PUBLIC
SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

IDB COUNTRY STRATEGY
2013-2018

NOVEMBER 2013

This document was prepared by Mercedes Aráoz, (CID/CME), Claudia Grayeb (CID/CME), Elizabeth Ochoa (CID/CME) and Miguel Coronado (CID/CME) with contributions from: Caridad Araujo (SCL/SPH), Ricardo Perez Cuevas (SPH/CME), Ignez Tristao (SPH/CME), Sergio Lacambra (INE/RND), Cesar Bustamante (RND/CME), Gines Suárez (INE/RND), Gregorio Arevalo (CTI/CME), Ramón Guzman (IFD/CMF), Leticia Riquelme (CMF/CME), Gmelina Ramírez, (CCS/CME), David Wilk (INE/CCS), Carolina Piedrafita (IFD/FMM), Nathalie Alvarado (IFD/ICS), María Eugenia de la Peña (WSA/CME), Sergio Ardila (INE/RND), Alberto Barreix (IFD/FMM), Carlos Pineda (IFD/FMM), Gustavo Garcia (IFD/FMM), Fernando Orduz (TSP/CEC), Carlos Mojica (INE/TSP), Pablo Guerrero (INE/TSP), Consuelo Ricart (LMK/CME), David Kaplan (SCL/LMK), Gloria Coronel (FMP/CME), Victor Escala (FMP/CME), Laura Alonso, Mauricio Lopez Prada, and Manuel Pacheco (CID/CID).

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ABBREVIATIONS

BANOBRAS	Banco Nacional de Obras y Servicios Públicos S.N.C.
CNCH	Cruzada Nacional Contra el Hambre [National Crusade against Hunger]
CONEVAL	Consejo Nacional de Evaluación de la Política de Desarrollo Social [National Council for the Evaluation of Social Development Policy]
EAP	Economically active population
ECLAC	Economic Commission for Latin America and the Caribbean
ICTs	Information and communications technologies
IMSS	Instituto Mexicano del Seguro Social [Mexican Social Security Institute]
INADEM	Instituto Nacional del Emprendedor [National Institute for Entrepreneurs]
INEGI	Instituto Nacional de Estadística y Geografía [National Statistics and Geography Institute]
ISDR	International Strategy for Disaster Reduction
MfDR	Management for development results
MSMEs	Micro, small, and medium-sized enterprises
NCB	National competitive bidding
NSG	Nonsovereign guaranteed
OECD	Organization for Economic Cooperation and Development
PDHO	"Oportunidades" Human Development Program
PEMEX	Petróleos Mexicanos
PND	Plan Nacional de Desarrollo 2013-2018 [2013-2018 National Development Plan]
R&D	Research and development
SEDESOL	Social Development Department
SEP	Department of Public Education
SHCP	Department of Finance and Public Credit
SME	Small and medium-sized enterprise
SNE	Servicio Nacional de Empleo [National employment service]
SOFOMES	Sociedades Financieras de Objeto Múltiple [Multiple purpose financial institution]
SSA	Health Department

EXECUTIVE SUMMARY

Economic and social context: The progress of Mexico's main economic indicators indicates a stable macroeconomic environment in the context of an open economy that is highly integrated with world trade. Growth (3.9% in 2012) has been accompanied by prudent fiscal policy and low and stable inflation. Nonetheless, there was backsliding on certain social indicators, which have yet to return to pre-crisis levels. Indeed, on current estimates, approximately half the population is living in poverty. The main challenge the government has identified in its 2013-2018 National Development Plan, which partly explains the difficulty in accelerating economic growth and reducing poverty, is the economy's low level of productivity. This is due to factors such as: informality, access to finance, limited competition, and lack of openness of certain key input markets to international investment, which has tended to push up the private sector's operating costs. To address these challenges, policies to eliminate barriers to productivity need to be implemented, in conjunction with measures to reduce poverty and regional disparities, while safeguarding macroeconomic stability.

The IDB in Mexico: Over the 2010-2012 country strategy period, 22 public sector projects were approved, for a total amount of US$5,437.29 million, with total disbursements of US$4,917.00 million. The Bank increased its share of the country's external financing requirements from 4.62% of total external debt in 2010 to 4.79% in 2012.

Sector priorities: The Bank's country strategy with Mexico 2013-2018 will focus on stimulating productive, social, and territorial development in order to boost the economy's growth potential. To this end, the IDB will support the country in the following areas: (i) public management; (ii) the financial system; (iii) labor markets; (iv) business competitiveness; (v) social protection; (vi) health; (vii) urban development; (viii) rural development; and (ix) climate change. The strategy's sectors will take into account gender, diversity, and integration, where appropriate, as crosscutting issues. Origination of IDB Group private-sector operations will target the strategy's priority areas, complementing sovereign guaranteed interventions, specifically in the financial, business competitiveness, health, urban and rural development, and climate change sectors, while also looking for additional business opportunities in areas where they can provide financial and nonfinancial additionality.

Lending framework: It is estimated that the financial scenario will reach an average approvals level of US$1.740 billion over the strategy period, while disbursements could be approximately US$1.500 billion a year. These amounts are tentative, subject to the availability of Bank resources and the annual programming exercise.

Main risks: The principal strategy implementation risks are: (i) macroeconomic, associated with a possible economic slowdown due to external factors and possible delays in implementing structural reforms; (ii) institutional, due to weaknesses in institutional management frameworks, particularly at the subnational level, and a lack of coordination; and (iii) natural disasters.

I. Country Context

1.1 The progress of Mexico's main social and economic indicators indicates a stable macroeconomic environment in the context of an open economy that is highly integrated with world trade.[1] Following the contraction caused by the 2009 financial crisis (-6.0%), the Mexican economy grew rapidly, with growth rates of 5.3% in 2010 and 3.9% a year in 2011 and 2012. The economy is projected to expand by 1.8%[2] in 2013. This growth has been accompanied by prudent fiscal policy and low and stable inflation. From 2010 to 2012 the fiscal deficit averaged approximately 3.5% of gross domestic product (GDP), net public sector debt was around 38% of GDP, and inflation varied within its target range of 3% to 4% (Annex II).

1.2 By contrast, there was backsliding on social indicators, which have been unable to return to pre-crisis levels. Between 2010 and 2012 the unemployment rate stood at around 5% of the economically active population (EAP), and real wages fell by 12.8%.[3] Over the same period, the number of people living in poverty stood at 51.7%, compared with 45.9% in 2005-2008.[4] Extreme poverty decreased in both percentage and absolute terms, from 11.3% (12.9 million people) to 9.8% (11.5 million people). However, there was no improvement in income inequality (the Gini coefficient remained around 0.50).[5]

1.3 In this context, the Government of Mexico presented its 2013-2018 National Development Plan (PND). The plan is aligned with the Pacto por México [Pact for Mexico] consensus—an accord between the country's various political groups that summarizes common public policy goals—and includes a series of public consultations. The PND set five goals: México en paz [Mexico at peace]; México incluyente [inclusive Mexico]; México con educación de calidad [Mexico with quality education]; México próspero [prosperous Mexico]; and México con responsabilidad global [Mexico with global responsibility]. Crosscutting strategies to democratize productivity, modernize and bring government closer to the people, and introduce a gender perspective were also put in place.

