he did not regard the conversion of SIDERMEX to a holding company as an essential element of the SIDERMEX restructuring exercise. What was important was that the responsibilities for strategy formulation and financial flows to the public sector companies be clearly identified. At the time of project preparation in 1986/87, the holding company seemed most appropriate to accomplish these objectives; however, time had passed and new alternatives may have emerged. He also indicated that he thought that privatization would be the superior solution in the sector, and that it should certainly be acceptable to the Bank as an alternative to the agreed restructuring.

Chris Barham

cc: Messrs. Mangan o/r; Mettala

ME 2916

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 23, 1990

TO: Mr. Kimmo Mettala (LEGLA)

FROM: Christopher Barham (LATTF) CB

EXTENSION: 38615

SUBJECT: MEXICO - Steel Sector Restructuring Project--Loan No. 2916-ME

Compliance with Second Tranche Release Conditions

1. The purpose of this memo is to request your clearance of the attached Notification to the Board for the release of the US$50 million second tranche under Part A of the subject Loan.

2. Further to our recent conversations and your request, we would like to clarify for you the status of the reorganization program for SIDERMEX which was contemplated under the Loan.

3. One of the conditions for second tranche release (Schedule 1 para. 5(a)) was that the Bank should be satisfied with the progress achieved by the Guarantor (Government) in the carrying out of the Steel Sector Reform Program detailed in the Schedule to the Guarantee Agreement. Inter alia, this Program required the completion of the comprehensive restructuring program of all steel sector companies, as embodied in the SIDERMEX Convenio.

4. The Convenio was an agreement signed in September 1986 between the Government and SIDERMEX which established a number of organizational and financial objectives which SIDERMEX would attempt in return for financial support from the Government. These objectives included:

(a) Assumption and conversion to equity by the Government of about US$883 million equivalent or 50% of the US$1.75 billion total debt of the SIDERMEX companies, to put them on a sounder financial footing; and

(b) Reorganization of SIDERMEX to rationalize its size and profile, and change its corporate structure to devolve responsibilities for all operating, marketing and financial activities from the corporate to plant levels. The new organization was expected to group all operations under five independent profit centers: AHMSA/FMSA, SICARTSA, Mines, Refractories and related operations, and Service Centers. SIDERMEX itself was to be transformed into a holding company that would perform strategic management and general supervisory functions for the parastatal steel sector.

The basic objectives of the contemplated reforms were to develop a more focussed, market-driven, and efficient set of operating companies, acting in accordance with clearly-articulated strategic plans and underpinned by a rational investment program for the sector.

5. To date, the Government and SIDERMEX have taken a number of important steps to comply with the agreements under the Convenio. First, on the financial side, the Government has carried out the agreed debt/equity conversions, thus putting the operating companies on a sounder financial footing. Second, on the organizational side: (a) the profile of SIDERMEX has been reduced; as at the end of 1989, some 42 of the 66 SIDERMEX subsidiaries which existed in 1986 when the Convenio was signed had been sold, liquidated, or merged, and an additional six were in process of restructuring; (b) the remaining subsidiaries--which are expected to total just 18 when the aforementioned restructurings are completed in 1990--are being consolidated into seven operating groups, substantially along the functional lines initially agreed; (c) the responsibility for all operating, marketing and financial activities for companies within these operating groups have been decentralized to the plant level; (d) SIDERMEX itself has been streamlined to focus on the functions of planning, coordinating and providing selected overhead services to the public sector companies, and its corporate staff has been reduced by 22%; and (e) in 1989 about 8,400 positions were abolished in the steelmaking and mining companies, with a view to making their operations more efficient.

6. Regarding the formal conversion of SIDERMEX to a holding company, which has not yet occurred, the Government has requested Bank assistance under the Loan to develop alternative sector organization and ownership options which may be more appropriate for the sector's future development than the simple conversion of SIDERMEX to the publicly owned holding company contemplated under the Convenio. These options would include proposals for privatization, a matter which has become politically more feasible than was the case at the time of appraisal.

7. We believe that the Government's request is appropriate in the context of its parastatal sector policy aiming at efficiency and enterprise privatization, and in light of the restructuring actions already taken. These actions have established a number of more efficient and focussed companies in the steel sector, operating with improved strategic direction and more rational investment plans. On this account, we believe they represent satisfactory progress with implementing the SIDERMEX restructuring program agreed under the Loan and that compliance with the tranche release condition pertaining to SIDERMEX's restructuring is satisfactory.

8. May we please have your clearance of the attached document?

Attachment

cw & cc: Mr. Knotter (LA2TF)

cc: Messrs. Mangan (o/r), Sethi (ASTTF); Hughes (LA2TF); Sugar (LOAEL)

CBarham:ph

Mr. [illegible]

ME 2916

FROM: Senior Vice President, Operations

February 12, 1990

MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)*
Release of the Second Tranche

1. As provided in Section 3.06 of the Guarantee Agreement of the Steel Sector Restructuring Loan (SSRL) to Nacional Financiera S.N.C. (NAFIN) of Mexico (Loan No. 2916-ME), discussions were held during recent weeks on the progress achieved in carrying-out the Steel Sector Reform Program assisted by the Loan. This memorandum summarizes recent macro-economic developments and progress in the fulfillment of the criteria for the release of the Loan's second tranche of US$50 million under Part A, as agreed during negotiations of the Loan.

I. BACKGROUND

2. Loan 2916-ME, a hybrid sector adjustment operation with both import financing and investment components, is intended to assist the Government of Mexico (GOM) in implementing comprehensive policy reforms for the public and private sectors and in carrying out a restructuring program. Part A of the Loan, a policy based component of US$100 million, finances imports of steel input materials and products. Parts B and C, the investment and technical assistance components of US$300 million, assist: (i) the public sector mining company, CMC, in the supply of raw materials; (ii) the public sector steel producer Altos Hornos de Mexico (AHMSA), and the private sector producer, HYLSA in improving their competitive positions in the production of flat products; and (iii) GOM in designing and implementing a sound sectoral policy for the further development of the steel subsector within the framework of a liberalized market environment. Major policy reforms include implementation of a price liberalization program, which has effectively eliminated controls on domestic steel prices, and a steel trade policy program, which has opened the domestic steel market to imports. Overall, the restructuring program aims at improving the availability of higher quality steels at internationally competitive prices to the downstream consuming industries, in order to enhance their role in the development of a more efficient export-oriented economy.

Distribution

Executive Directors and Alternates
President
Senior Management Council
Senior Vice-Presidents
Vice Presidents, Bank and IFC
Directors and Department Heads, Bank and IFC

*Questions on this document may be referred to Mr. Paul F. Knotter (Ext 38771)

12. Finally, with respect to Mexico's external accounts, the current account deteriorated from a 1988 deficit of US$2.9 billion to a 1989 deficit of around US$5 billion. There was a corresponding reduction in the surplus of trade in goods and non-factor services. Several factors accounted for this deterioration. First and foremost, there were the effects of a private sector-led recovery in investment and growth, which boosted net imports of capital and intermediate goods. Secondly, there was a temporary shortfall in income due to the effects of a severe drought. Offsetting this was a sharp improvement in the capital account, as inflows of private capital rose significantly. As a result, by the end of 1989, gross foreign reserves were at approximately the same level as at the end of 1988.

III. PROGRESS AGAINST TRANCHE RELEASE CRITERIA

13. Pursuant to Schedule 1, para. 5(a), of the Loan Agreement, conditions for second tranche release under Part A, require that the Bank shall be satisfied:

(a) with the progress achieved by the Guarantor in carrying out the Steel Sector Reform Program including completion of the SIDERMEX Strategic Plan and the restructuring of SIDERMEX;

(b) with the implementation of the Price Liberalization Program;

(c) with the completion of all measures referred to in the Steel Trade Policy Program; and

(d) that the Guarantor has elaborated its Global Steel Sector Policy Statement.

14. The criteria defined above have been met by the following actions taken by GOM and SIDERMEX:

(a) satisfactory progress on the Steel Sector Reform Program has been achieved. In December 1989 a SIDERMEX Strategic Plan consistent with the agreed investment program under the Loan and with the Global Steel Sector Policy Statement referred to under point (d) below was received by the Bank. Moreover, important actions, as provided for in the SIDERMEX restructuring agreement, have been taken to: (i) restructure the finances of the SIDERMEX companies; (ii) rationalize and regroup them, while decentralizing decision making on operational matters to the plant level; and (iii) reorganize, downsize, and refocus the activities of SIDERMEX itself on planning, coordinating and providing selected overhead services to the public sector steel companies. These actions imply that the objectives of the SIDERMEX restructuring agreement have been achieved substantially. Regarding the conversion of SIDERMEX to the publicly owned holding company which had also been anticipated in the SIDERMEX restructuring agreement, the Government has requested technical assistance under the Loan to develop alternative sector organization and ownership options, including possible privatization. Resultant studies are expected to be completed by mid-1990. We believe that the Government's strategy is appropriate in light of the restructuring actions already taken and in the context of its wider parastatal sector policy objectives;

(b) prices of steel products were satisfactorily liberalized in September 1989, as confirmed by GOM's letter dated September 11, 1989;

(c) prior to Board approval of the Loan, tariffs on steel products had been lowered to an average of about 10%, and quantitative restrictions for steel products had been removed. These measures have remained in effect since that time; and

(d) a satisfactory Global Steel Sector Policy Statement, integrating the public sector operating and investment strategy into the broader general framework for developing an internationally competitive steel sector and clarifying the future roles of the public and private sectors, was received from the Guarantor on January 5, 1990. This document elaborates on and is fully consistent with the Lineamientos De Politica Para La Industria Siderurgica Paraestatal (Steel Sector Policy Letter) referred to in Section 3.03 of the Guarantee Agreement, which outlined the sector policy framework supported by the Loan.

IV. CONCLUSION

15. After initial delays caused mainly by the need to give priority to implementing the Government's comprehensive economic stabilization program, progress on the overall program of sectoral restructuring has been satisfactory and the reform process in the steel subsector is now on track. All criteria for the disbursement of the SSRL's second tranche of US$50 million have been met and GOM and NAFIN [illegible]

Moeen A. Qureshi

Yellow

Mr. ...

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

ME 2916

March 13, 1990

Lic. Jose Angel Gurria Trevino
Subsecretary for International Finance
Secretaria de Hacienda y Credito Publico
Palacio Nacional
Mexico D.F., Mexico

Dear Lic. Gurria:

In the light of the recent government announcement concerning the privatization of the parastatal enterprises in the steel sector, we would like to discuss with the appropriate government officials: (i) the implications for the Government's steel sector program and for the implementation of the Steel Sector Restructuring project and (ii) any assistance the Bank may be able to provide in developing and implementing a privatization strategy for SICARTSA and AHMSA. Mr. Mangan would be available to visit Mexico beginning March 26 for about ten days and I have tentatively planned to join him in key discussions during April 2-4. Please let me know whether the proposed timing is convenient to the Mexican authorities.

With best regards,

Sincerely yours,

Paul F. Knotter
Chief
Trade, Finance and Industry Division
Country Department II
Latin America and the Caribbean

cc: Mr. Enrique Vilatela, Director General de Captacion de Credito Publico, Secretaria de Hacienda y Credito Publico (SHCP)

Lic. Antonio Cervera Sandoval, Director, Organismos Financieros Internacionales, Secretaria de Hacienda y Credito Public (SHCP)

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 4, 1990

TO: Mr. Paul Knotter, Division Chief LA2TF
Mr. Ibrahim Elwan, Manager CFSPS

FROM: Mr. Edmund Mangan, ASTIF
Mr. Carlos A. Corti, CFSPS

EXTENSION: 80800

SUBJECT: **MEXICO - SIDERMEX Privatization Identification Mission**
Back to Office Report

1. According to our Terms of Reference, we visited Mexico City beginning June 12, 1990 for approximately one week, in the context of the supervision of the Steel Sector Restructuring Project (Loan #2916-ME), to meet with the Government agencies responsible for the privatization of the state-owned steel sector. The purpose of the meetings was to explore possible alternatives for Bank support for the privatization of SIDERMEX. While in Mexico, we met senior representatives of the: Secretary of the Treasury (SHCP), Secretary of Budget (SPP), Secretary of Mining and Public Enterprises (SEMIP), SIDERMEX, and operating companies.

I. The Privatization of SIDERMEX Companies.

2. The privatization of the state-owned steel sector is the culminating stage of the restructuring process started by the Government of Mexico (GOM) in 1986, supported by Bank Loan #2916-ME, for US$400 million. The objectives of the Loan were to: (i) assist the GOM in implementing a comprehensive reform of the steel sector and in carrying out restructuring actions; (ii) assist the major players to rehabilitate potentially efficient plant and equipment with demonstrable viability, enhance product quality and reduce costs, eliminate bottlenecks to improve utilization of existing capacity, improve technical, financial and managerial controls and information systems, and develop human resources to achieve overall objectives of competitiveness; and (iii) assist the Government and the industry in elaborating a long-term strategy and policies. The policy based component for US$ 100 (Part A) has been fully disbursed, plus US$ 36 million of the investment (Part B) and technical assistance (Part C) components. There is about two-year delay in the execution of the project.

3. At the beginning of 1986, the SIDERMEX Group consisted of 3 integrated steel plants and 87 subsidiaries. The decision of the Government at the time was to keep in the SIDERMEX Group the large integrated steel producers,

the coal and ore mines, some of the marketing network, ferro alloy producers, and the production of refractory materials. To that purpose, SIDERMEX was transformed into a holding company performing strategic management and general supervisory functions over the parastatal steel sector. The marketing and production planning activity has already been transferred from the SIDERMEX corporate management to the plants. The rest were divested from the SIDERMEX portfolio during the reorganization process. As of today, SIDERMEX companies are grouped under five independent operational entities: AHMSA, SICARTSA, the raw materials division under the corporate name Carbon y Minerales Coahuila S.A. (CMC), Refractories and related operations, and international marketing and other non-technical units.

