

**PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE**

Report No.: AB5168

Operation Name	MX Economic Policies in Response to the Global Crisis DPL
Region	LATIN AMERICA AND CARIBBEAN
Sector	General finance sector (34%); General public administration sector (33%); General industry and trade sector (33%)
Project ID	P118070
Borrower(s)	GOVERNMENT OF MEXICO
Implementing Agency	SECRETARY OF FINANCE AND PUBLIC CREDIT
	Secretaria de Hacienda y Credito Publico Dr. Miguel Messmacher Titular de la Unidad de Planeacion Economica de Hacienda Publica Insurgentes Sur 1971 Torre III piso 13 Col. Guadalupe Inn Mexico D.F. Tel.+52-5536881486 e-mail miguel_messmacher@hacienda.gob.mx
Date PID Prepared	October 22, 2009
Date of Appraisal Authorization	October 19, 2009
Date of Board Approval	November 24, 2009

1. Country and Sector Background

Mexico has a highly open economy that has been substantially hit by the global crisis and the sharp drop in international trade. GDP contracted by 9.2 percent in the first half of 2009 compared to a year earlier. The Government has implemented a strong economic policy package to mitigate the impact of the economic contraction on social and economic indicators of well-being and provide a basis for a sound recovery of economic activity coming out of the crisis. The Government has been able to implement such policies following a sound track record of macroeconomic management supported by policy and institutional reforms in areas such as enhancing the sustainability of public finances, improving the efficiency of public expenditure, strengthening the stability of and the access to the financial sector, improved targeting of its active labor market policies and deepening the integration of the economy into the world economy. The Government's response to the current crisis included countercyclical fiscal stimulus which is now gradually withdrawn in combination with a proposal to increase non-oil tax revenues. The Government is also putting in place additional measures to further strengthen the regulatory framework for stability, access and consumer protection. The proposed Bank loan will provide financial support to the government to meet its financing needs created by the economic policies including the fiscal stimulus, while at the same time strengthening the medium-term policy framework for sustainable economic recovery and growth.

2. Operation Objectives

The Overall Program Development Objective is to support economic policies to mitigate the impact of the global crisis and strengthen the medium-term framework for sustainable economic recovery and growth. This will be achieved by further developing the regulatory, monitoring and financial framework for fiscal and financial sustainability, labor market efficiency and trade liberalization.

The four main Policy Areas of the DPL are:

- Implementation of countercyclical fiscal policies during 2009 while adopting measures to enhance medium-term fiscal sustainability for 2010 and beyond;
- Improvement of the regulatory framework for financial sector access, consumer protection and stability;
- Enhancement of short-term employment support programs while developing medium-term reforms for labor market efficiency and labor productivity; and
- Improving competitiveness by lowering international trade costs via reduction of Most Favored Nations (MFN) tariffs and simplification of the trade tariff regime and customs processes.

This DPL is a central element in the implementation of the 2008 Country Partnership Strategy.

3. Rationale for Bank Involvement

The proposed operation will support the following four policy areas: (i) fiscal and public expenditure management, (ii) financial sector, (iii) the labor market and (iii) trade integration. Policy interventions supported by the operation are further discussed below.

Policy Area I: Fiscal Policy and Public Expenditure Management

In the wake of the global crisis the Mexican authorities managed to initially increase and eventually maintain the level of public expenditure to withstand the sharp contraction in private aggregate demand. Contrary to previous cyclical downturns, the sharp fall in public sector revenue that can be attributed to a downturn in global and domestic economic activity has not been compensated by a sharp reduction in overall public expenditure or an increase in taxes and, in that way, fiscal policy is allowing automatic stabilizers to function. At the same time the government is recognizing the need for medium-term reforms to reduce the reliance on declining oil revenues.

While providing for short-term countercyclical measures, the government's program is thus strengthening the foundations for medium-term fiscal sustainability. In addition, it is complementing sustainability efforts with improvements in public expenditure management. The proposed operation would support the government's policies to (i) conduct a counter-cyclical fiscal management program, (ii) enhance non-oil tax revenue; and (iii) improve public expenditure management in particular through the approval and implementation of a Governmental Accounting Law.