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[1] Mexico has a network of 12 free trade agreements with 44 countries and participates actively in multilateral trade forums and agencies. Despite this degree of openness, as of 2012 year-end 79% of the country's exports were destined for the United States.

[2] Recent estimates by the Department of Finance and Public Credit. The International Monetary Fund (IMF) estimates 1.2%.

[3] Prior to the crisis, the average unemployment rate over the period 2005-2008 was 3.7%. Figures from CONEVAL, "Avances y Retos de la Política de Desarrollo Social en México 2012" [Progress and Challenges of Social Development Policy in Mexico 2012].

[4] Using the definition of asset poverty: inadequate income to obtain the basic food basket and make necessary expenditures on health, education, clothing, housing, and transportation. The figures for this measure have been comparable over the past decade (CONEVAL 2012).

[5] Individuals facing three or more social deficiencies and who receive an income below the minimum welfare threshold, i.e. who have a total income of less than the cost of the basic food basket, are considered to be in extreme poverty.

1.4 One of the first challenges to stepping up growth identified in the PND is the low levels of productivity in the economy. This explains the difficulty encountered in reducing poverty levels, and raising it is essential to boosting growth.[6] According to the PND, total factor productivity (TFP) has been on a long-term downward trend, falling at an average rate of 0.7% from 1980 to 2011,[7] while on average the country's labor productivity in the past decade has been lower than in other OECD countries.[8] A series of obstacles to productivity were identified. These include informality, access to finance, limited competition, and lack of openness to international investment in certain key input markets, which have tended to raise the private sector's operating costs.[9]

1.5 In this regard, one of the areas identified in which to raise productivity in Mexico is to guarantee that the economy has sufficient financing to leverage growth. Mexican companies (particularly MSMEs[10]) have difficulty accessing finance, and bank credit to the private sector is insufficient. The financial system is shallow, provides limited intermediation, and is highly concentrated. These problems go beyond public banks. Figures from 2011 indicate that bank financing[11] to the private sector was equivalent to 26.2% of GDP,[12] which is below the Latin American (44.7% of GDP) and OECD averages (154.7% of GDP). These issues must be addressed by promoting mechanisms to broaden access to credit. This also means improving the management of development banks, promoting strategic sectors, and supporting markets not served by the private financial system (e.g. MSMEs, agricultural sector, energy, and others).

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6 Getting it Right: A Strategic Agenda for Reforms in Mexico (OECD) (see pages 22-24) and http://pnd.gob.mx/.

7 National Development Plan (PND) 2013-2018, México próspero pillar.

8 Labor productivity in Mexico was 19.2% in 2012 compared with an OECD average of 45.7%.This negative productivity growth has translated into slow per capita income growth (1.2% over the last decade). Source: OECD. http://stats.oecd.org/

9 For a detailed analysis see the Mexican government's "El Programa para Democratizar la Productividad 2013-2018" [Program to Democratize Productivity 2013-2018], which identified the following barriers to productivity: (1) inefficient use and allocation of factors of production (labor, capital, land, and natural capital); (2) factors holding back business and individual productivity (human capital, education, training, investment in science and technology, business development, access to technology); (3) weaknesses in the business and investment environment (regulation, rule of law, insecurity, infrastructure, MSMEs' access to value chains); and (4) regional and sectoral gaps.

10 MSMEs with growth potential are understood to be those with the capacity to accumulate assets, and leeway to boost productivity and enter markets on a competitive footing; by contrast, subsistence MSMEs are those whose output produces no surplus and only allows basic needs to be met.

11 Internal credit to the private sector refers to financial resources granted to the private sector, for example through loans, purchase of securities other than equity investments, and commercial credit and other accounts receivables, giving rise to a redemption right. In some countries, these rights include credit to public enterprises. World Bank, 2011.

12 PND 2013-2018.

1.6 Mexico also shows signs of lagging behind in terms of technology development and innovation. Total spending in this area has not exceeded 0.5% of GDP in recent years, while the OECD average is around 2.5% of GDP. The lack of competition in sectors such as telecommunications, energy, and goods transportation has led to high costs and poor services. Levels of broadband internet penetration[13] are low and uneven and charges are high, representing a loss of social welfare equivalent to 1.8% of GDP[14] between 2005 and 2009. Improvements in competitiveness, global trade, and building a competitive environment in the economy require the development and consolidation of a logistical system capable of strengthening the national productive fabric.[15]

1.7 In parallel with this effort, Mexico needs to make more efficient use of its factors of production, in particular human capital. There is a high level of informality in the labor market, with almost 60% of the EAP in informal work, mainly concentrated in low productivity activities.[16] Human capital lacks adequate skills due to the low quality and relevance of education[17] and meager investments in vocational training and employability programs, and improving job prospects. Similarly, despite growing social development[18] spending, poverty levels have risen in absolute terms, and social services[19] still suffer from quality and coverage problems. This raises the challenge of making social and poverty reduction programs more effective, while improving their coordination with mechanisms to raise productivity.

1.8 Finally, macroeconomic and fiscal sustainability are prerequisites for reforms to improve productivity.[20] Although Mexico's public finances are healthy,[21] its revenue

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[13] Penetration in Mexico is 10.2% of inhabitants compared with an OECD average of 25.10%.

[14] Estimates of the OECD's social welfare calculated as a function of the loss of consumer surplus.

[15] According to the 2013-2014 Global Competitiveness Index, Mexico's competitiveness has fallen, dropping by two rungs on the ranking from position 53 to 55.

[16] Informal companies' productivity is estimated to be 45% lower than that of their peers in the formal sector. Economic Census, 2009.

[17] The results of the latest Programme for International Student Assessment (PISA) test (2009) found Mexico to be one of the countries with the largest number of students failing to meet minimum academic competency levels. It occupies 51st place out of 65 countries in sciences, 46th in reading, and 49th in math.

[18] The increase was 88% from 2000 to 2011 in real terms according to CONEVAL estimates. "Avances y Retos de la Política de Desarrollo Social en México" [Progress and Challenges in Social Development Policy in Mexico] 2012.

[19] In 2012, 21.5% of the population had no access to health services and 23.3% was living in food poverty. Additionally, 39.5% of Mexican households were not covered by social programs or social security.