4. The new 1989-1994 National Development Plan issued by the new Government of President Salinas limits the direct intervention of the State to Priority and Strategic Sectors. The Mexican Constitution and Laws do not include steel in these categories. Consequently, the GOM decided to privatize the SIDERMEX group. The GOM gives utmost priority to the privatization of the steel sector (expected before the end of the year), since the expected proceeds of the sale will be an important source of budget revenue. The decision to privatize is totally consistent with the objectives of the Steel Sector Restructuring Project (Loan #2916-ME) in implementing a comprehensive and far-reaching policy reform for the steel sector.

Government Strategy

5. The GOM has not yet developed an explicit strategy for the privatization of SIDERMEX. However, SHCP officials see the process as a three steps approach, as follows:

a) First, the adjustment of the book-value of the companies, before transferring the companies under the responsibility of the privatization task-force in SHCP. This issue is politically charged since the adjustment and revaluation of the financial statements of each company require the realization of substantial losses with the consequent exposure to public scrutiny;

b) Second, the formal transfer of responsibility of the revalued companies from SEMIP (functional authority of SIDERMEX) to the privatization task-force in SHCP; and

c) Third, the privatization process in itself--valuation, bidding, and closing.

6. The first step has already been initiated. However, given the political consequences that may arise, it might take some time to be completed. So far, the SEMIP/SIDERMEX group has not followed this step-wise sequence, which raises some questions about the coordination between SEMIP and SHCP, and the effectiveness and appropriateness of the measures already taken, as follows below. The coordination by an informal task-force, chaired by the Secretary of Hacienda and including by his Chief of Staff, the Secretary and Under Secretary of SEMIP, and the Comptroller General of Mexico is quite limited. While they occasionally meet on the subject, delays in creating the formal privatization

task-force still leaves the formal authority of the steel sector with SEMIP and SIDERMEX. These two institutions have sectoral interests and views in terms of the content and timing for divesting the operating companies [1], which not necessarily represent the consensus of the GOM. As an example, SEMIP has already contracted Price Waterhouse to establish the market value of the companies, which would subsequently be used as a basis for determining the sale prices, rather than using their assistance to adjust the book-value as required. Given the sensitive nature of the valuation results, SEMIP's premature action may delay the execution of the process. Similarly, neither relevant information has been made available nor contacts have been initiated with the investors' community, which still receives confusing signals in regard to the GOM privatization intentions.

7. In our judgement, given the scope and complexity envisaged in the divestiture of the SIDERMEX companies, comprehensive actions are still required in regard to the definition, organization, and processing of the divestiture strategy. In this regard, the Mission stressed the need to quickly and clearly address the organizational issues, assigning the necessary responsibilities to a formal "task-force" with full mandate to manage the privatization process. Initially, likely with support from the Bank, this task-force has to focus on defining the <u>divestiture strategy</u> and the <u>action-plan</u>.

II. Proposed Strategy for Bank Assistance

8. The role of the Bank in the privatization of SIDERMEX companies is a natural step after a substantial and long-standing commitment to the restructuring of the steel sector in Mexico. The presence of the Bank would provide the necessary transparency and credibility to the divestiture process, enhancing the value of the sale proceeds to the Government. In order to be effective, the Bank should stand ready to <u>assist the GOM in the design, financing and execution of the privatization strategy of the SIDERMEX companies</u>, once organizational issues and responsibilities are settled. For that purpose, CFSPS may assist the Region with a tailor-made approach, to reflect the specific needs of a proposed transactions.

9. Loan #2916-ME has US$4 million of unassigned funds that could be used to support privatization related preparatory actions and investments. However, the expected costs of such activities are substantially higher and the Bank might consider an investment operation to complement the Steel Sector Restructuring operation under execution.[2] Cofinancing from bilateral and private sources on a limited-recourse basis, for the restructuring and divestiture components not-elegible for Bank financing might also be available.

---

[1] SEMIP is considering: (i) to open the sector to foreign investments up to 100% ownership, or alternatively, to retain minority holdings; (ii) to divest ACEROS PLANOS after AHMSA; (iii) to require from AHMSA's bidders full commitment to execute the investment plan as initially planned.

[2] Alternatively, Bank support could be a self-standing component under the proposed Public Enterprises Reform Operation (PERL II).

Similarly, external debt conversion posibilities are open to the "financial engineering" strategy for privatization. In July 1989, Mexico became the first country to enter into a debt reduction agreement under the Brady initiative. As part of the overall accord, Mexico announced a new debt for equity conversion program which, unlike the previous program, up to US$ 1 billion is to invest in state owned companies being privatized and to infrastructure projects.

10. The proposed project (or project component) might consist of a Technical Assistance, an Investment Financing and a Guarantee component, as follows:

* a **Technical Assistance** component to finance the required advisory services for the design and execution of privatization strategy. It may include the services of auditors, appraisers, technical and managerial consultants, legal and investment banking services, to be retained by the privatization "task-force". Since the object of the sale is on-going business concerns, these services are amply justified in terms of the need for readying the corporations, selecting divestiture methods and modes, or valuation, among others.

* an **Investment Financing** component to assist in the financing of:

  (i) the direct costs of organizing the "task-force", and of executing each transaction--corporatization, packaging, promotion, marketing, underwriting;

  (ii) the financial and the physical restructuring of each firm before privatization [3], to the extent that these expenses are not covered under Loan #2916-ME. With the aim of making the investment a more atractive opportunity for potential interested parties and thereby, maximize the value to the GOM, there are certain company specific rehabilitation measures that need to be solved prior to the sale. The most noteworthy issues are: **Financial**--in cases where enterprises show a negative net worth, excessive leverage, overly costly financial liabilities, non-performing assets, investments in non-related activities, etc.; **Production**--for enterprises operating in different segments of the same industry decisions would need to be reached whether to offer them as a joint package, the elimination of production processes, replacement and/or upgrading of equipment, etc.; **Labor**--early retirement programs, renegotiation of contracts, reallocation, layoffs, etc.; and

---

3/ Financing for asset-restructuring after privatization may be advisable for tactical reasons--political momentum to speed-up the sale. In these cases, the provision of long-term financing to the investors could be justified for: (i) assets with externalities not exclusively captured by the cashflow of the company (antipollution); or (ii) assets where project financing attracts other long-term limited-recourse lenders (ECAs). To be consistent with the strategy of reducing sovereign risk coverage to commercial operations, Bank financing should provide a minority portion (<30%) of total costs.

Legal--to simplify the legal requirements of the transfer when existing corporate structures might appear unattractive to potential investors; and

(iii) the actual divestiture of the firm (financing the sale) when subsidiary effects are sought for, in cases like: workers ownership (ESOPs, "workers capitalism"), community ownership ("popular capitalism"), and/or pension funds' ownership ("institutional capitalism").

* a **Guarantee component** to back-stop the Government in policy commitments incorporated into the sale agreements. The project might partially guarantee against sovereign risk defaults of the GOM, as defined in the agreements [4]/, the repayment of principal on the loans financing the acquisition from third-party commercial creditors (banks, bondholders). Since unsecured commercial credit in substantial amounts might not be easily available to Mexico, the applicability of guarantees geared to reduce investors' sovereign risk perception of the proposed investments might be explored.

11. CFSPS, in support to the Region, may assist the GOM to: (i) identify, secure and bridge-finance preliminary preparatory activities of the process; (ii) explore the availability of Cofinancing from bilateral and private sources on a limited-recourse basis for financing the restructuring and divestiture components not-elegible for Bank financing; (iii) develop instruments and financial engineering techniques to mobilize investors into the program (debt swaps, ECO-type guarantees, etc.); (iv) coordinate and negotiate with official and private parties involved with the privatization project the financing and security arrangements required in the sale contracts; and (v) provide advice to parties on ways to enhance the financial quality and credibility of the privatization program.

III. Tentative Work-plan

12. As noted in para 5, crucial political decisions are in the critical path of the SIDERMEX companies' privatization. Contingent upon the actions required by GOM, CFSPS, in support to the Region, could immediately mobilize the required financial, legal and technical expertise to assist the GOM in designing and executing the divestiture strategy. If an independent Investment Operation, CFSPS might proceed according to the following preliminary timetable:

---

[4]/ Bank supported guarantees may be complemented by IFC participations. Expanded Cofinancing Operations (ECOs) are medium- or long-term private financing transactions undertaken by Bank borrowers in the international credit or capital markets with partial credit support from the Bank. Mexico is not elegible yet under the present ECO Facility, however, a similar instruments might be packaged with bilateral funding.

1.	Terms of Reference	August 30
2.	Pre-appraisal Mission	September 1-15
3.	Preliminary Financing Initiative	September 30
4.	Pre-Appraisal Meeting	October 15
5.	Final Executive Project Summary (EPS)	October 30
6.	Appraisal Mission	November 15-30
7.	Yellow Cover Staff Appraisal Report (SAR)	December 30

In case of a free-standing project component under the proposed PERL II, the timing of further steps would largely be determined by the progress in preparing that operation. The Mission requests management guidance on how to proceed.

cc. Messrs. Kashiwaya (CFSVP), Steckhan, Lee (LA2DR), Segura (LATDR), Martinez, van Wijnbergen, Varallyay, Di Tullio, Johnson (LA2CO), Halperin (LA2IN), Iskander, Blitzer, Mendez (LATTF), Linder (LACVP), Sugar (LOAEL), Collel, Molnar (LEGLA) Raghavan, Sethi (ASTIF); Paul (CL1DR), Nassim (CCFDR), Voljc (res.Rep), CFSPS Staff.

MC - 2916

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: July 30, 1990

TO: Files

FROM: Hans Binswanger, Acting Director, LA2 H. Binswanger

EXTENSION: 31871

SUBJECT: MEXICO - SIDERMEX: Funding Proposal for Japanese Grant Facility

1. On July 25, 1990 Mr. Ibrahim Elwan, CFSPS, wrote a memorandum to Neil Hughes, Acting Division Chief, LA2TF, with an attached Technical Assistance Funding Proposal for the Japanese Grant Facility. The purpose of this memorandum is to confirm that LA2 has no objection to the Japanese Grant being made available to the CFSPS, which is in accordance with a request from the Japanese, rather than to LA2.

2. As agreed with Mr. Elwan, paragraph b of his memorandum now reads as follows: "Under this arrangement, it would make sense that the Country Department takes the lead and responsibility for policy and lending strategy while our Group would provide assistance in the area of financial engineering as and when requested, with close coordination with the Region."

cc: Messrs. Choksi (LACVP), Steckhan o/r (LA2DR), Quijano (LACVP), Halperin (LA2IE), Knotter and Hughes (LA2TF).

ME-2416

TECHNICAL ASSISTANCE FUNDING PROPOSAL FOR JAPANESE GRANT FACILITY

A. COUNTRY: MEXICO

B. PROJECT: Technical Assistance for Privatization of SIDERMEX

C. TASK MANAGER: Carlos A. Corti, CFSPS, Ext. 80800

D. PROJECT COST/FINANCING:

Japan Grant Funds:	US$	2.0 M
World Bank Privatization Group:	US$	.10 M
Government:	US$	.30 M [1]
TOTAL PROJECTED COST	US	$2.40 M

E. PROJECT BACKGROUND

1. The privatization of the state-owned steel companies is the culminating stage of the process of restructuring initiated by the Government of Mexico (GOM) in 1986, supported by a Bank loan for US$400 million (Ln. 2916-ME). In 1986, the SIDERMEX Group consisted of 3 integrated steel plants and 87 subsidiaries. At the time GOM decided to keep in the SIDERMEX Group the large integrated steel producers, the coal and ore mines, some of the marketing network, ferro alloy producers, and the production of refractory materials. SIDERMEX was transformed into a holding company performing strategic management and general supervisory functions over the parastatal steel sector. The marketing and production planning activity was transferred from the SIDERMEX corporate management to the plants. The rest were divested from the SIDERMEX portfolio during the restructuring process. Currently, SIDERMEX companies are grouped under five independent operational entities: AHMSA; SICARTSA; the raw materials division under the corporate name Carbon y Minerales Coahuila S.A. (CMC); Refractories and related operations; and international marketing and other non-technical units.

2. GOM's National Development Plan (1989-1994) limits the direct participation of the State to priority and strategic Sectors which do not include steel. Consequently, GOM decided to privatize the SIDERMEX group. GOM gives utmost priority to the privatization of the steel sector (expected before the end of the year). The expected proceeds of the sale would represent an important source of revenues for the budget. Moreover, the privatization of SIDERMEX is fully consistent with the objectives of the Steel Sector Restructuring Project (Ln 2916-ME), which calls for liberalization and deregulation of the sector with a view to reducing its burden on the national budget and increasing its

---

[1] Support in kind by GOM.

accountability and efficiency.

3. Government Strategy. GOM is in the process of developing the strategy for the privatization of SIDERMEX. The Secretary of the Treasury structured the process into three steps:

a) The valuation of the net worth of the companies before transferring the companies under the responsibility of the privatization task-force in SHCP;

b) The transfer of the revalued companies from SEMIP (functional authority of SIDERMEX) to the privatization task-force in SHCP; and

c) The implementation of the privatization process.

This approach to privatization is consistent with the practices established so far in countries that have pursued this option for divestiture. In fact, Mexico has been more successful in its privatization program than a large number of developing countries that continue to pursue the same policies. In the case of the privatization of SIDERMEX, the size of the transaction is expected to be extremely large, which would require significant input in the area of financial engineering i.e., provisions, agreements, guarantees, stand-by facilities, debt equity swaps, etc. While the Mexican policy makers are quite versed on the aspects of financial engineering, they could gain important benefits from assistance in structuring the security packages that would attract lenders and investors to participate in the privatization process by providing new financial instruments that could be used in the case of Mexico as well as other heavily indebted developing countries. Unless the SIDERMEX privatization process is supported by instruments that would make possible a quick, efficient, and economic disposal of the assets, the likelihood of future success in the other major sectors of the economy where large enterprises would need to be privatized, would be reduced.