Policy Area II: Financial Access with Stability

For more than a decade, financial sector policy has featured prominently in Mexico's development agenda with the dual objective of promoting stability with access. Overall the Government has supported these objectives through a multi-pronged strategy that encompasses improvements to the regulatory framework, a strengthening of institutions responsible for financial markets oversight, and pro-active market access policies through development finance institutions (DFIs). DFIs have undergone substantial improvements in their governance and institutional structure

In the wake of the global financial crisis, the Government has sustained the overall policy direction noted above but has moved quickly to mitigate risks exposed by the global crisis through regulatory changes and a more active role played by DFIs to prevent a sharp credit contraction by private financial institutions that would have aggravated the economic contraction. The most important regulatory reforms implemented in 2009 seek to address (i) the protection of consumers of financial services, (ii) the expansion of channels for the provision of financial services through banking agents, (iii) market transparency, and (iv) the transparency and impact of DFIs. Prudential regulations have also been strengthened.

Policy Area III: Labor Market

Labor policies constitute one the five key pillars of the program to confront the global crisis that President Calderón announced in January 2009. The objectives of these policies are to improve the employability of the labor force, its wages and productivity, and protect labor incomes during the crisis. This operation supports the core active labor market policies implemented by the Government, in particular improvements in the institutional set up of the Temporary Employment Program (PET) and its related expansion to urban areas.

The Government recently strengthened PET including the Secretary of Labor and Social Protection in the program's coordination. Along with these institutional changes, several other modifications have been introduced in an effort to increase its targeting and effectiveness. The most important changes are (i) the PET's extension to the urban areas, targeting those with the highest rates of unemployment; (ii) the participation of the National Employment System (SNE) as an important channel to facilitate access and reach out to potential beneficiaries; (iii) the harmonization of information under one coordinated strategy; (iv) the increased frequency of results' publications and coordination committee gatherings; and (v) the program's systematic evaluation. Indeed, external evaluations conducted by the National Evaluation Council (CONEVAL) have shown an increase in the PET's targeting effectiveness. Due to its favorable evaluation and further improvements in its targeting, the Government increased spending on the PET by 142 percent during the period of January-June 2009 compared to the same period in 2008 to reach a larger number of beneficiaries. Further increases are planned for 2010.

The Government has complemented the above with an expansion of other active labor market policies (in particular job networking and intermediation services and training programs) as well as passive labor market policies to sustain the standard of living of the unemployed.

Policy Area IV: Trade Integration

Despite the trade policy reforms implemented since the 1980s, the Government of Mexico had identified gaps in its trading regime and opportunities to further reduce trading costs. A study conducted by the Ministry of Economy identified inconsistencies in Mexico's tariff structure. According to this study, higher tariffs were applied to inputs than to final products resulting in negative effective protection. The antitrust authorities also provided a critical assessment of Mexico's trade regime in an opinion in 2008, highlighting that the tariff structure discriminated between importers and created distortions that limited the ability of domestic producers to compete with foreign producers. The effective elimination of these distortions requires that all producers gain access to international markets on a non-discriminatory basis. The antitrust authorities also highlighted the need to address existing non-tariff constraints, primarily related to customs service providers.

The proposed operation seeks to support the Government's efforts to further Mexico's trade integration through a comprehensive tariff reform and staged reduction of the MFN tariffs on manufactured imports to be implemented over a five year period (2009-2013). The reform was adopted in December 2008. These measures complement other labor and financial sector reforms that seek to build a more competitive productive base and generate the conditions for sustainable growth and will also decrease costs to consumers with a positive social impact. The comprehensive reform rationalizes the tariff structure, reduces distortions, and trade costs. Overall, the reform is expected to lead to welfare gains. The enacted trade reform will reduce trade diversion, create greater regulatory certainty and cut the operational costs of the current users of special import regimes. Due to the high administrative costs of accessing the special import regimes, larger companies had been the main beneficiaries of these programs. The tariff reduction makes the special imports regimes less attractive (or relevant) and the general import regime more accessible to all producers. Hence, the tariff reform is expected to widen access for smaller enterprises to more efficient inputs on a non-discriminatory basis increasing their competitiveness. The reform will also reduce costs to consumers.