[20] PND 2013-2018.

and spending levels are below average compared to its OECD peers. The challenge for fiscal policy is to ensure a sustainable increase in expenditure and improve efficiency. Tax revenues are around 10% of GDP. The tax base is narrow, and the structure of taxation has encouraged informality. There is a risk of income volatility due to the dependence on oil resources (which represent around 33.4% of the total),[22] and the rules on contingent savings tend to be deficient. To make expenditure efficient, results-based budgeting needs to be binding, and social spending targeted. The foregoing has to be accompanied by coordination of taxation and spending competencies with subnational governments, and improvements in the transparency and financial situation of states and municipios. This is essential to ensure sound fiscal management and reduce regional inequalities.[23, 24]

1.9 Lastly, Mexico suffers from wide disparities in development between regions, in both rural and urban areas. Over the last decade there have been no signs that the states lagging behind have been closing the gap with the more advanced ones. Output per worker in the 10 least productive states is 2.5 times lower than that in the 10 most productive.[25] This situation is compounded by the differences in institutional and administrative capacity between subnational governments and the lack of basic infrastructure to generate an attractive environment for business (including issues of violence and human capital development). The concentration of population growth in the cities has led to disorderly and socially exclusive growth there, while rural development has been left behind due to the low productivity of the agricultural sector, whose value added per worker was just 23.2% of the OECD-area average in 2011. The challenge is therefore to develop policies encouraging

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21 According to Article 11 of the Regulations for the Federal Budget and Fiscal Responsibility Law (LFPRH), the budget deficit, excluding spending on investments in Petróleos Mexicanos (PEMEX) and its subsidiary agencies, must be equal to zero. Exceptionally, as a result of priority economic and social conditions in the country, a non-zero budget deficit may be envisaged. In such cases, the authorities must state the specific amount of the financing necessary to cover it and the exceptional reasons justifying it.

22 As at 2012 it was 7.6% of GDP.

23 State and municipal low levels of revenue and high degree of dependence on federal transfers have resulted in weak administrative management and little transparency and accountability for spending, pushing the regions' debt balance to 2.9% of GDP in the first quarter of 2013.

24 The government presented a Social and Fiscal Reform with its 2014 economic package. These reforms are in line with the diagnosis in the National Development Plan and the Pacto por México agreements. The objectives are: (i) raising Mexicans' quality of life, guaranteeing a social safety net for all of the population, and (ii) speeding up the country's economic growth and consolidating economic stability. The main features of the reform, which has now been passed by Congress, are: (i) a responsible Treasury, (ii) strengthening the State's financial capacity, (iii) improving equity, (iv) facilitating compliance with tax obligations, (v) encouraging formality, (vi) promoting federalism, (vii) strengthening PEMEX, and (viii) improving spending quality. The set of measures approved in the reform are forecast to generate Mex$180 billion in 2014, equivalent to 1.1% of GDP, and the increase in resources will be equivalent to 2.4% of GDP in 2018.

25 The informality in this group of states is 21 percentage points lower, and poverty 28.6 percentage points.

sustainable productive development in the countryside, envisaging efficient use of natural resources, particularly water, the orderly growth of cities, and climate change mitigation and adaptation efforts.

II. THE IDB IN MEXICO

2.1 **Over the 2010-2012 country strategy period the strategy rested on four pillars encompassing 10 priority sectors**:[26] (i) in the social area, the strategy aimed to support the process of designing social protection programs targeting the poor and raising their efficiency; improving the quality of education and access to and length of time spent in the educational system, and improving labor market integration; (ii) in the productive area, it invested in water, sanitation, and transportation infrastructure; access to finance in the housing and MSME sectors; and improved productivity in agriculture; (iii) it helped strengthen public finances at the federal, state, and municipal levels; and (iv) it supported the climate change adaptation and mitigation agenda at both the federal and subnational levels. The development of states and municipios and private sector participation were included as crosscutting elements.

2.2 **Over the 2010-2012 country strategy period, 22 public sector projects were approved, for a total amount of US$5,437.29 million, and total disbursements came to US$4,917.00 million.** The sectors with the largest volumes of approvals were: reform and modernization of the State, with US$1.310 billion (24%); social investment, with US$1.121 billion (21%); and financial and capital market development, with US$1.069 billion (20%). The Bank increased its share of the country's external financing requirements from 4.62% of total external debt in 2010 to 4.79% in 2012 (June).

2.3 **The portfolio of public sector operations in Mexico is young.** At the end of 2012 the portfolio had 21 operations with an approved amount of US$4,425.07 million and an average age of 1.5 years. In terms of disbursements, over the period 2010-2012, Mexico was the country in which the Bank made the most investment loan disbursements relative to the balance available at the start of

[26] The main achievements and lessons learned during the last country strategy period were in the areas of productivity, improving SME access to credit for renewable energy projects, and housing. Positive outcomes were also observed in the labor market indicators deriving from the training and employment programs supported by the Bank over the last 10 years. Progress was also made on the public management of subnational governments, through the financing of infrastructure, public services, and institutional strengthening, identifying the need to continue exploring options for working with subnational agencies in order to reduce transaction costs and duplication of efforts. In social development, progress was made on the agenda of evaluation and improvement of the "Oportunidades" Human Development Program (PDHO), identifying room for improvement in monitoring and coordination activities. In the territorial development area, access to basic services and urban infrastructure were expanded, and the need to work more closely with communities to ensure the sustainability of works was a key lesson learned. Water and sanitation coverage was extended in rural areas, and in the climate change area, support was given to implementing the government agenda.

the year.[27] This performance is partly the result of the portfolio's consolidation in recent years in programmatic areas delivered via flexible long-term instruments, and reflects the fact that the country has sufficient execution capacity to increase levels of resource absorption.

2.4 Over the period 2010-2012, the **private sector windows** approved 71 operations for a total of US$1.076 billion, of which US$939 million were loans, US$100 million guarantees, US$21 million equity investments, and US$16 million technical cooperation operations. These operations were concentrated in the petrochemical (US$300 million), energy (US$181 million), infrastructure investment (US$150 million), and housing (US$50 million) sectors.[28]

III. PRIORITY AREAS FOR BANK ACTION

3.1 Mexico has been characterized by responsible macroeconomic management. However, faster economic growth would allow the country to address the development challenges mentioned earlier. For this, policies aimed at removing barriers to productivity need to be implemented, together with measures to reduce poverty and regional imbalances, while safeguarding macroeconomic stability.

3.2 Thus, during the period 2013-2018 the Bank will work along three lines in the country: productivity, social development, and territorial development.[29] In the productivity pillar, interventions are planned in public management, the financial system, the labor market, and business competitiveness. In the social development pillar, the Bank will work on social protection and health; and in the territorial development pillar, it will contribute to urban and rural development, and tackling

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27 Between 2010-2012, Mexico maintained an undisbursed balance of investment loans at the start of each year of US$1,896.6 million and has disbursed them at a rate of 44.3% a year, exceeding the Bank's average of 24.6% a year.

28 The Bank's active private sector portfolio in September 2013 came to US$475 million.

29 Although these three pillars are closely interrelated, they are presented separately in order to delimit the areas of Bank intervention in the country.

climate change.[30] The priority pillars and areas mentioned are aligned with the PND and the priorities set in the Ninth General Increase in the Resources of the Bank (GCI-9).[31] Origination of IDB Group private sector operations will target the strategy's priority areas,[32] complementing sovereign guaranteed interventions. New business opportunities will also be sought in sectors in which they can offer financial and nonfinancial additionality.