Role of the Bank

4. The role of the Bank would be to assist GOM in the implementation of its program for the privatization of state-owned enterprises. It would provide advise in the areas of engineering and finance, emphasizing an integrated approach to matching the technical restructuring of the enterprise with the financial instruments needed to successfully achieve its privatization.

F. DESCRIPTION OF THE PROPOSED TECHNICAL ASSISTANCE

5. The proposed technical assistance would provide support to GOM in the process of privatization of SIDERMEX. It would involve :

(a) Advice on the framework for privatization, supported by expert advice both in Mexico and internationally to enhance the capabilities of GOM;

(b) Contribute to the formulation of a financial package or packages to support divestiture; and

(c) Assist in the identification and the mobilization of sources of financing, both debt and equity, to enhance the potential for the sale of the enterprise.

(d) Assist in the promotion and marketing of the privatization transaction

G. TIMETABLE

6. Technical Assistance (Preparatory Support)

Preparation of a conceptual framework for potential financial instruments to support privatization:	August 15, 1990
Mission to agree on a framework for collaboration with Mexican Government	October 07, 1990
Appointment of consultants and task force from the Operational, Legal, and Financial Complexes of the Bank	November 07, 1990

H. EXPECTED DISBURSEMENT OF GRANT FUNDS

7. Salaries and Fees

(a) Consulting Specialists 25 man-months @ US$10,000	US$250,000
(b) Long term consultants 25 man-months	US$250,000
(c) Consulting firms: legal, technical, financial, etc. 100 man-months	US$1,000,000
(d) Promotion: investment banking services, underwriting, etc. 50 man-months	US$500,000

MEXICO

STEEL SECTOR RESTRUCTURING PROJECT (LOAN NO. 2916-ME)

Technical Assistance Funding Request

A. Country : Mexico

B. Project Steel Sector Restructuring Project

C. Appraisal Date : Project was appraised in March and May 1987

D. Board Date : March 3, 1988

E. Task Manager : Edmund Mangan (ASTIF), Extension 78000

F. Project Cost/ Financing :

	(US$ million)
Costs	
Part A (Imports)	100.0
AHMSA	479.7
CMC	184.4
HYLSA	278.4
SIDERMEX	7.5
Total	1,050.2
Financing	
IBRD	400.0
Short-term Debt	64.0
Internal Cash Generat.	586.2
Total	1,050.2

G. Background

1. The Mexican steel industry has a theoretical installed capacity of just over 9.0 mtpy of crude steel. Over 80% of sectoral production, value-added and employment are accounted for by SIDERMEX and its major subsidiaries SICARTSA and AHMSA -- which are publicly-owned -- and HYLSA, which is a private company. A large share of AHMSA's inputs of coal and iron ore is provided by CMC, another SIDERMEX subsidiary.

2. Following slow growth in the 1940s and 1950s, protectionist policies coupled with heavy Government investment and operating subsidies allowed the industry to grow rapidly in the 1960s and 1970s. During the 1976-81 oil boom, demand for steel products grew faster than production and imports increased. However, the economic crisis of 1982 severely curtailed demand, and domestic steel production fell sharply. Company debt grew greatly, and cash flow problems resulted in inadequate maintenance and lagging technological development.

3. In the late 1980s the Government initiated two important sets of policy reforms which set in motion forces promoting restructuring of the steel

industry. First, it began shifting towards an outward-oriented growth strategy by gradually reducing protection and eliminating domestic price controls. Second, it began adopting measures to reduce the number of state-owned enterprises (SOEs) and require improved performance of those remaining. These policies resulted in a number of important changes: (i) tariffs on steel products were lowered to an average of about 10%, and quantitative restrictions on steel products were removed; (ii) steel product prices were liberalized substantially, within the constraints of the "PACTO" and "PECE" economic stabilization programs; (iii) strategies were announced since November 1989 demarcating the roles of the public and private companies in the steel sector and establishing a specific strategic plan for SIDERMEX; and (iv) important steps were taken to restructure SIDERMEX and its subsidiaries (including AHMSA) financially and organizationally; meanwhile, the activities of SIDERMEX itself were reorganized and refocussed on planning, coordinating, and providing selected overhead services to its subsidiaries.

4. In March 1990 the Government announced its intentions to privatize SICARTSA, AHMSA and CMC. However, it was decided to continue to implement the modernization program funded under the Bank project in the meantime. Moreover, based on a program agreed with its creditor banks in July 1989, the Government has initiated a debt-reduction program under which interest payments to participating creditors will be partially secured by a roll-over collateral account covering three semi-annual interest payments. This account will be funded inter alia from disbursements (set-asides) under selected Bank loans.

H. Project Description

5. Loan 2916-ME is a hybrid sector adjustment operation with both import-financing and investment components. It is intended to assist the Government and the private sector in adjusting to the comprehensive policy reforms discussed above.

6. Part A of the loan, totalling US$100 million, is a fast-disbursing component consisting of two equal tranches. The first tranche was used to finance imports of inputs for the steel industry. The second tranche was made available to help fund debt-reduction set-asides (para.4).

7. Parts B and C, totalling US$300 million, help finance components designed to improve competitiveness in public and private sector entities as follows:

(a) Within AHMSA, the project would help shift the product mix to flat products and heavy structurals, while improving quality and lowering production costs. Financing would be provided for: (i) equipment to improve steel-making facilities and the hot and cold rolling mills; (ii) upgrading of utilities and services to improve plant-wide maintenance; and (iii) consultants services to enhance management information systems, engineering and project management, and provide local and foreign training of personnel.

(b) Within CMC, the project would concentrate on raising productivity in the coal mining operations and strengthen the Hercules iron ore operation. Financing would be provided for: (i) replacement of mining, transport and conveyor equipment; purchase of new coal crushers; and installation of an iron ore concentrator; and (ii) consultants services to implement new accounting and management information systems and provide project management and training.

(c) Within SIDERMEX, the project would finance studies aimed at: (i) developing a long-term strategic plan for the company and its subsidiaries; (ii) undertaking a corporate-wide asset revaluation study and translating the results into a suitable financial structure; (iii) implementing the organizational and financial restructuring measures that emerge from the long-term strategic plan; (iv) assist in the planning of long-term strategic investments; and (v) providing assistance for implementation of corporate level management information systems.

(d) Within HYLSA, the project would concentrate on improving the competitive advantage of the Flat Products Division through investments in cost reduction, productivity and quality improvement. The main objective of this portion of the project would be to help maintain a competitive balance between HYLSA in the private sector and AHMSA in the public sector. Financing would be provided for: (i) equipment for steelmaking and hot and cold rolling mills; and (ii) consultants services to assist with detailed engineering and project supervision.

8. The project is now moving ahead. All policy conditions supported by Part A of the loan have been met, and the funds have been disbursed. SIDERMEX is proceeding with its various studies. Within AHMSA, modernization of the Hot Strip Mill is underway, and a team from British Steel Consultants is carrying out the various technical assistance activities contemplated for AHMSA under the loan. In the case of CMC, a team of consultants has assisted the company to make major operational improvements, and procurement of equipment is in process. HYLSA has delayed the initiation of its investment activities contemplated under the project, pending clarification by SIDERMEX and the Government of their strategic intentions in the sector. The clarifications on these point issued since November 1989 (paras. 3 and 4) should enable HYLSA to decide shortly on the scope of its participation under the project.

I. Description of Proposed Technical Assistance

9. Operations in an integrated steel plant, by their nature, lead to generation of air and water pollutants, most of which mainly affect the local environment. These emissions may include coke and sinter dust, iron oxide fume, acidic gases, sulphur dioxide and nitrogen oxides. Additionally, metals such as lead, zinc, and cadmium may be emitted, together with fluorides, limedust, acid mist, oil mists, polycyclic aromatics and benzene from some processes.

10. The AHMSA plant in the city of Monclova has a mixture of operations and technologies, some of which include effective pollution controls and others with none whatsoever. While implementation of the Bank-supported project will lead to environmental improvements through the shutdown of some obsolete and polluting equipment and the improvement of pollution

control systems, important pollution problems (e.g. at the Siemens Martin open hearths) will remain. This proposal is therefore to request grant funds to finance a study to determine the major sources of air and water pollution at AHMSA's plant in Monclova, and help develop a program to monitor and improve environmental conditions.

11. Specifically, the proposed study would:

(a) Identify and measure the types, sources and amounts of various air and water pollutants generated at AHMSA's facility, and identify the sites affected by their emission. An assessment would be made of the degree of compliance with industrial pollution regulations and standards prevailing both in Mexico and internationally.

(b) Develop an understanding of those natural features (e.g. topography, meteorology, geology, hydrology and hydrogeology) which affect the assimilative capacity of the regional environment, with a view to assessing the environmental impact of such emissions. This would be accomplished through the application of computerized modelling techniques, drawing upon existing data sources as feasible.

(c) Identify the extent of environmental improvement which will likely result from the implementation of the modernization program being implemented under the project.

(d) Propose cost-effective changes in plant operations which would reduce plant emissions. Special attention would be placed on improved water management at all stages of the manufacturing process, both as a means of water conservation and as a way to reduce the discharge of noxious effluents.

(e) Propose cost-effective modes of waste management which would lead to more efficient resource utilization and corresponding reductions in discharged pollutants.

(f) Propose a comprehensive measurement and monitoring program, with a related training program for AHMSA staff, to put in place an ongoing pollutant monitoring program.

12. Execution of the study could begin by about June 1, 1990. It would require about 25 man-months of consultants' time and take about twelve months to complete. Most of the work would be carried out on-site in Monclova. The study would cost about US$500,000, including travel and subsistence expenses.

J. <u>TIMETABLE</u>

Appointment of Consultants	June 1, 1990
Start of Work	July 1, 1990
Issuance of Progress Reports	
Report 1	August 31, 1990
Report 2	October 31, 1990
Report 3	December 31, 1990

AIDE MEMOIRE

SIDERMEX PRIVATIZATION

Mr. Edmund Mangan visited Mexico from March 26 to April 6 on a World Bank mission to discuss the announced plans of the Government to privatize the SIDERMEX companies and to assess the impact of this decision on the Steel Sector Restructuring Program supported by the World Bank Loan 2916-ME. The following are the views of the mission which will be discussed with Bank management in Washington.

In summary the mission believes that the decision to privatize is consistent with the Steel Sector Reform Program and is the logical next step in overall subsector restructuring. The mission recommends: (i) that the modernization program embodied in the existing loan be continued; (ii) that the Government move as rapidly as possible in the privatization process with the best available international assistance; (iii) that the Government consider a broad distribution of the capital stock in the firms; and (iv) that World Bank assistance continue at a Goverment level and loan funds be reallocated as necessary to support the privatization process.

BACKGROUD

The major goal of Government work in the Steel Sector over the last four years has been to transform the public sector companies under SIDERMEX, into a group of solvent and viable enterprises, with technically upgraded facilities, that are able to produce internationally competitive products, to better serve the country's downstream users. This goal has been supported in general by the Bank in its industrial sector work and in particular by the Steel Sector Restructuring Loan for US$400 million made in 1988. The objective of this loan was to assist the Government in developing its policy toward the steel industry and to improve the raw material supply and modernize selected flat products facilities in both the public and private sectors. The further step of privatization of the public sector portion of the industry is the logical extension of the restructuring process and a continuation of the effort to achieve these goals and objectives. At the same time it offers the possibility of eliminating further financial drain on the Government budget in support of the steel sector.

THE CURRENT LOAN

Satisfactory progress has been made with regard to the Steel Sector Reform Program embodied in the loan. The conditions for disbursment for Part A have been met. The modernization program for AHMSA in Part B.1 is well underway as is the mining improvement program for CMC in Part B.2. The major committments under the loan for these parts of the project will be completed during 1990. The mission believes that these programs are necessary for the long term health of the industry, add significant value to the enterprises and should be completed as quickly as possible. Part B.3 which was intended to provide technical assistance to SIDERMEX in its holding company role has approximately US$4.0 Million uncommitted. These funds could be reallocated and made available to the Government to assist in the privatization effort.

Part C was intended for the private sector firm HYLSA. It is expected that this part will be further delayed until the outcome of the privatization effort is clear and a final investment strategy is developed by HYLSA. The purpose of this part was to maintain competition in the sector in the flat products area. Depending on the participation of HYLSA in the final sale of public sector assets, use of these funds may have to be reevaluated, however, the mission believes that the delay until that time should be accomodated by the Government and the Bank.

Overall the mission believes that there has been satisfactory progress in steel sector reform, that the loan provides needed assistance in meeting the goals and objectives for the steel industry and that the program should continue.

PRIVATIZATION

The process that will be followed in the privatization of the SIDERMEX companies is critical to attaining the restructuring objectives. It is not steel industry assets that are being sold but operating companies. Therefore it is necessary that these companies are well run during the period to enhance their value. The management of the firms should be involved in the process to the degree possible in order to avoid a decline in performance due to uncertainty on their part. Most importantly it is necessary that the process be handled as rapidly as possible in the most professional manner.

The mission understands that within a short time, the assets of each of the companies will be transfered to an assigned bank selected by SHCP. At this time, the SIDERMEX Holding Company would no longer exist, and all responsibilities for operation, marketing, finance and other business activities would be handled directly by the companies. They would deal independently with the assigned bank and the Government through the remaining steps in the process. At this stage, SHCP is expected to identify who will be responsible for directing and carrying out the process, how staff from various Ministries and key members of the former SIDERMEX organization will be used, what the role of the assigned bank will be and how direction for the companies will be provided. The mission believes that it is important to quickly and clearly address all of these organizational issues and dedicate full time the people and resources necessary to professionally handle the very complex task of privatization.