4. Financing

Source:

Borrower	US\$0 million
International Bank for Reconstruction and Development	US\$1500 million
Total	US\$1500 million

5. Institutional and Implementation Arrangements

Implementation of the loan will require close coordination among Government agencies and the Bank. The Ministry of Finance (SHCP) constitutes the primary counterpart, and the National Banking and Securities Commission (CNBV), The National Commission for the Protection of Users of Financial Services (CONDUSEF), the Ministry of Labor (STPS), and the Ministry of Economy (SE) will also be involved in program implementation. As the Bank's primary counterpart, the SHCP will be responsible for coordinating information reporting on the program's monitoring indicators, and the Bank team will also maintain a close dialogue with Government counterparts. All the indicators have been discussed with the Government authorities and agreed on during program appraisal.

Since the proposed DPL is part of an ongoing programmatic engagement in the four policies areas (fiscal and public expenditure management, financial sector, labor market policies, and trade integration and facilitation), the Bank will have the opportunity to monitor the reform impact beyond 2010. This will be important given that in many cases the target indicators for 2010 cannot be reflective of the full impact of the reform. The proposed technical assistance in the area of access to finance, investment operations underway and proposed new operations with development banks, as well as future FSAPs Updates will provide an opportunity to oversee the full fledged impact of these reforms. Two critical Technical Assistance loans were approved last year—one for results based management and budgeting, and another for customs administration—that will provide the basis for monitoring implementation in other key areas of the proposed operation over the medium-term. In addition, there is a non-lending technical assistance underway in the area of labor market policy. *Furthermore, a full PSIA analysis of the policies adopted by the Mexican Government to cope with the crisis will be produced by Bank staff in calendar year 2010.*

6. Benefits and Risks

The proposed loan would support the Government's core economic policy implementation during the economic downturn—the fiscal, financial, labor market and trade policies that both combat the crisis and provide the basis for renewed economic growth.

A risk to this operation is a substantial modification by Congress to the economic package and budget law proposed by the administration. Debates within Congress are progressing; however the final budget that is ultimately approved could represent an unexpected worsening of the fiscal position in 2010. Perhaps more importantly, structural medium-term revenue enhancing measures might not be approved. Mitigating factors include the Government's extensive negotiation and public dissemination efforts, as well as the broadly recognized need for a reduction in dependence on volatile and uncertain oil revenue and the possibility that the executive may implement alternative policies under its control if required.

Another risk is the possibility of a weak recovery from the current economic downturn including a “double dip” recession in the United States, Mexico's main trading partner, that could lead to a second year of subpar economic and public sector revenue performance. Fiscal outcomes would be jeopardized, and it may be difficult for the Government to maintain expenditure levels for key social and infrastructure programs. A mitigating factor is that Mexico's fiscal track record has assured good access to financial markets with a credit rating still two notches above investment grade. There should be adequate access to credit to borrow through a second downturn, so long as medium revenue reform measures are approved by Congress. The Government has confirmed that the policies and institutions supported by the DPL are given priority in its economic program.

Efforts to improve the flow of credit through the financial system could be overcome by negative developments, such as a substantially weaker economic recovery than currently anticipated. The financial system remains sound; however, a second round of negative economic development inevitably could lead to additional increases in non-performing loans and limited scope for banks to extend credit. Mitigating factors include the strong initial condition of the financial system, the scope for additional financial intermediation by the country's development banks, the strong

credibility in the conduction of monetary policy by the country's central bank, as well as stress tests conducted regularly by the CNBV.

Labor market conditions could continue to deteriorate even during an incipient recovery. The Government may need to expand or enhance the measures supported in the proposed DPL in order to mitigate the social and economic impact of such deterioration. These actions could confront fiscal constraints—particularly in the event of a “double dip” recession. A mitigating factor is the improved targeting, evaluation and coordination in the implementation of Government's social programs as well as the progress in public expenditure management to guide the reallocation of public expenditure.

7. Poverty and Social Impacts and Environment Aspects

The program is expected to have a negligible or even somewhat beneficial environmental impact. The government's fiscal program is consistent with environmental sustainability. Environment sustainability is one of the key pillars of Mexico's 2007-2012 National Development Plan that seeks to mainstream environmental sustainability principles in sectoral policies and economic development. Despite the economic crisis, the government has explicitly maintained its commitment to environmental sustainability and has continued to develop and implement public policies that protect the environment, including the development of infrastructure policies that combat climate change and green house gases.