A. Productivity

3.3 In the PND, the Mexican government envisages structural reforms and actions aimed at raising productivity and economic development in a context of macroeconomic stability. Additionally, the program to democratize productivity will coordinate the government's actions to implement policies to remove barriers constraining the productive potential of citizens and businesses, create incentives for economic actors to make efficient use of productive resources, and comprehensively analyze public revenue and expenditure policies so that the government's strategies and programs encourage formal work. The Bank will support these government goals through the following priority areas:

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[30] The Bank will enter the Government of Mexico's new priority areas, such as business competitiveness (technology development, innovation, and logistics) by aligning several of its interventions with the government's productivity agenda. In turn, the Bank will build on the existing portfolio in areas in which it has experience and those in which it has traditionally worked. Thus, with the new country strategy, the Bank will continue its interventions, aligning them with the government's priorities as follows: (i) in social protection it will continue its progress on improving the efficiency and operation of the PDHO; (ii) in the labor market, it will seek to expand support to employment and training programs with positive impacts on employment rates and earnings; (iii) through the financial sector, it will aim to improve access to financing for sectors such as MSMEs, housing, transportation, and renewable energy; (iv) in urban development, it will work to continue reducing urban poverty through better access to basic services and community infrastructure and transportation; (v) in rural development, activities will be aimed at raising agricultural productivity and extending the coverage of water and sanitation services for the rural population; (vi) in climate change it will intensify support for implementing the Mexican government's agenda to combat climate change at the national and subnational level; and (vii) in the public management area, work will continue on increasing the capacity to generate income at the federal and subnational level and improve spending effectiveness and efficiency.

[31] Interventions in the areas of labor markets, social protection, health, and urban and rural development will contribute to the "poverty reduction and equity enhancement" target. In public management, the financial sector, and climate change, they may contribute to the "climate change, sustainable energy, and environmental sustainability" target, while those in business competitiveness could contribute to the "regional integration and cooperation" target.

[32] In particular, the financial sector, business competitiveness, health, urban development, rural development, and climate change.

a. Public management

3.4 The federal government's levels of revenue collection and spending (13.7% and 19.5% of GDP, respectively) have been below the average for OECD countries (26.3% and 46.5%, respectively) and Latin America (18.4% and 27.1%, respectively). Thus, the challenge for fiscal policy is to increase these levels to ensure a sustainable rise in expenditure and its efficiency. Both the complexity of the tax system, which has weakened the tax base,[33] and the delay in implementing the results-based budgeting system, have limited the State's financial capacity. This situation is replicated at the subnational level. The states' revenue collection is among the lowest in the OECD (3.6% of total fiscal revenue, compared to 20.9% for the OECD),[34] and the growing financing requirements have meant that the level of subnational debt has risen (representing 3% of GDP in 2012). Another aspect affecting fiscal management is the cost associated with natural disasters.[35] There is a deficit in investment in disaster prevention compared to expenditure on responding to them. For each dollar invested in disaster prevention 34 dollars are invested in disaster response.[36]

3.5 Through the actions envisaged in the PND's "México próspero" line, the Government of Mexico aims to strengthen the public finances through its social and fiscal reform–now passed by Congress–that calls for, among other things, increasing public sector revenue and greater fiscal federalism, which will expand the State's capacity to meet spending needs and boost economic growth.

3.6 The Bank's strategic objective is to support the strengthening of public management at the federal and subnational levels. For this purpose, technical and financial support will be given to: (i) supporting the social and fiscal reform and the efficient use of public resources; (ii) improving subnational management by promoting fiscal responsibility and controlling debt;[37] and (iii) promoting risk identification, analysis, prevention, and mitigation and strengthening governance, in order to reduce the fiscal vulnerability of the State and the population to natural disasters.

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[33] The State has foregone revenue of approximately 5.5% of GDP in the last five years (SHCP, 2011) while the increases in public spending have not translated into improved levels of welfare. Source: ¿Cómo gastar mejor para crecer? [How to Spend Better for Growth?], September 2013, Ethos Public Policy Laboratory.

[34] Fiscal policy for inclusive development. The systems are not strictly comparable given the fiscal decentralization arrangements in each country. OECD, 2012.

[35] Over the last 20 years these have caused losses of US$82.778 billion. International Strategy for Disaster Reduction (ISDR) (2011a).

[36] The high likelihood that events of smaller magnitude will materialize calls for investments in preventive actions in order to reduce the fiscal pressure, since the risk of this type of event cannot be transferred. A recent study calculates the annual expected loss or pure risk premium for Mexico for catastrophic seismic events at around US$800 million a year. Additionally, the annual expected loss for smaller, more frequent, events is higher, coming to US$2.540 billion. ISDR (2011a).

[37] One possible area of technical assistance that has been identified to support improvements to federal and subnational public management is supporting the modernization of civil registers.

3.7 The main risks the Bank may face in the areas of intervention include: (i) a breakdown in political agreements or the government's capacity to negotiate the proposed reforms; and (ii) poor quality subnational financial management information, which may be mitigated by working with other federative entities and municipios on the development of fiscal improvement plans.

b. Financial sector

3.8 The Mexican banking system is sound in terms of profitability, liquidity, and capitalization.[38] However, its depth, measured in terms of bank credit to the private sector relative to GDP (18.26% of GDP), degree of banking intermediation (74.4% of GDP),[39] level of private savings and use of the formal banking system (25.5% of GDP), do not reflect the country's level of economic development. The low level of private sector financing has repercussions in all credit segments. There are several areas of activity insufficiently served by the financial system, such as mortgages, the agricultural sector, energy, and infrastructure. These have been financed primarily through instruments provided by development banks. The latter serve a multiplicity of sectors, but their share has been insufficient (representing 8.73% of total lending to the private sector)[40] due to the rigid regulatory framework, which prevents them from taking on bigger risks, thus limiting their potential to trigger and complement credit to the private sector. Additionally, low bank penetration persists as a result of infrastructure gaps and a lack of financial knowledge among the population.[41]

3.9 As part of the PND's "México próspero" target, the government aims to foster access to finance and expand the coverage of the financial system, particularly through development banks.

3.10 The IDB Group's overarching goal in the sector is to increase the level of finance available to the real economy. To that end, through sovereign guaranteed interventions and technical assistance, work will focus on: (i) improving the regulatory and institutional framework for development banks and the rest of the financial system; and (ii) supporting development banks' programs to promote financing in their areas of intervention.[42] For their part, the nonsovereign guaranteed (NSG) windows will seek to develop private financial intermediaries primarily

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38 The system's aggregate capitalization and each bank's individual index are over the 10% minimum required under Basle III, that of commercial banks being 15.95% in 2012. Mexico was the first Latin American country to implement Basle III banking regulations. Commercial banks' net earnings came to Mex$86.689 billion in 2012 and their liquidity was more than 100% over the regulatory requirements. Source: Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission].

39 Mexico's levels of intermediation are below those of Chile (162.2%), Colombia (167.9%), Brazil (87.2%) and others like China (251.2%). Global Financial Development Data Base.

40 Figures on money supply and financial activity. Banco de México. July 2013.

41 Encuesta Nacional de Inclusión Financiera 2012 [National Financial Inclusion Survey, 2012].

42 The development banks' areas of action include: productive development, the agricultural sector, infrastructure, housing, energy efficiency, renewable energy, and financial inclusion.

catering to businesses' needs. The aim will be to focus particularly on MSMEs, by supporting financing alternatives to expand their access to credit.[43] Resources will also be channeled into promoting access to finance, whether to purchase new homes or improve existing ones, with a view to meeting demand for mortgage loans.