Once the internal organization is clear, the mission recommends that direct assistance from an international banking or investment firm, expert in mergers and acquisitions and with steel industry experience, be contracted to act as a partner throughout the process. This assistance would enhance the capability of dealing with possible international investors, joint ventures with national groups and broaden the professional expertise and capabilities being applied to the process.

One of the first technical steps to be undertaken is the evaluation of the enterprises in financial terms along with an assessment of the businesses and their potential value to investors. This will provide the basic information needed to characterize the companies and further develop the strategy for their sale. Terms of reference have been prepared by SIDERMEX for the necessary outside assistance in carrying out these evaluations including the possible grouping of firms and assets. The mission agrees that these terms of reference cover the scope of work that should be undertaken at this stage. However the mission recommends that the work described be carried out after the organizational issues are settled and with the aid of the international investment firm selected as a partner. Unallocated funds from Part B.3 of the loan could be reasingned to assist in payments to the international firm or to undertake related work as the Government may request.

CAPITAL STOCK

The privatization of the companies offers the opportunity to consider various alternatives for ownership of the companies. These range from 100% foreign investment to combinations and joint ventures of foreign and local participants. The mission suggests that a broad distribution of the capital stock of the firms may help ensure the long term health of the industry and maximize participation of Mexico's private sector. The following example includes elements that might be considered:

a) a portion of the stock offered to domestic investors or groups to ensure local interest and participation in decision making;

b) a portion of the stock offered abroad to ensure an international market for a part of the company's capital stock and its products;

c) a portion of the stock held by the Government with a time bound committment to place part on the domentic stock market to create liquidity in the shares, and a part made available to local smaller investors in towns where the facilities are located, in order to create a broader interest in the success of the local plants; and

d) the balance of the stock held by the companies for management and employees and made available through salary purchase, savings plans and performance bonuses that would build a basis for individual long term committments to the company.

This final step may help to replace the security that management and employees will feel they are loosing in the transition from public sector employment.

CONCLUSION

The mission believes that the privatization of the SIDERMEX companies is a bold move and is one of the largest and most important steel industry activities now being undertaken anywhere in the world. It will be watched closely and with great interest by Goverments and other firms throughout the international steel community. The efforts in Mexico may well provide a guide for other countries and industries to follow. This emphasizes the need for the process to be carried out in the most timely and professional manner. The Bank should continue, as appropriate, to assist particularly in the areas of technical assistance and direct advice to the Government.

Mexico City April 5, 1990

THE WORLD BANK/IFC/MIGA
OFFICE MEMORANDUM

ME LN 2916

ME. Environmental Sector

DATE: May 20, 1991

TO: Files

FROM: Eugene D. McCarthy, Resident Representative, LA2MX

EXTENSION: 683-8859

SUBJECT: Visit to Monterrey and Monclova

1. I visited both Monterrey and Monclova in the period May 15-17, both visits in the context of a Bank supervision mission for the Steel Restructuring Project (2916-ME), and on which Ed Mangan will be reporting in detail. My visit also coincided with an interesting conference - in Monterrey - on the environment, attracting high level representation from SEDUE and a strong representation from industry which had its latest environmental wares on exhibit. Monterrey is currently in the throes of a highly visible election for a new governor, in which the governing PRI party is strongly backing its own candidate (Socrates Rizzo) against its principal challenger, the PAN candidate, Rogelio Sada, in a city and regional area of Mexico where the PAN party continues to have a strong hold. The environment, a growing public issue for Monterrey, is now an integral theme of the political debate.

2. There were three aspects worth some brief comment on my visit to Monterrey:

(a) meeting with the Governor of Nuevo Leon, Jorge Treviño;

(b) the environment;

(c) the HYLSA steel plant, one of the 3-4 likely bidders in the privatization of the AHMSA steel complex in Monclova (cf. paragraph 3).

The meeting with the Governor lasted about an hour. He has an academic background in law, doctorate studies at the Sorbonne, 20 years as a Diputado, and apparently the first governor in Nuevo Leon without a strong political background, in the traditional sense. He was gracious and courteous, showing a surprising degree of general interest in the World Bank's activities (for a city where we have had much less of a presence than IFC or IDB): in terms of specifics, however, little concrete. With just a few months left in his six-year term, his mind was likely on the next phase of his professional and public responsibilities. Transport infrastructure, the continuing shortages of water and the environment were mentioned as priority areas for financing. The environment is already becoming an important issue for Monterrey and this Environmental Conference (held in Monterrey on May 16/17) attracted not only the two senior officials from SEDUE (Patricio Chirinos and Sergio Reyes Lujan) but also overseas participation, mainly from the U.S. and Switzerland; the summary program is attached (Annex I). Not surprisingly, industry and transport

ATT.

are the main sources of pollution in Monterrey, an urban area where a systematic plan to address the environmental concerns is rapidly becoming a matter of urgency. The environmental issues of Monterrey, and the neighboring area of the State of Nuevo Leon, could usefully form part of our environmental sector work, once the Technical Assistance project for SEDUE and, hopefully, the Transport Air Pollution project in the D.F., are beyond appraisal.

3. The other subject of my visit - the Mexican steel industry, in particular the privatization process - is also at an intriguing stage. In Mexico City, the Ministry of Hacienda, advised by McClellan, are systematically taking the preparative steps for the privatization of AHMSA. There appear to be only four potential buyers (three Mexican investors and a possible non-Mexican bid from Japanese, U.S. or, less likely, U.K. sources), some three more months of preparation, and still some contractual work to be done in stipulating the tariff "rules" (for gas, electricity). The Subsecretary of Mining, Elias Ayub, is cautious about the outcome; he feels it will be a more difficult undertaking to attract private investors to steel than to FERTIMEX (whose privatization is underway). At the privately owned HYLSA steel plant in Monterrey I was impressed with the operation and they are eyeing the AHMSA privatization with interest.

4. In Monclova by contrast, where the AHMSA plant is located, 2-1/2 hours by road from Monterrey, and once the capital of Texas, the town is experiencing the anguish of Mexico's steel industry. A community of 250,000 whose main economic livelihood has been steel for almost five decades, is living through the full social 'restructuring' cost that Consett, Corby and the Clyde industries lived through earlier in the U.K. From an employment of 23,000 in AHMSA, it has been reduced to 14,000 in just over a year, and the target is to go below 10,000 by the end of the calendar year. The young (without benefits) and the old (with some benefits) have been the main groups to go. With some 50,000 family members feeling the direct consequences of this lay-off, I was surprised that the socio-economic consequences were not more visible. Though there is an admirable resilience within the community, Monclova still faces uncertainty. A clear-cut outcome to the privatization later this year will provide a basis to rehabilitate, rationalise and forward plan in this steel industry; prolonged delays will produce the opposite, and continued economic hardship for this community.

Attachment

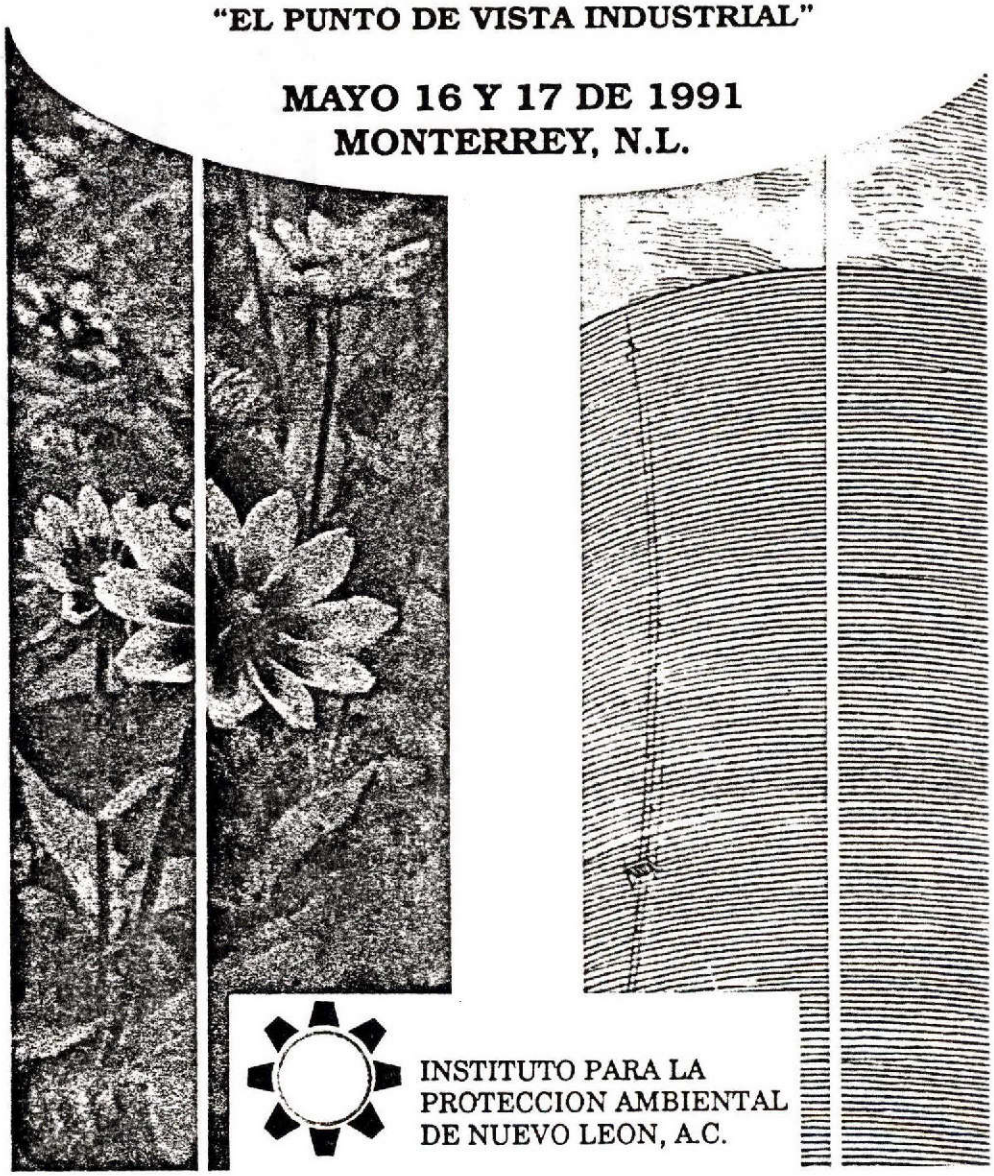
Distribution

Messrs/Mmes. Steckhan, Knotter, LA2DR; Squire, van Wijnbergen, LA2C1; Halperin, LA2IE; Lee, LA2HR; Binswanger, LA2AG; Voljc, LA2C2; Birdsall, LATEN; Freeman, CL1D1; Mangan, ASTIF; Kaplan, LATEN; Draaisma, Arevalo, LA2MX

PRIMER FORO
Y EXPOSICION INDUSTRIAL
PARA LA PROTECCION AMBIENTAL

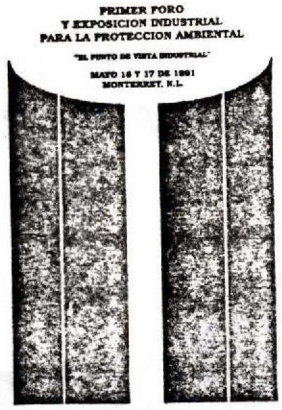
"EL PUNTO DE VISTA INDUSTRIAL"

MAYO 16 Y 17 DE 1991
MONTERREY, N.L.



INSTITUTO PARA LA
PROTECCION AMBIENTAL
DE NUEVO LEON, A.C.

PROGRAMA GENERAL



EL EVENTO INTERNACIONAL MAS IMPORTANTE EN MEXICO EN MATERIA ECOLOGICA

Fecha:
16 y 17 de Mayo de 1991
Horario:
8:00 a 19:00 Hrs.
Sede:
CINTERMEX,
Parque Fundidora, Monterrey, N.L.,
México

PARTICIPANTES INVITADOS:

Secretaría de Desarrollo Urbano y Ecología
Secretaría de Desarrollo Urbano
Secretaría de Salud
Instituto Mexicano del Petróleo
Texas General Land Office
Universidad de Lamar
Universidad Autónoma de Nuevo León
Instituto Tecnológico y de Estudios Superiores de Monterrey
Centro de Ciencias de la Atmósfera, UNAM
Universidad de Barcelona
Cámara de la Industria de Transformación de Nuevo León
CONCAMIN

INSTITUTO PARA LA
PROTECCION AMBIENTAL
DE NUEVO LEON, A.C.