The enacted tariff reform is expected to have a negligible or even somewhat beneficial environmental impact. First, the reform does not apply to agricultural products. Second, tariffs for environmental goods¹ are lowered and the import of these will no longer require following cumbersome procedures of multiple trade agreements. Third, Mexico's environmental regulations are in agreement with the Banks' overall environmental safeguards and these regulations will continue to apply to imports as well as for the granting and enforcement of construction and business operation permits. Moreover, the simplification of trade procedures will now facilitate their enforcement. Improvements in the systems of customs administration agency and its interfaces with other public agencies, including SEMARNAT, will facilitate the enforcement of these regulations.

The program is expected to have a positive poverty and social impact on the poor and vulnerable groups. A poverty and distribution analysis carried out by Bank staff assesses in more detail the poverty and social impacts of policies included in the fiscal, labor market and trade policy areas. These findings are complemented with an additional qualitative assessment of the impacts of financial sector policies.

An evaluation of the distributive impact of the budget proposal by the SHCP shows a very progressive impact in terms of the absolute incidence on households in the bottom three deciles of the income distribution. This occurs as the introduction of new taxes and changes in existing

¹ The environmental goods and services industry consists of activities which produce goods and services to measure, prevent, limit, minimise or correct environmental damage to water, air and soil, as well as problems related to waste, noise and eco systems. This includes cleaner technologies, products and services that reduce environmental risk and minimise pollution and resource use (OECD, Policy Brief, September 2005). Environmental goods are classified into four categories: pollution management, cleaner technologies and products, resource management, and environmentally preferable products.

tax rates, including the proposed “contribution to reduce poverty” on consumption, is more than compensated by an allocation of additional budget resources to expand the conditional cash transfers under *Oportunidades* and other social programs benefitting the poor.

Financial sector policies supported by this operation are expected to have a positive social impact. In particular, the approval of a regulatory framework for the provision of banking services through agents will permit the expansion of basic financial services to lower income groups of the population through new cost-effective channels, helping to narrow the current wide gap. The enhancement of the regulatory and supervisory capacities of CONDUSEF should lead to greater transparency in financial contracts and better informed users of financial services, particularly benefitting lower income households and micro and small entrepreneurs

Temporary employment programs are considered an appropriate mechanism for dealing with cyclical downturns in the labor market. These programs provide an income support for those who lost their job and, given the self-targeting mechanism—usually at a pay below minimum or nearly minimum wages—focus on those most in need of finding an income source. The PET is a potentially useful and adequate mechanism for dealing with the current crisis as it is a flexible and appropriate program for dealing with the cyclical aspect of the crisis.

The tariff reform is expected to lead to positive net welfare gains. The reform will reduce costs to consumers. At the productive level, the sectors that will benefit from the tariff reforms are mainly the agricultural, construction, and services sectors that generate 85.7 percent of total employment. Within these, SMEs are expected to benefit more in relative terms given that it had been relatively more costly for them to access the special imports regimes. Regarding the manufacturing sector, the authorities expect that the potentially affected companies comprise 14.3 percent of total employment². The activities that could be negatively affected are textiles industries, plastics, metal products, leather products, paper, printing and related industries, chemicals, wood industry, and oil and coal related industries. Several of these industries have experienced a fall in their participation in total manufacturing employment and value added prior to the crisis. The recent expansion of active labor market programs (especially the temporary employment program, the retraining program, and job networking) supported by the third pillar of this operation will provide assistance to workers that might be adversely impacted by the tariff reform.

8. Contact point

Contact: Jozef Draaisma
Title: Sr Country Economist
Tel: +52-55-5480-4208
Email: jdraaisma1@worldbank.org
Location: Mexico City, Mexico (IBRD)

Contact: Esperanza Lasagabaster
Title: Sr Financial Sr. Economist
Tel: 202-473-2880

² Information provided by the Ministry of Economy.

Email: elasagabaster@worldbank.org

9. For more information contact:

The InfoShop

The World Bank

1818 H Street, NW

Washington, D.C. 20433

Telephone: (202) 458-4500

Fax: (202) 522-1500

Email: pic@worldbank.org

Web: <http://www.worldbank.org/infoshop>