3.11 The Bank's intervention in the sector could be compromised by unexpected episodes of high volatility in the international markets affecting the stability of the financial system, or possible delays in implementing reforms in the sector, particularly as regards development banks. This situation could be mitigated by providing technical assistance and support to the reform implementation process.

c. Labor market

3.12 Although the skill level of the country's human capital has progressed in terms of mean years of schooling attained, which rose from 6.6 years in 1991 to 8.8 in 2012, this has not been reflected in improvements in labor productivity, which has been declining over the last 20 years.[44] Moreover, the government's efforts to foster a skills-based vocational education and training system have been inadequate, and have failed to establish a job skills standards certification system geared towards employers' requirements. At the same time, the economy has not benefited from the demographic dividend, due to the limited capacity to create quality jobs in the formal sector (the number of informal workers stands at 60% of the EAP). Additionally, the labor market is characterized by high turnover of workers between the formal and informal sectors, which limits the opportunities for professional development, given that companies have little incentive to provide employees with vocational training. Thus, over 20%[45] of formal hiring is on short-term contracts. Mexico's worker protection system also has its shortcomings. Mexico is the only OECD country without an unemployment insurance system, exacerbating the issue of people working in suboptimal conditions and pushing up levels of informal work.[46]

3.13 The PND's “México próspero” pillar aims to foster quality employment, enhance employability, promote job skills development, and fine tune worker protection systems and procedures, in particular by implementing unemployment insurance.

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[43] To promote it, support needs to be given to financial innovation, capital markets, and nonbank financial institutions (SOFOMES, etc.), including financing in local currency. It will also seek to bring the unbanked into the formal financial system through alternative channels such as correspondent banking.

[44] OECD data (Labour Productivity Growth–OECD Stat) show Mexico to be one of the countries where labor productivity has declined.

[45] IDB calculation based on the career database for workers belonging to the Mexican Social Security Institute (IMSS) between 1997 and 2005.

[46] According to the National Statistics and Geography Institute (INEGI), 13 million people are in suboptimal contractual conditions.

3.14 The strategic objective in this sector is to improve productive workforce integration in quality jobs. The Bank will support the targeting and implementation of policies to: (i) align secondary and higher technical education and training initiatives for workers with the country's growth priorities; (ii) invest in active employment policies by improving the quality of intermediation services and expanding workplace training; (iii) support the design and implementation of unemployment insurance; and (iv) help develop a regulatory framework and social security system that encourages the creation of formal jobs.[47]

3.15 The principal risks in the sector are related to the limited scope of labor reform to encourage the creation of quality jobs, and the lack of interest of companies in participating in the various labor programs promoted by the government to that end. The Bank will mitigate these risks through technical assistance for designing effective policies.

d. Business competitiveness

3.16 The business sector's[48] total factor productivity and its contribution to economic growth have dropped by 0.35% on average in recent years, affecting the competitiveness of Mexican companies and their participation in global value chains. The Mexican export model is highly concentrated in certain sectors and by destination, and it has a large import component,[49] demonstrating the need to raise local value added, strengthen links, build supply chains within Mexico's system of production, and strengthen linkages with global markets. Additionally, there are major regional disparities in productivity performance. This explains the persistent income gaps between regions[50] and highlights the need to set competitiveness policies that take the regional context into account. The factors underlying this performance include: (i) a deficit in investment in innovation and entrepreneurship; (ii) lack of competition and difficulty accessing telecommunications; (iii) weakness in the optimization of logistical infrastructure use; and (iv) limitations in the institutional framework (particularly at the regional level) and in the business environment, affecting business development and/or contributing to regional disparities.

3.17 In relation to innovation, the country's investment (0.48% of GDP) in research, development, and innovation is meager and is well below that of comparator

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[47] This will be complemented by activities in the health area.

[48] Includes the whole secondary sector of the economy.

[49] Three sectors account for 60% of exports; and over 80% are destined for the United States. The national content of Mexico's exports to the U.S. is 28.5%, while that of China's is 45.5%.

[50] Between 1993 and 2008 the Mexican economy's labor productivity dropped by 6.8%. The states with positive growth rates, including "winners" and "catching up" regions, registered growth of 5.1% and 2.0%, respectively. However, both the "falling behind" regions and the "losers" had average annual growth rates of close to -1.1%, a drop of 15% over the period. This regional difference highlights a clear trend towards divergence in productivity rates.

countries.[51] For its part, entrepreneurship in Mexico has been characterized by the creation of sole proprietorships or family firms in low productivity businesses, many of them in the informal sector. The majority belong to the commercial and services sectors (67% and 26%, respectively), with limited innovation. This state of affairs is consistent with Mexico's 62nd place out of 118 countries on the 2013 Global Entrepreneurship Index ranking.

3.18 In terms of access to and use of productive infrastructure, Mexico came in 47th place out of 155 countries on the World Bank's 2012 Logistics Performance Index,[52] and administrative and institutional obstacles remain to coordinating programs between the three levels of government and the private sector. Access to, and use, of telecommunications services is limited. Mexico is at the bottom of the ranking among OECD countries in terms of broadband penetration, and it is 63rd out of 144 countries on the Information Technology Index.

3.19 The income gap between regions coexists with a wide variation in institutional capacity and the business environment. According to Doing Business, there is considerable heterogeneity in how the Mexican states perform on ease of doing business indicators.[53] This is seen in the widely differing conditions and costs, correlated with the progress of productivity, particularly among SMEs.[54]

3.20 The initiatives aimed at boosting productivity in the "México próspero" pillar of the Mexican government's PND include promoting competitiveness by developing and fostering value chains, supporting innovation and technology development, fostering entrepreneurship, and improvements in technological and logistic connectivity.

3.21 The Bank's objective in this area is to strengthen business competitiveness. To achieve this, its activities will focus on: (i) building capacity for innovation and business entrepreneurship, focusing on SMEs and the integration of Mexican companies in global value chains; (ii) consolidation of a framework for the

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51 Latin America's research and development (R&D) investment came to 0.75% of GDP, Brazil's 1.16%, and the OECD's 2.3%.

52 Despite investments in Mexico's infrastructure, the transportation system is still lagging in terms of competitiveness, occupying 68th place out of 144 evaluated in terms of infrastructure. At the sector level it is in 50th place for highways, 60th for railroads, and 64th for ports and airports, again out of the same number of countries. There are clearly still big challenges and areas of opportunity in which its efficiency and competitiveness can be improved.

53 Registering property may take up to six times as long as in the most efficient states and cost three times as much. Similarly, the time taken to enforce a contract is twice as long and is 50% more expensive than in the best cases (World Bank, 2012).

54 According to World Bank analysis, ease of contract enforcement is correlated with productivity. SMEs in states such as Coahuila, Jalisco and Nueva León, where resolving commercial disputes is more efficient, show higher levels of labor productivity than those in states such as Puebla and Veracruz, where resolving commercial disputes is less efficient. This effect is not apparent in the large business cohort.

planning and optimization of logistic infrastructure use;[55] (iii) strengthening the framework for the development of telecommunications and promotion of the use of information and communications technologies (ICTs) (including the National Digital Strategy), and (iv) reducing transaction costs and improving the institutional and policy framework to promote business development, particularly at the subnational/regional level.[56] The NSG windows will support this objective by seeking to promote the development of value chains, logistic systems and telecommunications, by enabling excluded populations to access ICTs and seeking out potential opportunities in terms of infrastructure and public-private or private only investments.