Jueves 16

8:00-8:30	**Registro** Vestibulo del Centro de Convenciones
8:30-9:00	**Ceremonia Inaugural** Salón "C" Bienvenida, Ing. Roberto Rodriguez Puente, Instituto para la Protección Ambiental de Nuevo León, A.C. Inauguración del Foro Industrial, Lic. Jorge A. Treviño Martínez, Gobernador Constitucional del Estado de Nuevo León.
9:00-10:15	**Sesiones Plenarias** Salón "C" "Perspectivas del Control de la Contaminación", Lic. Patricio Chirinos Calero, Secretario de Desarrollo Urbano y Ecología. "Desarrollo Sostenido: Reto Global para la Industria", Dr. Stephan Schmidheiny, Presidente del Consejo Empresarial para el Desarrollo Sostenible.
10:15-10:30	**Inauguración de la Exposición Industrial** Area de Exposiciones Temporales de CINTERMEX Corte del Listón Simbólico, Lic. Patricio Chirinos Calero, Secretario de Desarrollo Urbano y Ecología.
10:30-13:00	**Sesiones Plenarias (continuación)** Salón "C" "Normatividad en Contaminación", Fís. Sergio Reyes Luján, Sub-Secretario de Ecología, SEDUE. "Descentralización en el Control de la Contaminación", Ing. Alberto Ortiz Certucha, Secretario de Desarrollo Urbano, Gobierno del Estado de Nuevo León. "Ventajas Competitivas en la Solución de Problemas Ecológicos", Ing. Luis Angel González Charles, Vicepresidente de la División de Mejoramiento Ambiental, Grupo Cydsa. Sesión de Preguntas y Respuestas.
13:00-15:00	**Comida-Conferencia** Salón "B" "Financiamiento para el Control de la Contaminación en las Industrias", Lic. Alfonso H. Ramos G., Director Regional Noreste de Nacional Financiera. Sesión de Preguntas y Respuestas.

15:00-17:00 **Sesiones Técnicas**
Simultáneamente se llevarán a cabo las pláticas con dos temas:

1.- Residuos Sólidos. Incineración
Salón "C"

"Methods of Hazardous and Industrial Waste Handling and Disposal",
Dr. David L. Cocke,
Univ. de Lamar, Beaumont, Tx., EUA.

"Incineración de Residuos Peligrosos",
Ing. José de Jesús Vargas,
Tratamientos Industriales Tijuana Internacional, S.A.

"Importación y Exportación de Sustancias y/o Residuos Peligrosos",
Dra. Cristina Cortinas de Nava,
Directora General de Salud Ambiental,
Secretaria de Salud.

"La Geologia Ambiental en la Selección de Sitios para el Depósito y/o Confinamiento de Desechos Industriales",
Ing. Salvador Marin Córdoba,
Ing. Enrique Aguilera Hernández,
Instituto Mexicano del Petróleo.

Sesión de Preguntas y Respuestas.

2.- Contaminación Atmosférica
Salón "G"

"Los Clorofluorocarbones en México a la Luz del Protocolo de Montreal",
Ing. José Angel Andión Garcia,
Quimobásicos, S.A. de C.V.,
Grupo Cydsa.

"Combustibles Alternativos para Vehiculos Automotores",
Garry Mauro,
Texas General Land Office, Austin, Tx., EUA.

"Los Energéticos Derivados del Petróleo y su Relación con la Contaminación Atmosférica en México",
Ing. Rodolfo Casas Barba,
Instituto Mexicano del Petróleo.

"Evaluación de Contaminantes en Emisiones de Fuentes Fijas",
Ing. Francico J. Guzmán,
Ing. Manuel de J. Guajardo S.,
Valuatec Servicios Técnicos,
Grupo Vitro.

Sesión de Preguntas y Respuestas.

17:00-19:00 **Conferencias sobre Equipos en Exposición Industrial**
Salónes "C" y "G"

Conferencias Técnico-Comerciales
Serán programadas durante la tarde de acuerdo con los Expositores.

Sesión de Preguntas y Respuestas.

8:30-10:30	**Sesiones Plenarias** Salón "C" "Perspectives on Worldwide Environmental Issues", Sydney J. Everett, Stanford Research Institute, Menlo Park, California, EUA. "Presentación del Proyecto Piloto para el Mejoramiento Ambiental de la Zona Metropolitana de Monterrey", Mauricio Athié Lambarri, Comisión de Comunidades Europeas. Dr. Hernando Guerrero, Comisión Nacional de Ecología, SEDUE. "Preparing for the Nineties: Anticipating Environmental Controls in Industrialized Countries", Dr. A. Mel Gajraj, Comisión de Comunidades Europeas.
10:30-11:00	**Receso**
11:00-13:30	**Sesiones Plenarias (continuación)** Salón "C" "Importancia de la Investigación Aplicada a la Solución de Problemas Ambientales: Caso México", Dr. Humberto Bravo A., Centro de Ciencias de la Atmósfera, U.N.A.M. "La Industria y el Medio Ambiente en México: Perspectivas para el Siglo XXI", Dr. Francisco Szekely, Asesor Naciones Unidas, International Institute for Management Development, Lausanne, Suiza. Sesión de Preguntas y Respuestas.
13:30-15:00	**Comida-Conferencia** Salón "B" "Experiencias en la Ciudad de México y Recomendaciones al Sector Industrial", Ing. Guillermo Barroso Montull, Comisión de Ecología, CONCAMIN. Sesión de Preguntas y Respuestas.
15:00-17:00	**Sesiones Técnicas** **Simultáneamente se llevarán a cabo pláticas con dos temas:** **1.- Aguas Residuales** Salón "C" "Problemática del Agua en México", Ing. José F. García Quintanilla, ATLATEC. "Carrousel. Sistema de Oxidación Biológica", Ing. Sergio García Gutiérrez, Baker Process Technology de México, S.A. de C.V.

"Mejoramiento del Medio Ambiente Mediante Reactores Biológicos",
Dr. Alberto Salinas Franco,
Centro de Desarrollo Biotecnológico, ITESM.

"El Agua y la Sociedad",
Ing. José Luis Adame de León,
Comisión Nacional del Agua,
Delegación Nuevo León.

Sesión de Preguntas y Respuestas.

2.- Basura o Desperdicios
Salón "G"

"Reciclado de Plásticos",
Lic. Jaime Bonilla Ríos,
Centro de Desarrollo Biotecnológico, ITESM.

"Alternativas Tecnológicas de Utilización de Compostas y Lodos Activados",
Ing. Francisco Medina Gómez,
Centro de Desarrollo Biotecnológico, ITESM.

"Recuperación de Plata y Mercurio de Pilas Botón Agotadas",
Dr. Ferran Espiell,
Universidad de Barcelona, Barcelona, España.

"CEMEX: Energy for Environmental Preservation",
Dr. Frank C. Stevens,
Grupo Cementos Mexicanos

Sesión de Preguntas y Respuestas.

15:00-17:00 **Conferencias Sobre Equipos en Exposición Industrial**
Salon "I"

Conferencias Técnico-Comerciales
Serán progamadas durante la tarde de acuerdo con los Expositores.

Sesión de Preguntas y Respuestas

17:30-19:00 **Convivio**
Salón "B"

THE WORLD BANK/IFC/MIGA

OFFICE MEMORANDUM

DATE: June 7, 1991

TO: Mr. Moeen A. Qureshi

FROM: Rainer B. Steckhan, Acting Vice President, LAC

Steckhan

EXTENSION: 38074

SUBJECT: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)
Proposed Amendment to the Loan Agreement

1. Attached please find for your approval and subsequent distribution to the Board of Directors for their approval on a non-objection basis a Memorandum from the President requesting an amendment to the Loan Agreement of the above-referenced loan to extend the grace period of the loan by one year with a consequent reduction of two years in the principal repayment period. Background to this proposal is provided below. The first amortization payment under the loan falls due on June 15, 1991. In order for the Government to benefit from the proposed extension, we need to obtain your approval by June 14, 1991 at the latest in order to change the loan records and avoid the technical complications arising from a retroactive adjustment which would affect the Bank's currency pool-based billing system.

2. Although initially slow, progress in the reform of the steel sector as agreed with the Bank and supported under Part A of the project has proceeded satisfactorily, and in the case of privatization, progress has exceeded expectations. Both tranches of the loan under Parts A and D of the project amounting to US$100 million have been disbursed. The investments under Part B of the project have been somewhat delayed due mainly to investment and price controls that were put in place by the Government as part of broad economic measures to control inflation and stabilize the economy. About US$150 million equivalent has been committed in contracts and about US$66 million has been disbursed to date.

3. The privatization process is expected to be completed this year and the Government has requested a one year extension of the grace period in order to provide the new prospective owners with sufficient time to review the investment program agreed with the Bank and for the purchaser to eventually take part in the decisions on its completion. I therefore recommend that, in order to assist the Government with their sector privatization efforts, the proposed extension of the grace period be granted.

From: The President June , 1991

MEXICO: Proposed Amendment to the Steel Sector Restructuring Project (Loan 2916-ME)

1. This memorandum proposes a modification of the amortization schedule of Loan 2916-ME to permit a one year extension of the grace period.

2. On March 3, 1988, the Executive Directors approved a hybrid sector adjustment and investment loan of US$400 million equivalent to Nacional Financiera, S.N.C. (NAFIN), to assist in implementing a comprehensive and far-reaching set of policy reforms for both the public and private steel sectors and in carrying out needed sector and company restructuring actions. The project is assisting in (i) financing imports of raw materials; (ii) improving the competitive position of the flat products producers; (iii) designing and implementing a sound steel sector reform program; and (iv) carrying out Mexico's debt reduction plan.

3. The project started slowly mainly because of difficulties in reaching agreement on the strategy for implementation of the steel sector reform program. However, recent actions have gone well beyond the Government's commitments and the state-owned segment of the industry is now in the process of privatization. The investment components of the project were further delayed, mainly due to the Government's efforts to control capital investment and budgetary expenditures as part of its successful economic measures to stabilize the economy. US$100 million of the loan under Parts A and D of the project has been fully disbursed in two tranches of US$50 million equivalent each for the financing of imports of input materials (the sector adjustment component of the project) and debt reduction. Under Part B of the project, which supports raw materials and flat products development in the public sector (amounting to US$225 million equivalent), about US$150 million equivalent has been committed in contracts and about US$66 million equivalent has been disbursed as of June 3, 1991. The portion allocated to Part C of the project (US$75 million equivalent) to assist in the flat products development for the private sector, was canceled by the beneficiary (HYSLA SA de CV), which expects to participate in the purchase of the public sector flat products company. At the present rate of progress, allowing for the expected delays due to privatization, it is estimated that the project cannot be completed before December 1995, i.e. about 2-1/2 years later than planned.

Distribution

Executive Directors and Alternates
President
President's Council
Vice Presidents, Bank, IFC and MIGA
Directors and Departments Heads,
Bank, IFC and MIGA

*Questions on this document may be referred to Mr. Mangan (Ext. 82699).

rm 590

etailed instructions on completion of
This Form are in Annex D of OD13.05.

THE WORLD BANK
IBRD and IDA - Implementation Summary

Run Time: 06/12/91 at 16.47.15

This Summary is (_) the initial summary / (X) part of a mission report / (_) an update

Regional Office:	Project Name:	Loan/Credit Numbers:	L/C Amt ($XX.XM/SDR)	Type of Lending Instrument:
VP - LATIN AMERICA	STEEL RSTRCTRNG Project Code:6MXCPA164	L29160	Original:400.0 Revised:325.0	SIM/DRL

Country:	Borrower:	Board Date:	Signing Date:	Effective Date:
MEXICO	NAFINSNC	03/03/88	03/15/88	03/16/88

Managing Dept/Div Name:	Dept/Div Code:	Task Manager:		
INFRASTRUCTURE & ENERGY OPR DIV	31440	MANGAN	Mission End Date: 05/23/91 Next Mission (mo/yr): 11/91	Last 590: 12/13/90 This 590: 06/10/91

SECTION 1: Summary of Project Development Objectives:

The objectives of the project are to (a) enhance competitiveness in the steel sector through the implementation of the Price Liberalization Program and the Steel Trade Policy Program; (b) restructure SIDERMEX operations financially, organizationally and administratively; (c) rehabilitate the AHMSA steel Production facilities and the SIDERMEX mining operations; and (d) modernize HYLSA.

SECTION 2: Summary of Project Components:

Part A eligible raw material and steel product imports.
Part B investment in AHMSA, CMC, SIDERMEX
Part C investment in HYLSA.
Part D debt reduction plan.

SECTION 3: Project Data and Performance Ratings:

Basic Data	Closing Date	Project Cost ($XX.XM)
Original (from SAR/PR):	12/31/93	$1,050.0
As Formally Revised:		
Expected-Last Form 590:	12/31/93	$1,050.0
Expected-This Form 590:	12/31/93	$1,050.0

Disbursement (mo/yr) 05/91	($XX.XM)	(% of L/C)
Original SAR/PR Forecast:	$356.4	89.1%
Formally Revised Forecast:		
Actual Disbursement:	$166.2	51.1%
Disb. Forecast for CFY:	$90.8	27.9%
Actual for CFY:	$25.1	7.7%

Number of formal closing date extensions: 0
Date of last closing date extension (mo/yr):

Reporting: End of period covered by last project progress report (mo/yr): 05/91

Indices	This Form 590	Last Form 590
Closing Delay	.0%	.0%
Cost Overrun	.0%	.0%
Disbursement Lag	53.4%	51.0%

Audits and Accounts	Number
Overdue Audited Financial Statements:	0
Overdue SOE Audits:	0
Overdue Special Account Audits:	0
Qualified and Unsatisfactory Audits:	1

Mandatory Ratings	This Form 590	Last Form 590
Overall Status	2	2
Project Development Objectives	1	1
Compliance With Legal Covenants	2	2
Project Management Performance	2	2
Availability Of Funds	3	3

Other Ratings	This Form 590	Last Form 590
Procurement Progress	3	3
Training Progress	3	3
Technical Asst. Progress	2	2
Studies Progress	2	2
Environmental Aspects	2	2
Financial Performance	3	3
Monitoring and Evaluation	NR	NR

SECTION 4: Supervision Management:

Names Of Mission Members	Member Specialization	Participated In The Previous Mission (Yes/No)
E. MANGAN	TASK MGR./ENG.	Y

Time Spent On Supervision	(mo/yr) 06/91
S/W Up To Current FY :	87.8
S/W Planned During Current FY:	22.0
S/W Actual During Current FY - Total :	15.3
In Field :	4.0

IMPLEMENTATION SUMMARY - FORM 590 - Loan 2916-ME

Section 5: ACTION PREVIOUSLY AGREED OR RECOMMENDED

Domestic steel prices were fully liberalized in 1990. The Government, through SHCP began the process of privatization of the public sector steel companies in March 1990, assisted by two domestic banks and S.G.Warburg & Co.Inc. and McLellan and Partners of the UK. The previous mission learned that SHCP had suspended the investments for Part B.1. The Bank supported the privatization effort but objected to the suspension of investments and recommended review by the technical advisors to SHCP.