3.22 Potential delays in approving and implementing reforms and secondary laws on telecommunications and the government's digital agenda could be risks, potentially hindering the Bank's opportunities for intervention. There are also risks inherent in the possible lack of coordination between public agencies and bodies responsible for competitiveness and innovation issues, and the recent creation of the National Institute for Entrepreneurs (INADEM). To mitigate these risks, operations should be accompanied by a strong interagency dialogue and technical cooperation component to raise stakeholders' awareness of the importance of the proposed reforms and continuing support for them.

B. Social development

3.23 To address the social development challenges, in the PND the government has set out the goal of achieving an “Inclusive Mexico” in order to overcome lags, such as those in social protection, and improve health coverage.

a. Social protection

3.24 The share of Mexico's population living in poverty has remained above pre-crisis levels (45.5% in 2012). The incidence of poverty is highest among the young and indigenous people.[57] Poverty affects rural areas (61.6%) more than urban ones (40.6%). However, whereas from 2010 to 2012 rural poverty declined by 3.4%, urban poverty rose by 0.2%. The scarcities faced by the population were reduced over the period, but access to food was a problem for 23.3% of the population,

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[55] Includes actions such as setting a national logistics policy, developing information systems regulation, and institutional structure, all from a regional perspective.

[56] These actions are complementary to those proposed under the territorial development pillar.

[57] Poverty affects as much as 53.8% of the population under 18, while among the indigenous population the poverty rate is 72.3% (CONEVAL estimates, using the measure of poverty that defines it as having at least one social deficiency and receiving income below the welfare threshold, the value of which is equivalent to the cost of a combined food and nonfood basket). Even though the poverty rate in 2012 was similar to that recorded in the late 1980s, Mexico underwent a recovery and sustained reduction in poverty after the 1994 crisis up until 2006 (pre-crisis). For example, poverty of assets went from 69.0% in 1996 to 42.9% in 2006 (source: CONEVAL). This number rose to 52.3% in the 2012 measurement partly as a result of economic performance, the effects of the global economic crisis, and the increase in the cost of the basic basket since that time.

access to health services for 21.5%, and shortcomings in education for 19.2%. The "Oportunidades" Human Development Program (PDHO) has been the cornerstone of efforts to tackle poverty and has made significant headway.[58] However, significant challenges still remain on various fronts. For example, it is estimated that 17% of children and 20% of young people (ages 6 to 18) in urban and rural areas belonging to PDHO beneficiary households do not attend school. Moreover, there are approximately 75,000 localities that are not reached by the PDHO or the Food Support Program (PAL) owing to a lack of institutions providing health care services. This highlights the need for closer coordination with other programs and sectors, so that PDHO beneficiaries can access benefits that would raise their productivity and ability to generate income.

3.25 The social inclusion pillar of the PND calls for bolstering the capacity of households with deficiencies so as to contribute to raising their standard of living and enhancing their productive capacity. The government has launched the National Crusade against Hunger (CNCH), which aims for closer coordination among the three levels of government to target interventions on municipios with the largest populations in extreme poverty. The PDHO, one of the instruments present in the priority municipios, is being redesigned to improve its effectiveness and align it with the CNCH.

3.26 The Bank will therefore target its support in this area on helping to break the intergenerational cycle of poverty by fostering the development of capacities associated with nutrition, health, and education. Interventions will be geared towards: (i) supporting the identification and implementation of improvements in the design, efficiency, and evaluation of the PDHO; (ii) strengthening interagency coordination with the various public entities responsible for providing education, health, and nutrition services; and (iii) providing financing for conditional cash transfers.[59]

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[58] The PDHO has contributed to building capacities and reducing poverty and inequality, and to the accumulation of human capital. If PDHO transfers are subtracted from household incomes, the percentage of the population below the minimum welfare threshold would rise by 3.4 percentage points (1.5 in urban areas and almost 10 in rural areas). Moreover, the PDHO is helping to reduce inequality. The Gini coefficient would rise from 0.48 to 0.50 without PDHO transfers at the national level and from 0.48 to 0.55 in rural areas (IDB, 2012). In terms of nutrition, a significant share of cash transfers (approximately 75%) is used to buy food (Angelucci *et al*., 2009). In education, enrollment rates among children and young people have been raised by between 1 and 5 percentage points in urban areas (Behrman, *et al.*, 2011). In health, evaluations indicate people in rural areas are now more likely to use health services (SEDESOL, 2008). However, despite these accomplishments, the PDHO faces major challenges.

[59] Synergies exist with the labor markets and health areas. One feature of the PDHO's redesign is to link young beneficiaries with employment services, where the Bank hopes to help make graduates from preparatory education more employable. In health, the Bank will work to ensure effective health service coverage, particularly in rural communities and communities lagging behind that comprise PDHO intervention areas.

3.27 The principal risks arise from: (i) possible delays in implementing the PDHO redesign improvements, given that effective coordination with other social sector institutions and different levels of government will be necessary; (ii) the future expansion of the PDHO in CNCH municipios, which may pose additional operational challenges; and (iii) the heterogeneous nature of the studies and evaluations that inform decisions. To mitigate these risks, the Bank will make technical assistance resources and its staff available to provide technical support for implementing the PDHO's design improvements and expansion.

b. Health

3.28 The health sector is complex and fragmented. It offers the population incomplete and uneven protection despite increased budgetary efforts, which boosted its resources from 3.1% of GDP in 2009 to 6.6% in 2012.[60] The foregoing is partly explained by inefficient resource management in a structure characterized by scant convergence of policies between institutions and programs with differing scopes, services, and coverage. Although health service coverage has improved and the share of the population without access fell from 29.2% in 2010 to 21.5% in 2012, access is not equitable and the schedules of benefits offered by the various health institutions remain unequal.[61] Another challenge is to promote a health model with a stronger focus on preventive rather than curative services. This is against a backdrop of high rates of the main risk factors for chronic illness, such as physical inactivity, smoking, overweight, obesity, and high alcohol consumption.

3.29 The government's main strategy as regards health is to ensure access to services and improve people’s health through protection and prevention actions. In this regard, the Bank's strategic objective is to strengthen and integrate health promotion and prevention and disease control actions and to make universal access to health services a reality. To achieve this, the Bank will provide technical assistance and funding, with specific investment programs aimed at formulating and implementing health programs and policies, primarily in four areas: (i) improving the management and stewardship of public spending on health; (ii) strengthening the governing role of the Health Department; (iii) supporting public health actions; and

60 Federal expenditure budget (PEF) 2012.

61 The health sector is comprised of both public and private institutions. On the public side, service delivery is split between the Mexican Social Security Institute (IMSS) financed from contributions deducted from employees’ payroll, and Health Department (SSA) services for the population not covered by social security, which is paid for from general resources. In recent years, public sector spending on health for the uninsured population has risen sharply, and the State’s per capita contribution for SSA services exceeds that for the IMSS. Although this has significantly improved access to healthcare, the segmentation has negative impacts on the sector’s performance and efficiency and on the performance of the labor market. The focus in the health sector therefore aims to improve the stewardship, management, and efficiency of public spending on health, offering better control and oversight of budget management, reducing overlaps in resource allocations, and achieving a balance in the per capita spending allocation, and consequently greater equity in the benefits people covered by the various social security institutions receive. The first steps will aim to define a single benefits plan for the whole population.