Section 6: ACTION BY (a) BORROWER AND (b) BANK SINCE PREVIOUS FORM 590

(a) SHCP advisors reviewed the investment program under the loan and recommended continuation of the project. The Government proceeded with the privatization process but has not yet allowed the investments for Part B.1. to continue. (b) The Bank has continued to support the privatization effort, but has also urged resumption of the investments. Part C of the loan for the private sector steel company HYLSA was canceled at the borrowers request.

Section 7: SUMMARY OF CURRENT PROJECT STATUS AND MAJOR PROBLEMS

Emphasis continues to be on the privatization of the SIDERMEX companies, with their sale expected in 1991. All portions of Part A of the loan, the Steel Sector Reform Program, are being satisfactorily maintained. Part B, the public sector investment component for AHMSA, CMC, and SIDERMEX is slowly progressing, but further delays are expected in Part B.1, the AHMSA portion, due to indecision by SHCP on funding and authorization for investments.

Section 8: SUMMARY OF AGREEMENTS AND FURTHER ACTIONS

SHCP, even after receiving a recommendation from its advisors to continue the investment project included in the loan, instructed AHMSA to delay its commitments until the second half on 1991. It is not clear whether they will be allowed to continue at that time. The action is contrary to the commitments agreed in the legal documents, and continues to jeopardize the investment part of the project and loan. The mission recommends that the Bank again convey its concern to SHCP on this issue but withhold any further action until the second half of 1991, when AHMSA will attempt to place one of the pending contracts. If further delays materialize, the viability of the project and the investment objectives may be in doubt and would have to be reappraised by the new owners and the Bank before continuing.

The holding company, SIDERMEX, will be eliminated shortly, and Part B.3 of the loan will no longer be needed. A request is expected from NAFIN to cancel the unused portion of US$4 million. Amortization payments for the loan are scheduled to begin in June 1991. In support of privatization, NAFIN has requested that the Bank extend the grace period of the loan for one year.

NAME OF PREPARING OFFICER: REVIEWED BY: (DIVISIONAL MANAGER) REVIEWED BY

E.K.Morgan Ricardo Halperin

MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)
Supervision Mission May 12 to 23, 1991

Aide Memoire

1. This Aide Memoire summarizes the findings of Mr. Edmund Mangan, who visited Mexico on a Bank Supervision Mission, from May 12 to 23, 1991. The Mission met with SHCP, SEMIP and SPP to review subsectoral issues, with NAFINSA the borrower, and with AHMSA, CMC and SIDERMEX, the beneficiaries, to review the status, project components and next steps, and with HYLSA, to discuss their plans after the cancellation of Part C of the loan.

2. In summary, reform in the steel subsector including the privatization of the SIDERMEX companies continues to progress satisfactorily. The investment parts of the loan however, continue to be delayed, even after review by SHCP and their financial and technical advisors, who recommended proceeding with the project. All aspects of Part A of the loan, the Steel Sector Reform Program, have been satisfactorily implemented and are being maintained. Part B, the public sector investment component for AHMSA, CMC, and SIDERMEX is progressing, but with delays due to the privatization process. Part C, the private sector investment component was cancelled at the request of the beneficiary HYLSA.

Steel Sector Reform

3. Part A US$100 Million Equivalent. The Steel Sector Reform Program is being carried out fully in the spirit of the agreements with the Bank. The prices for all steel products have been completely freed with the exception of tinplate which has been raised much closer to international prices and is also expected to be free shortly. The trade liberalization program continues with low tarriffs on steel products and no other limitations on steel imports. The remaining portions of the program are satisfactorily addressed under the privatization program for the public sector steel companies.

4. The privatization of the SIDERMEX companies is proceeding rapidly under the direction of SHCP. The documentation needed for prospective buyers has been prepared by the two domestic banks, with the assistance of S.G.Warburg & Co.Inc. and McLellan and Partners of the UK. The government expects that both foreign and domestic bidders will prepare their offers in the next few months and that the companies will be sold well before the end of the year. The mission advised that the Bank continues to support the privatization effort.

Steel Sector Investment

5. NAFINSA, continues to satisfactorily handle documentation relating to the investment program. However, none of the audited financial statements as specified in the legal documents for fiscal 1990 have been received. The mission again stressed that audited annual financial reports, prepared in accordance with Bank Guidelines, reflecting covenants under the various legal agreements and Supplementary letters, should be sent promptly to the Bank and

within six months of the close of each fiscal year. Although NAFINSA promised attention to this issue, the audits may be further delayed due to the write down of assets in the 1990 annual reports in preparation for privatization.

6. The budget for 1991 for AHMSA and CMC was reviewed and appears adequate to carry out the project. However, all investment commitments have been delayed by SHCP until the second half of 1991, and it is unclear at this time whether any further investments will be allowed before the sale of the companies. The mission reiterated its previous view, supported by the report of the advisors to SHCP, that the investment program adds value to the companies and that these delays are reducing the returns from the project and the final selling price of the companies.

7. Discussions were held with SHCP regarding the possibility of cancelling the uncommitted portions of the loan amounting to about US$ 80 Million, along with the possibility of extending the grace period for one year to assist in privatization. The mission believes that the companies would be of greater value, and would have the best chance of meeting the goals and objectives of the project and loan, if the Bank allows the one year extension and SHCP continues to make available the uncommitted portions of the loan to the new owner of AHMSA and CMC. The mission advised that SHCP should seek direct discussions with Bank management in Washington on these questions.

8. Part B.1 US$ 170 Million Equivalent. The project at AHMSA is moving ahead technically. Project management assistance continues to be provided by British Steel Consultants. An extension to their contract for work beyond October 1991 is still pending. The Mission reviewed the technical details and status of the project and found that the last four investment packages, using ICB two stage bidding procedures, will be ready for contract placement in June and July of this year. The mission urges SHCP to allow placement of these contracts which would complete the commitments against Bank funds to be disbursed for AHMSA.

9. The Mission reviewed and found satisfactory, the Phase I Environmental Assessment work completed by AHMSA and UEC Environmental Services Inc.. The Phase I report presented covers the initial appraisal of the environmental condition of the plant and provides new information and data that is likely to lead to additional investment requirements, particularly in the area of water treatment. The Mission requested a brief summary of the Phase I report highlighting the main findings and ranking the major environmental concerns.

10. Progress on the AHMSA Action Plan was reviewed and found encouraging. There has been significant progress in developing and implementing training programs, information systems improvement and plant rehabilitation, all of which are critical areas for the plant. The operating performance and the financial position of the company are equally encouraging, both for the year 1990 and 1991 to date. The company finished last year with an operating profit, but a small loss after charges for revaluation of assets. Additional reductions in personnel and further rationalization of facilities are planned in order to cope with higher levels of import competition, resultant lower sales volumes, higher input costs and lower prices. These measures are extensive and are expected to maintain AHMSA's profitability through the first half of 1991 and impact positively on the sale of the company.

11. <u>Part B.2 US$ 50 Million Equivalent</u>. The Mission reviewed the technical and financial performance of CMC and notes that operating improvements are being sustained in both the Coal and Iron Mining areas. The Project Manager within CMC, with minor consultant assistance, is satisfactorily handling the remaining work under the project. A new Technical Assistance contract with BHP has been negotiated and critical packages for procurement under the loan are being processed. A revised project schedule was reviewed along with the CMC Action Plan. The Action Plan results are also positive and further rationalization is planned to maintain operating and financial performance.

12. <u>Part B.3 US$ 5 Million Equivalent</u>. The corporate entity SIDERMEX will likely be closed shortly. There is approximately US$ 4 Million remaining uncommitted in this part of the project. The mission discussed with SHCP, the options of reallocating the funds, using them to assist in privatization, or cancelling the remaining portion. No conclusion was reached and it was suggested that this should be taken up in the context of discussions on the other uncommitted amounts.

13. <u>Part C US$ 75 Million Equivalent</u>. At the request of HYLSA this part of the loan was canceled earlier this year. The original concept of maintaining a balance between public and private sector capability, which was the basis for including HYLSA in the loan, seems no longer valid since the entire industry will shortly be in the private sector. HYLSA advised that they have reorganized at the corporate level to make available the resources necessary to properly evaluate their position with regard to the purchase of AHMSA and the other public sector steel facilities to be sold.

Mexico, May 22, 1991

cc Secretaria
John

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

DATE: 27-Nov-1991 10:07am

TO: See Distribution Below

FROM: Edmund Mangan, EMTIE (EDMUND MANGAN)

EXT.: 32429

SUBJECT: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)

Attached is a brief EM from the Mexico Resident Rep office giving some of the details of the recent privatization of the Mexico public sector steel industry holdings, formally SIDERMEX. Included were three major operating steel plants, one mothballed facility and raw materials, mining and service and support operations. Overall this represents about 60% of Mexico's steel capacity and about 7 million tonnes of anual production.

The Bank has long been involved with the steel industry in Mexico in both the public and private sectors. The privatization step is the final culmination of recent involvement in the industry's restructuring process started first with the Public Investment Review carried out by the Bank in 1985, the Steel Sector Strategy Study done by the Bank in 1986 and finally the Steel Sector restructuring Loan in 1987. This loan and project are under active supervision and have provided the vehicle for the Bank to assist in developing the overall strategy for the sector and objective third party advise to SHCP as the privatization process developed.

It is interesting to note that in the final bids for these companies there is significent participation by Mexico private sector entrepreneurs who were not formally steel producers. The Alpha Group which owns HYLSA, the second largest steel company in Mexico behind SIDERMEX, bid on all of the facilities. Apparently they were not able to mobilize enough resources or were not willing to make the longer term committments to completing the current project and the further investment programs needed to develope and maintain a healthy steel industry.

This restructuring and privatization program is rich with experience and it may be worthwhile for the Bank to study it in some detail. This study if undertaken might also review other programs in the steel sector, for example, the recent privatization by Brasil of Usiminos, the largest and probably the most modern facility in Latin America. Public sector steel industry restructuring and privatization is actively being pursued throughout the world and this may be the opportunity for the Bank to contribute significantly to the effort by sharing the results and publishing the broad lessons learned here that are applicable in other countries and other industries.

DISTRIBUTION:

TO:	Carl Dahlman	(CARL DAHLMAN)
TO:	Mary Shirley	(MARY SHIRLEY)
TO:	Ibrahim I. Elwan	(IBRAHIM I. ELWAN)
TO:	Xavier Simon	(XAVIER SIMON)
TO:	Harold E. Wackman	(HAROLD E. WACKMAN)
TO:	Vivek Talvadkar	(VIVEK TALVADKAR)
TO:	Varel Freeman	(VAREL FREEMAN)
TO:	Stephen Ettinger	(STEPHEN ETTINGER)
TO:	Malcolm D. Rowat	(MALCOLM D. ROWAT)
TO:	Paul Meo	(PAUL MEO)
TO:	Rest of Distribution Suppressed	

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

DATE: 26-Nov-1991 05:29pm EST

TO: See Distribution Below

FROM: Joost Draaisma, 31480   (JOOST DRAAISMA AT A1 AT MEXICO)

EXT.: 550-7238

SUBJECT: Sale of Steel Industry.

Last Friday, the sale of the steel industry was announced by SHCP. A total amount of US$ 1,512.5 million was announced to be involved in the sale, made up of 340 million dollar in cash, 195 million dollar in nominal government debt titles, 585 million dollar in promised investments, 350 million dollar in long term debat take over, 42.5 million dollar in minority government participation.

The steel industry complex is split up between 3 private investment groups, both national and international.

Altos Hornos de Mexico

NORTH

A mexican group called Grupo Acerero del Norte, headed by Javier Autrey and Alonso Ancira took over the plant equipment of AHMSA, 29% of the Pena Colorada mine, Aceros Planos and the equipment of the Colada Continua Numero Tres. GAN will run this new operations in an association with the US company Southern California and the Dutch Hoogovens. Their offer consisted of 145 million dollar cash, 535 million dollar new investment and take over of 350 million dollar long term debt obligations.

Sicartsa 1

A second mexican group called Villacero, headed by Julio Villareal and Enrique Sinente, will take over an 80% stake in Siderurgica Lazaro Cardenas-Las Truchas (Sicartsa-1st. fase) for an amount of 170 million dollar. The remaining 20% government minority participation is valued at 42.5 million dollar.

Sicartsa 2

Finally, a group called Caribbean Ispat from India acquired a 29% stake in the Pena Colorada mine and Sibalsa. Their offer consisted of 25 million dollar cash, 195 million dollar nominal gobernment debt titles and 50 million dollar of promised new investment. This group owns 2 steel mills in India, 2 in Indonesia and one in Trinidad and Tobago.

The first conclusion to be drawn from this deal, is that although the resources obtained by the federal government are not very substantial, the authorities are assuring the necessary modernization of the steel industruy through participation of foreign firms, as well as the work of approximately 15,000 AHMSA workers. The new owners have announced that the workers can maintain their contract and that problems of overstaffing can be resolved by relocation.

DISTRIBUTION:

TO:	EUGENE MCCARTHY	(EUGENE MCCARTHY @A1@VAX12)
TO:	DANIEL OKS	(DANIEL OKS @A1@VAX12)
TO:	SWEDER VAN WIJNBERGEN	(SWEDER VAN WIJNBERGEN @A1@VAX12)
TO:	LYN SQUIRE	(LYN SQUIRE @A1@VAX12)
TO:	PAUL KNOTTER	(PAUL KNOTTER @A1@VAX12)
TO:	RAINER STECKHAN	(RAINER STECKHAN @A1@VAX12)
TO:	RICARDO A. HALPERIN	(RICARDO A. HALPERIN @A1@VAX12)
TO:	EDMUND MANGAN	(EDMUND MANGAN @A1@VAX12)

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

DATE: 27-Nov-1991 01:00pm

TO: Edmund Mangan (EDMUND MANGAN)

FROM: Xavier Simon, EDIFI (XAVIER SIMON)

EXT.: 36377

SUBJECT: RE: MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)

Ed, I agree it is a case worth documenting--by far the richest in experiences that I have ever come across. Let's discuss how this might be done. How about lunch next Wednesday, Thursday or Friday--your convenience, let me know. Xavier

CC: VENKATESWARAN (VENKATESWARAN @A1@CHINA)
CC: Marko Voljc (MARKO VOLJC)
CC: Ricardo A. Halperin (RICARDO A. HALPERIN)
CC: Paul Knotter (PAUL KNOTTER)
CC: Rainer Steckhan (RAINER STECKHAN)
CC: Paul Meo (PAUL MEO)
CC: Malcolm D. Rowat (MALCOLM D. ROWAT)
CC: Stephen Ettinger (STEPHEN ETTINGER)
CC: Varel Freeman (VAREL FREEMAN)
CC: Rest of Distribution Suppressed

Mexico: SIDERMEX

~~AHMS~~ AHMSA (ALTOS HORNOS de MEXICO)

North: Bank was involved in restructuring this plant under ____ project at the time of the de la Madrid administration. There was no original intention to divest the plant at that time. Bank anticipated that the plant needed US$225m plus an equal amount in pesos from the Mexican Govt. for restructuring. Bank and Govt. investments totaled US$200m at the time of sale. The plant was sold (100%) for US$145m cash, US$350m in assumed debt, plus investment commitments of US$535m. The Govt. assumed no debt.

South -- Sicartsa 1: Built back in the '70s with Bank assistance. Plant was pretty much debt-free. Sold 80% for US$175m cash; no debt assumed by buyer and no investment commitments. Govt. retains 20%.

Sicartsa 2: Mistake from the beginning. Bank approved a loan for Sicartsa 2 in '79(?), but Govt. cancelled. Bank was against building the plant when Govt. cancelled. Cost the Govt. US$3.5 billion to build the plant. US$1.5 billion in debt was left on the plant when it was sold. Govt. sold 100% for US$25m, plus US$195m in debt, and commitments of new investment of US$50m.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION/MIGA

OFFICE MEMORANDUM

DATE : December 18, 1991

TO : Mr. Ricardo Halperin, Division Chief, LA2IE

FROM : Edmund L. Mangan, EMTIE ELM

EXTENSION : 32429

SUBJECT : MEXICO - Steel Sector Restructuring project (Loan 2916-ME) Supervision Report

1. I carried out a Supervision Mission from December 4 to 11, 1991 under terms of reference dated December 2, 1991. Attached are the Working Version of the Form 590 (due to computer problems an Updated Version cannot be produced at this time), Aide Memoire, draft letters and Table of Compliance.

2. The privatization of AHMSA and CMC is complete along with the sale of all of the former SIDERMEX companies. The purchaser of these companies, Grupo Acerero del Norte (GAN), has requested that Part B of the project and loan be continued. The Aide Memoire and several of the reports contain details of the purchase along with information relating to the supervision mission. They will be entered in the Project Implementation Index File (PIIF), forwarded to the LAC Information Center and made available on request.

Author	Title of Report	Date Issued
GAN	World Bank Facility for AHMSA, Special Report detailing the purchase of AHMSA and CMC and plans of the Group.	December 1991
GAN	Presentation on the Technical Program.	December 1991
AHMSA	Restructuring Program, Progress Report, Budget Revision, Schedule and Action Plan.	December 1991
CMC	Restructuring Program, Progress Report, Budget Revision, Schedule and Action Plan.	November 1991

4. The mission was advised by the borrower NAFINSA, that audited financial statements for the year 1990, have been sent to the Bank, for AHMSA, CMC, SIDERMEX and HYLSA along with audits of the special account from NAFINSA.

Attachments:

cc: Messrs./Mmes. Sri-ram Aiyer, Aguilar (LACVP); Steckhan, Knotter (LA2DR); Kanchugen (LA2C1); Segura, (LATDR); Birdsall (LATEN); Collell, Van Puymbroeck (LEGLA); Sugar (LOAEL); Wackman (EMTIE); Res. Rep. Mexico; LAC Files, Project Files

Form 590

THE WORLD BANK
IBRD and IDA - Implementation Summary

Run Time: 01/08/92 at 09.38.14

Detailed instructions on completion of This Form are in Annex D of OD13.05.

*** Working Version ***

This Summary is (_) the initial summary
(X) part of a mission report
(_) an update

Regional Office:	Project Name:	Loan/Credit Numbers:	L/C Amt ($XX.XM/SDR)	Type of Lending Instrument:
VP - LATIN AMERICA	STEEL RSTRCTRNG Project Code:6MXCPA164	L29160	Original:400.0 Revised:321.0	SIM/DRL

Country:	Borrower:	Board Date:	Signing Date:	Effective Date:
MEXICO	NAFINSNC	03/03/88	03/15/88	03/16/88

Managing Dept/Div Name:	Dept/Div Code:	Task Manager:	Mission End Date: 12/11/91	Last 590: 09/13/91
INFRASTRUCTURE & ENERGY OPR DIV	31440	MANGAN	Next Mission (mo/yr): 05/92	This 590: 01/07/92

SECTION 1: Summary of Project Development Objectives:

The objectives of the project are to (a) enhance competitiveness in the steel sector through the implementation of the Price Liberalization Program and the Steel Trade Policy Program; (b) restructure SIDERMEX operations financially, organizationally and administratively; (c) rehabilitate the AHMSA steel Production facilities and the SIDERMEX mining operations; and (d) modernize HYLSA.

SECTION 2: Summary of Project Components:

Part A eligible raw material and steel product imports.
Part B investment in AHMSA, CMC, SIDERMEX
Part C investment in HYLSA.
Part D debt reduction plan.

SECTION 3: Project Data and Performance Ratings:

Basic Data	Closing Date	Project Cost ($XX.XM)
Original (from SAR/PR):	12/31/93	$1,050.0
As Formally Revised:		
Expected-Last Form 590:	12/31/93	$1,050.0
Expected-This Form 590:	12/31/93	$1,050.0

Disbursement (mo/yr) 11/91	($XX.XM)	(% of L/C)
Original SAR/PR Forecast:	$380.2	95.0%
Formally Revised Forecast:		
Actual Disbursement:	$182.4	56.8%
Disb. Forecast for CFY:	$26.4	8.2%
Actual for CFY:	$13.3	4.1%

Number of formal closing date extensions: 0
Date of last closing date extension (mo/yr):

Reporting: End of period covered by last project progress report (mo/yr): 06/91

Indices	This Form 590	Last Form 590
Closing Delay	.0%	.0%
Cost Overrun	.0%	.0%
Disbursement Lag	52.0%	52.6%

Audits and Accounts	Number
Overdue Fin. Stmnts/Project Accounts:	0
Overdue SOE Audits:	0
Overdue Special Account Audits:	0
Qualified and Unsatisfactory Audits:	0

Mandatory Ratings	This Form 590	Last Form 590
Overall Status	2	2
Project Development Objectives	1	1
Compliance With Legal Covenants	1	2
Project Management Performance	1	1
Availability Of Funds	2	3

Other Ratings	This Form 590	Last Form 590
Procurement Progress	2	3
Training Progress	3	3
Technical Asst. Progress	2	2
Studies Progress	2	2
Environmental Aspects	2	2
Financial Performance	2	2
Monitoring and Evaluation	NR	NR

SECTION 4: Supervision Management:

Names Of Mission Members	Member Specialization	Participated In The Previous Mission (Yes/No)
EDMUND L. MANGAN	ENGINEER	Y

Time Spent On Supervision	(mo/yr) 01/92
S/W Up To Current FY :	.0
S/W Planned During Current FY:	20.0
S/W Actual During Current FY -	
Total :	3.8
In Field :	.0

IMPLEMENTATION SUMMARY - FORM 590 - Loan 2916-ME

Section 5: ACTION PREVIOUSLY AGREED OR RECOMMENDED

The Bank provided continued support for the privatization of the SIDERMEX Companies and recommended SHCP resume investments under Part B.1 of the loan. SHCP advisors reviewed the investment program under the loan and recommended continuation of the project.

Section 6: ACTION BY (a) BORROWER AND (b) BANK SINCE PREVIOUS FORM 590

(a) The Government completed the privatization process in November 1991 with the successful sale of the former SIDERMEX companies. SHCP did not follow the recommendations of the Bank or their advisors and continued the suspension of investments for Part B.1. The holding company SIDERMEX, was eliminated and the US$4 million unused portion of Part B.3, was cancelled.

(b) The Bank urged the continuation of investments under Part B.1. A request from NAFINSA to extend the grace period of the loan for one year was declined by the Bank.

Section 7: SUMMARY OF CURRENT PROJECT STATUS AND MAJOR PROBLEMS

The steel industry is now totally in the private sector, which represents the culmination of the restructuring effort by the Government in the steel subsector. Part A of the loan, the Steel Sector Reform Program, continues to be satisfactorily maintained and in completing the privatization process has gone beyond the scope originally envisioned. Part B, the investment component for AHMSA and CMC is moving ahead slowly. The new owner has requested the Government and the Bank to allow the continuation of the project and loan as part of their overall investment program. The major problem for the new owner will be to attempt make up some of the project time lost during the suspension of investments.

Section 8: SUMMARY OF AGREEMENTS AND FURTHER ACTIONS

In response to the request by the new owners to transfer the Bank loan, SHCP agreed to continue the loan guarantee, NAFINSA agreed to continue as the borrower and intermediary and the new owner agreed to continue the project and loan as originally designed. The mission agreed to have draft modifications to the legal documents prepared in Washington for review and negotiation, tentatively in Mexico, in January 1992 and also to provide more detailed information on the procedure and timing after further review with Bank management. The mission agreed that the procurement process should continue uninterrupted while the legal documents are being modified.

NAME OF PREPARING OFFICER: REVIEWED BY: (DIVISIONAL MANAGER) REVIEWED BY

E L del Ougan

MEXICO - Steel Sector Restructuring Project (Loan 2916-ME)
Supervision Mission December 4 to 11, 1991

Aide Memoire

1. This Aide Memoire summarizes the findings of Mr. Edmund Mangan, who visited Mexico on a Bank Supervision Mission, from December 4 to 11, 1991. The Mission met with SHCP the loan guarantor, to review subsectoral issues including the privatization of public sector steel companies, with NAFINSA the borrower, with AHMSA and CMC, the beneficiaries, and with Grupo Acerero del Norte (GAN), the purchaser of these two companies covered by the loan.

2. In summary, the privatization of AHMSA and CMC has been completed as part of the sale of all of the former SIDERMEX companies. The steel industry is now totally in the private sector, which represents the culmination of the restructuring effort by the Government in this subsector. Details of the sale are included below. Part A of the loan, the Steel Sector Reform Program, continues to be satisfactorily maintained and in completing the privatization process has gone beyond the scope originally envisioned. Part B, the investment component for AHMSA and CMC continues to move ahead and has been reviewed by GAN and their technical partner, the Dutch steel producer, Hoogovens. They have requested the Government and the Bank to allow them to continue the project and loan as part of their overall investment program.

Steel Sector Reform

3. Part A US$100 Million Equivalent. The Steel Sector Reform Program is being carried out fully in the spirit of the agreements with the Bank. The prices for all steel products are completely free. The trade liberalization program continues with low tariffs on steel products and no other limitations on steel imports. The remaining portions of the program are all fully satisfied with the privatization of all of the public sector steel companies.

4. The privatization of the SIDERMEX companies was completed in November 1991 by SHCP. The sale totaled about US$1,512.5 million equivalent including, US$340 million cash, US$545 million government debt, US$585 million in investments, and US$42.5 million in minority government participation. Three separate private investment groups, two national and one international, were involved in the sale.

5. Grupo Acerero del Norte (GAN), a Mexican group, purchased the steel company AHMSA and the mining company CMC. They also obtained 29% of the Pena Colorada iron ore mine, the facilities of Aceros Planos and other steelmaking and continuous casting equipment formerly belonging to SIDERMEX. Their offer consisted of US$145 million cash, take over of US$350 million long term debt obligations and US$535 million new investment. Villacero, a second Mexican group, purchased 80% of Siderurgica Lazaro Cardenas (Sicartsa 1) for US$170 million. The remaining 20% government participation is valued at US$42.5 million. Finally, an Indian group, Caribbean Ispat acquired 29% of the Pena Colorada mine and Sibalsa (Sicartsa 2). Their offer consisted of US$25 million cash, US$195 million government debt and US$50 million new investment.

6. The sale of the SIDERMEX companies concludes a process begun in early 1990, which has been assisted by the Bank and which has generated a great deal of interest in Mexico and throughout the world. In assessing the final terms of the sale, the cash and debt transferred to the new owners by the federal government is about as expected, representing only a fraction of the asset or replacement value of the facilities. However, the investment level committed by the new owners is larger than anticipated. This is especially significant taking into consideration the current world steel capacity oversupply and the number of state owned steel companies being offered for sale.

7. Overall, the mission believes that the sale is highly successful. The winning bidders for the two major domestic firms AHMSA and SICARTSA 1, are Mexican with international technical and financial advisors. Neither group is currently involved in steel production, but both will provide serious domestic competition in addition to a new entrepreneurial spirit in the industry. In their bids, they committed not only to improved efficiency and other factors associated with private sector ownership, but also to major investment programs which will modernize the industry and provide world class quality, cost and service to the downstream Mexican steel consumers. These are the most important factors to ensure a healthy steel industry in the long run.