(iv) expanding the population's actual health service coverage. It will also continue its support for the Salud Mesoamérica 2015 initiative to speed up the achievement of the millennium goals for child and maternal health, while strengthening cooperative ties with the region's health sector. For their part, the IDB Group's private sector windows will seek to complement the delivery of basic and specialized services, focusing on investments in health facilities, including hospitals and diagnostic clinics subcontracted by public insurers.

3.30 The potential risks to which the Bank's proposed actions are exposed are: (i) public management, monitoring, and accountability risks; (ii) lack of coordination between the various stakeholders at the federal and local levels; and (iii) lack of political will to achieve the reforms necessary in the sector. To mitigate these risks, the Bank will support the Health Department by strengthening communications and performing rigorous studies and evaluations to verify progress and refocus activities.

C. Regional development

3.31 Another of government priority is for growth to be balanced and favor all regions. This is a priority both for the PND's "México próspero" and "México incluyente" targets and is a crosscutting part of the government's action.

a. Urban development

3.32 Mexico's cities have grown in size six-fold over the last 30 years, and its urban population has doubled over that period.[62] The new urban population has established itself on the outskirts of cities in both formal and informal settlements. These generally have infrastructure and public service deficits,[63] with residents often traveling long distances to work.[64] Transportation has therefore become a challenge for urban development. The growth of cities, in conjunction with fragmented, poor quality, low capacity, and uncoordinated public transportation without the necessary road infrastructure, combined with poor institutional capacity to manage transportation systems, has resulted in urban mobility problems in most of the country's cities. Lastly, the lack of planning of urban growth is compromising cities' social, economic, and environmental sustainability, particularly in marginal areas, where loss of public space breaks down the social fabric.

3.33 The Mexican government's priority actions include: (i) generating sustainable, smart urban development; (ii) reducing the housing shortage and lack of basic

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[62] "La expansión de las ciudades 1980-2010" [The Expansion of Cities, 1980-2010]; Secretaría de Desarrollo Social [Social Development Department] (2011).

[63] The lack of urban planning by local governments has resulted in formal semi-urbanized neighborhoods, with high concentrations of poverty, which need complementary investments to integrate them fully into the city. The deficit of infrastructure services in these intraurban areas corresponds to 11% for water, 8% for drainage, and 2% for electricity, with substantial gaps in terms of paving, sewerage, and solid waste collection.

[64] Urban households spend up to 50% of their income and over three hours a day on urban transportation.

public services; and (iii) generating an urban environment that helps inhibit the causes of crime and violence.

3.34 The Bank's objective in the sector is to promote the orderly, safe, and sustainable growth of cities. It will work to foster incentives and programs enabling the revitalization of downtown and/or depressed urban areas; it will help build local government's capacity to improve urban planning and manage comprehensive social policies to prevent violence, particularly against women. The Bank will also support efforts to overcome the qualitative housing deficit, and it will support public solutions for the population who are unable to obtain a mortgage on account of their income and/or the fact that they work in the informal sector. It will also invest in improving neighborhoods to create safe communities; it will continue supporting sustainable transportation, primarily in subnational entities, to enable the development of urban transportation plans, and will provide technical assistance to strengthen the institutional structure. Lastly, the Bank will continue promoting sustainable development of emerging cities through its Special Program for the Emerging and Sustainable Cities Initiative. The NSG window will help provide better access to basic services for low-income population groups, complementing the public network for water, sanitation, and efficient and renewable energy.

3.35 The principal risk for the Bank's interventions is the lack of institutional capacity at the local level for coordinating actions with the agencies in charge. This could be mitigated by promoting crosscutting interventions and increased institutional strengthening.

b. Rural development

3.36 The development of the country's rural areas, which are home to over 60% of its poor, is being held back by the agricultural sector's low productivity, lack of access to basic services, and scarcity of opportunities to earn an income.[65] This situation calls for a comprehensive response that combines improvements in agricultural policies with social policy to alleviate poverty[66] and provide services.

3.37 The agricultural sector accounts for 3.9% of Mexico's GDP and employs 13% of the EAP,[67] but its productivity rates have stagnated in recent years. Between 2011 and 2012, agricultural GDP dropped in real terms by 0.6% and rural output by 7.1%.[68] This performance is due to inconsistent programs and policies, duplication,

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[65] The agricultural sector is characterized by a marked duality between a large number of smallholdings mainly producing for own consumption and a small number of large-scale commercial farms that account a large share of agricultural production (OECD).

[66] For example, cash transfers through the "Oportunidades" program inject liquidity into rural economies.

[67] World Development Indicators (WDI), 2012.

[68] The volume of production was 159 tons in the case of the 50 main crops.

and the inefficiency and lack of targeting of rural public spending.[69] Moreover, agriculture is one of the sectors hardest hit by climate change.[70] Another aspect that has held back rural development is the lack of water supply and sanitation services. There are over 188,000 localities[71] with fewer than 2,500 inhabitants that suffer from serious gaps in water and sanitation services, coverage being 78.8% and 69.4%, respectively, compared with national rates of 91.6% and 90.2%. Although the gaps in access to these services have narrowed in recent years, these localities continue to concentrate three quarters of the population living in extreme poverty.[72]

3.38 The Government of Mexico's priorities for rural development include fostering rural productivity through investments in the agricultural sector. The Bank's objectives are to: (i) raise productivity and competitiveness in the agricultural sector;[73] and (ii) improve the coverage of water services in rural areas. The Bank's intervention will be oriented to providing technical assistance and financing for: (i) analysis and reform of existing programs leading to better targeting of rural spending,[74] its economic efficiency, and the functioning of goods and services markets; (ii) establishment of measures to reduce the sector's vulnerability to climate change; and (iii) expanding coverage of water and sanitation services in rural communities.[75] The private sector will aim to increase productivity through anchor companies integrating small agricultural producers in their value chains, with the possibility of technical assistance from participating financial institutions.

3.39 The principal risks identified for the Bank's actions in the sector are: (i) a drop in international prices for agricultural products—which may be mitigated by

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69 The efficiency of rural public spending is affected not only by the design parameters and operating rules of individual programs, but also the lack of coordination of the immense number of programs aimed at rural areas.

70 The agricultural sector is one of the most vulnerable to climate risks, considering that it suffered 80% of the economic losses deriving from climate disasters in Mexico, estimated at over US$10 billion over the period 1980-2005. ECLAC, 2007. A recent analysis for Mexico projects estimated losses for 2100 of 42% to 54% of agricultural production, under various climate scenarios. It is envisaged that fishing and aquaculture will be affected by reduced catches of commercially attractive species of between 30% and 70% in regions at high latitudes and with a drop of up to 40% in the tropics.