Steel Sector Investment

8. Discussions were held with SHCP regarding the transfer of the Bank loan to the new owners. SHCP agrees to continue the loan guarantee, NAFINSA agrees to continue as the borrower and intermediary and the new owner agrees to continue the project and loan as originally designed. The mission agreed to have draft modifications to the legal documents prepared in Washington for review and negotiation, tentatively in Mexico, in January 1992. The mission agreed to provide more detailed information on the procedure and timing after further review with Bank management in Washington.

9. Part B.1 US$ 170 Million Equivalent. The project at AHMSA continues to move ahead technically with project management assistance provided by British Steel Consultants. The overall project has been reviewed by GAN, and their technical partner Hoogovens, and a decision has been made to proceed with the remaining portions as quickly as possible. The remaining investment packages, using ICB two stage bidding procedures, are expected to be ready for contract placement in early 1992. The mission agreed that the procurement process should continue uninterrupted while the legal documents are being modified.

10. Part B.2 US$ 50 Million Equivalent. The project at CMC also continues to move ahead. A review with GAN has been completed and the decision made to proceed with the project in both the Coal and Iron Mining areas. It is their intention to centralize control of the operations of AHMSA and CMC at the steel plant location in Monclova and to more closely connect the operations of the two firms. The mission agrees with these decisions and will proceed with requesting the necessary revisions to the legal documents.

Mexico, December 11, 1991

The World Bank 1818 H Street, N.W. (202) 477-1234
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT Washington, D.C. 20433
Cable Address: INTBAFRAD

December 18, 1991

Lic. Juan Manuel Izquierdo Sosa
Gerente de Financiamientos Multilaterales
Nacional Financiera
Insurgentes Sur 1971 Torre Norte 8 Piso
01020 Mexico, D.F.
MEXICO

Dear Lic. Juan Manuel Izquierdo:

Re: Loan 2916-ME Steel Sector Restructuring Project

Thank you for the courtesies extended to the Bank mission headed by Mr. Mangan which visited Mexico between December 4 to 11, 1991 to review progress with the project. We are pleased to note the advances recorded in the mission's Aide Memoire of December 11, 1991 (copy attached), especially with regard to the successful privatization of the former SIDERMEX Companies. We look forward to continuing close cooperation with NAFINSA, the Government, and the participating companies in the next phases of this project and loan.

The mission advises that the new owners of AHMSA and CMC, Grupo Acerero del Norte (GAN), wish to continue the project and take over Part B of the Loan. We understand that in support of GAN, the Government is willing to continue the loan guarantee and NAFINSA is willing to continue as the borrower and intermediary. On this basis, the Bank will begin to prepare draft ammendments to the legal documents for review. A formal request from the Government will be required for the changes agreed in that review. In the meantime, we confirm the mission's decision that the procurement process should continue uninterrupted while the legal documents are being modified.

Mr. Mangan will respond separately on any outstanding project issues and we will also advise on the timing for modification of the legal documents.

Sincerely yours,

SIGNED AND SENT DEC. 19, 1991

Ricardo Halperin
Division Chief
Infrastructure & Energy Operations
Country Department II
Latin America & Caribbean Regional Office

Attachment

cc: Lic. Jose Angel Gurria Trevino, Subsecretario de Asuntos Financieros Internacionales, SHCP

Lic. Antonio Cervera Sandoval, Director de Organismos Financieros Internacionales, SHCP

MEXICO - STEEL SECTOR RESTRUCTURING PROJECT (LOAN 2916-ME)
DECEMBER 1991 SUPERVISION MISSION

Status of Compliance with Legal Covenants as of December 12, 1991

Agreement	Section	Status	Original date	Revised date	Description of covenant	Comments
Loan	4.01	OK			NAFIN to furnish audited financial statements for project account for expenditures under Part A.	Audited statement received for 1990.
	4.02	OK			NAFIN to furnish audited financial statements for Special Account.	Audited statement received for 1990.
	Schd. 6.I(3)	OK			AHMSA to maintain ratio of current assets/ current liabilities of at least 1.2 and D/E ratio less than 67:33.	In compliance based on 1990 audited information.
	Schd. 6.I(4)	OK			AHMSA not to incur additional debt which would cause D/E ratio to exceed 67:33 and projected debt service coverage ratio to fall below 1.5.	In compliance based on 1990 audited information.
	Schd. 6.II(3)	OK			CMC to maintain debt service coverage ratio not less than 2.0 and cash generation/capital expenditure ratio not less than 0.5.	In compliance based on 1990 audited information.
	Schd. 6.IV(3)	NA			HYLSA to observe financial covenants similar to those included in Debt Restructuring agreements with its private creditors.	Part C canceled at HYLSA's request. Debt restructuring agreement with private creditors was concluded in October 1989.
Guarantee	2.03	NA			Government to provide adequate counterpart funding.	Funding for the investments in Part B to come from new private sector owners.
	3.03	OK	07/31/88		Government to issue satisfactory global steel sector policy statement.	Satisfactory policy statement received in January 1990.
	3.04	OK	12/31/88		Government to implement and maintain liberalized steel prices.	Prices officially liberalized on September 7, 1989; and removed from PACTO agreements in September 1990.
	3.05	OK			Government to implement Steel Trade Policy Program and maintain it in effect in manner consistent with Steel Sector Reform Program.	Tariffs on imported steel products reduced in 1987 and maintained at 0-15%, with the average being about 10%. Performance satisfactory.
	3.06	NYD			Government to prepare report on progress of Steel Sector Reform Program upon request.	Not requested.
SIDERMEX	2.01(b)	NA			SIDERMEX to designate and maintain satisfactory Project Manager within 90 days after first disbursement under Part B.	SIDERMEX closed as part of the privatization process. Part B.3 canceled at Government request.

Agreement	Section	Status	Original date	Revised date	Description of covenant	Comments
	2.06(a)	OK	03/31/88		SIDERMEX to prepare satisfactory Strategic Plan.	Satisfactory plan received in January 1990.
	2.06(b)	NA	11/01/88		SIDERMEX to review Strategic Plan annually with Bank.	Not applicable (see above).
	2.07	OK	06/15/88		SIDERMEX to carry out restructuring program in accordance with "convenio."	Privatization moves the program farther than envisioned in the convenio.
	4.01(b),(c)	OK			SIDERMEX to furnish audited financial statements to Bank, including audit of and separate opinion on accounts identifying expenditures under Part B.3.	1990 audit received.
	4.02	OK	09/15/88		SIDERMEX and subsidiaries to revalue fixed assets and adjust balance sheets accordingly.	Revaluation of assets completed in June 1990 as part of the privatization process.
CMC Project	2.01(b)	OK			CMC to establish and maintain Project Management unit to carry out the project.	Satisfactory performance.
	2.06	OK			CMC to prepare and implement Action Plan and review progress with Bank annually, beginning 6 months after first disbursement under Part B(2).	Satisfactory performance.
	3.04	OK			CMC to carry out satisfactory restructuring program and reorganize itself as holding company for mining operations.	Satisfactory plan received May 1989.
	4.01	OK			CMC to furnish audited financial statements to Bank, including audit of expenditures under Part B(2) of project.	1990 audit received.
HYLSA Project	2.01(b)	NA			HYLSA to designate and maintain satisfactory Project Manager within 90 days after first disbursement under Part C.	Part C of the loan canceled at HYLSA's request.
	2.06	NA			HYLSA to prepare and implement Action Plan and review progress with Bank annually, beginning 6 months after first disbursement under Part C.	Not applicable (see above).
	4.01(b)	NA			HYLSA to furnish audited financial statements to Bank, including audit of and separate opinion on expenditures under Part C.	Not applicable (see above).
	4.02	OK			HYLSA to formulate program with its creditors to restructure its debt and formalize satisfactory agreements with such creditors to implement debt	"Second-round" debt restructuring agreement with private creditors concluded in October 1989.

Agreement	Section	Status	Original date	Revised date	Description of covenant	Comments
					restructuring plan consistent with financial requirements of Part C.	
AHMSA Project	2.01(b)	OK			AHMSA to designate and maintain satisfactory Project Manager within 90 days after first disbursement under Part B.1.	Satisfactory performance.
	2.06	OK			AHMSA to prepare and implement Action Plan and review progress with Bank annually, beginning 6 months after first disbursement under Part B.1.	Satisfactory performance.
	4.01(b)	OK			AHMSA to furnish audited financial statements to Bank, including audit of and separate opinion on expenditures under Part B.1.	1990 audit received.

Key: OK - Covenant complied with.
Soon - Compliance expected in reasonably short time.
NYD - Not yet due.
NA - Not applicable.

From Privatisation International, October 1991

Brazil's difficulties with Usiminas may accelerate steel company sales in Mexico

MEXICO'S steel privatisation has been given an unexpected fillip by the difficulties over the sale of Usiminas, Brazil's largest steel mill.

Jacques Rogozinski, the head of Mexico's privatisation unit, has said the government may now accelerate the sale of **Sicartsa 1**, **Sicartsa 2** and **Altos Hornos de Mexico** (Ahmsa), Mexico's three state-owned steel mills. He said that the government would call for bids for at least one of the three companies this month, and that following the problems encountered by Brazil's steel privatisation it might call for bids for all three.

Bids would be due by November, and the companies would be sold by the end of the year. However, Mr Rogozinski underlined that if conditions proved unfavourable the sales could still be postponed until next year.

The Mexican steel privatisation has proved to be one of the most difficult and time-consuming of those managed so far. As Aaron Turnell, the official in Mexico's finance ministry directly responsible for the sale, has said, the steel privatisation differs from the sale of Telmex, the telephone utility, in three ways. The world steel companies, unlike the telephone ones, have little spare cash; the steel industry is in secular decline; and steel is a competitive tradeable good.

Steel privatisation has been further held back by the need to negotiate a new labour contract. On September 10 the unions at Sicartsa finally approved, after a painful period of deadlock, the new contract by 51% to 47%, thereby allowing the government to fire up to 1,775 workers, contract out to non-union workers and eliminate the clause requiring vacant jobs to be filled immediately. On September 17 unions at Ahmsa reached a similar agreement.

Before re-designing the labour contract, the government broke up the holding company Sidermex into Sicartsa 1 and 2 and Ahmsa; closed down four Siemens Martin steel making furnaces at Monclova i Coahuila state because they were causin too much pollution; assumed the consortium's $1.2 billion debt; and abruptly halte most of the three companies' investmen plans. Ian McGregor, formerly of Britis Coal and British Steel, was hired by th Mexican government to help restructure th steel companies.

Mr Rogozinski claims that each stee mill has more than one potential buyer. Ahmsa, which according to Mexican press reports is worth around $350-450 million, will probably be sold to a Mexican company (Alta or Imsa) perhaps in conjunction with a foreign bidder. The company produces 3.5 million tonnes of steel plates a year.

Sicartsa 1, with production of around 1 million tonnes of steel slab a year, could be worth $200 million. Sicartsa 2, with 2 million tonnes of slab production, requires so much investment (up to $400 million) that it could be given away to a company willing to make the necessary commitments. Italian, Indian and Japanese firms are all showing interest.

Damian Fraser,
Mexico City

RECENT BANK SALES IN MEXICO

CONFIA: August 4, sold for $294 million, or 3.73 times book value, to businessmen from Abaco Brokerage—Jorge Lankenau, Jose Maiz Mier.

BANORIENTE: August 11, sold for $73 million to group headed by Marcelo and Ricardo Margain Berlenga. Mergen group does not own brokerage but has factoring and leasing companies.

BANCRESER: August 18, sold for $140 million, or 2.53 times book value, in placing by consortium headed by Roberto Alcantra Rojas, Carlos Mendoza Guadarrama and Ruben Goldberg.

BANAMEX: August 26, 50.7% sold to consortium led by Acciones y Valores for $2.3 billion. Price offered per share was $19,220 pesos per share, 2.62 times book value. Next bid was 2.32 book value. Twenty per cent is to be bought by regional boards, putting total proceeds to government at $3.2 billion.

Argentine phone sales soon

ARGENTINA'S government now says it hopes to sell its remaining 30 per cent share in the country's two privatised telephone companies by November, over six months later than originally planned. It should raise $800-1,000 million in cash—compared with the $214 million in cash and $5.03 billion in debt certificates raised from the sale of 60 per cent of the company last year.

Martin Redrado, head of the national securities commission, said the sale would come in several stages. The first stage was completed at the end of September, when the underwriters advanced the government $300 million in cash to help it balance its books. In the second stage, the underwriters, Morgan Stanley and its Argentine partner Banco Roberts, together with Banco de Galicia of Spain, Banco Tornquist, an affiliate of Crédit Lyonnais, and locally-owned Banco Rio de la Plata, will float the shares on the local and international capital markets.

Redrado said the shares were worth about $800 million, given that the companies are expected to earn aggregate net profits of $240 million this year. The expected share price is based on a projected price/earnings ratio of 10, substantially less than the ratio of 12-13 for the privatised Chilean and Mexican telephone companies.

The government is offering another sweetener in addition to the price discount, by agreeing to tie existing telephone rates to the US dollar, adjusted by the US retail price index.

Pariba

PARIBAS has wor
the Argentine gov
Obras Sanitarias
water company. A
although Schroc
qualified of the
tract, it was und
posed a lower c

The OSN mandate follow[...]
July to award the Segba contract to First Boston, though N M Rothschild was the favourite to clinch the deal. Morgan Stanley advised on the initial ENTel sale with Banco Roberts while the then minister decided not to hire independent advice for the sale of Aerolineas.