71 INEGI, Conteo de población y vivienda 2010 [Population and Housing Survey 2010].

72 Thus, in the rural sector 5.5 million people lack access to this service, while eight million do not have an improved sanitation system or connection to the sewerage system.

73 This objective will be complemented with those set for business competitiveness and the financial sector. In particular, synergies will be sought with actions to foster innovation and the integration of Mexican companies into global value chains (paragraph 3.21), and improvements in access to finance through development bank programs (paragraph 3.10), thus helping to implement a comprehensive, multisectoral approach to the problems of Mexico's rural sector.

74 The aim is to fine-tune program design to target poor farmers, in particular, seeking to reduce the incentives they generate to tie owners to the land.

75 These actions are complemented by proposals regarding social protection and the financial sector, which envisage support to the PDHO and the channeling of finance through development banks to the agricultural sector, respectively.

agricultural producers having better access to finance; (ii) the risk of natural disasters affecting cropland areas, which may be alleviated by investing in prevention works in vulnerable areas; (iii) low sustainability of investments due to the lack of professionalization of service providers, for which training in administration and operations could be provided; and (iv) the lack of local institutional capacity, for which technical assistance will be provided.

c. Climate change

3.40 Climate change is a challenge that needs to be addressed by various government bodies and at different levels. Only a quarter of federative entities have state climate change programs, and five states have laws on the issue. Fiscal, financial, and economic structures that result in inefficient use of natural resources persist. In recent years, Mexico has confronted a growing number of impacts resulting from extreme hydro-meteorological events, which have resulted in loss of human life and had high economic and social costs.[76] As well as being associated with a higher incidence of events, this increase is also a result of the increased exposure caused by growing urbanization, for example.[77]

3.41 The Government of Mexico will therefore aim to strengthen national climate change policy and minimize the vulnerability of urban and rural areas to the effects of climate change.

3.42 The Bank's strategic objective is to support the implementation of national climate change policy fostering adaptation measures taking a long-term approach. The Bank will therefore work on: (i) developing planning tools to identify adaptation measures in a way that coordinates the three levels of government to meet the needs of the most vulnerable population groups in the areas affected, including indigenous populations; (ii) designing and promoting adaptation measures that address integrated watershed management and soil restoration; (iii) developing platforms or research and innovation programs, evaluating and monitoring public policies; (iv) reducing vulnerability and increasing the resilience of human settlements in rural, urban, and coastal areas, strategic infrastructure and production systems; and (v) conserving and sustainably using ecosystems and maintaining the environmental services they provide. The Bank's NSG windows will look for opportunities in the financing and operation of investments that reduce climate impacts and foster adaptation through renewable energy, energy efficiency, and adopting technology to reduce emissions, as well as exploring opportunities for investments in natural gas transportation and distribution systems.

3.43 The main risk identified in the sector is the lack of intersector and interagency coordination and coordination between the three levels of government, to the

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[76] The economic damage associated with these events increased by an annual average of Mex$730 million between 1980 and 1999 to Mex$21.950 billion in the period 2000-2012.

[77] The country has 1,385 municipios considered to be high risk (high vulnerability and probability of occurrence of climatic events).

detriment of execution of climate change projects. To address this issue, institutional strengthening in the adaptation and mitigation area will be supported, as will generation of relevant information with which to support projects.

D. Areas of crosscutting action

3.44 The strategy envisages incorporating gender, diversity, and integration considerations as crosscutting themes. Specifically, in health, education, social protection, climate change, and rural development, special emphasis will be given to incorporating the gender and diversity perspective, with particular attention paid to the indigenous population in vulnerable areas in Bank interventions. The Bank may also work on multisectoral and interagency programs with a gender perspective. Integration aspects will be considered in the health and business competitiveness areas. The mechanisms for implementing these crosscutting aspects will be defined during strategy implementation.

E. Dialogue areas

3.45 The Bank will intensify the dialogue with the Mexican government on energy, education, and citizen security in order to generate the support it needs. The recently presented energy reform will open up opportunities to strengthen the sector with investments enabling hydrocarbon output and electricity generating capacity to be increased and the country's energy costs to be reduced. Similarly, education reform is opening up spaces for dialogue with the government to work on improving quality, access, and time spent in the educational system.

IV. LENDING FRAMEWORK

4.1 **The government mainly finances itself through local debt markets** and has a high credit rating[78] allowing it to access international markets on favorable terms. The government will have an expansionary fiscal policy in 2014, which will entail increased financing requirements, including obtaining resources from international financing agencies if the financial conditions they offer are appropriate.[79]

4.2 The public sector financial requirements for 2014 will rise to 4.1% of GDP, a figure that is 1.2% higher than that forecast for 2013. It will then gradually drop to 2.5% of GDP in 2017, and remain on the same level in 2018-2019 as the fiscal stimulus is withdrawn.[80] Most of this borrowing requirement is expected to be met in the local debt market, while the remainder will be financed in international markets. This increase in financing requirements over the country strategy period gives the IDB more space to expand its operations directly via the sovereign guaranteed window and indirectly with the private sector.

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[78] BBB, BBB+.

[79] Competitive repayment terms and rates compared with other financing instruments to which the country has access.

[80] General Economic Policy Criteria, SHCP 2014.

4.3 Over the country strategy period, it is **estimated that the Bank could reach average annual approval and disbursement levels of US$1.740 billion and US$1.500 billion, respectively,** subject to the Bank's financial resource availability and annual programming exercises. This would keep debt with the Bank at an average of 0.7% of GDP and 5.8% of the country's total external debt over the period. These levels of financing could be exceeded if there is sufficient demand for projects for federative entities, in the context of the reform to regulate state and municipal borrowing.[81] Additionally, the country's real resource absorption capacity will depend on the Bank's financial costs being competitive, the Bank's having local cash balances, and the Bank aligning itself with country systems.

V. STRATEGY IMPLEMENTATION

5.1 Mexico's public procurement and financial administration and control systems are sound, allowing the Bank to rely on the budget, treasury, accounting, internal and external audit, and public procurement subsystems to supervise its operations. Thus, during the 2013-2018 country strategy period, the Bank will step up the use of country systems to help boost public spending efficiency and reduce transaction costs.

5.2 The aims in terms of procurement include: (i) supporting the revision of the consulting services procurement method, so as to incorporate it in the future for country system use; (ii) phasing out ex post review by external auditors or Bank consultants as the country system for public procurement is adopted for each project; (iii) supporting continuous improvement of the public procurement system, including implementation of a professional development program for public procurement staff and the establishment of a public procurement performance management and supervision system. In the financial management area, the Bank will focus its efforts on: (i) simplifying the Bank's reports for expense reporting and facilitating increased use of reports generated by the country system; (ii) deepening the review and understanding of the subsystems used in projects at the federal and subnational level to contribute to their strengthening and process efficiency; and (iii) supporting the ASF on the implementation of modernization tools developed by international organizations with expertise on the matter. These activities will support implementation of the Bank's project portfolio in Mexico.

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[81] The financial reform initiative proposes measures to expand the role of development banks in financing productive investment projects throughout the country. This could facilitate the channeling of more resources to states and municipios and generate increased demand for Bank financing. Additionally, the reform to regulate the states' and municipios' indebtedness (being debated in Congress) will foster improvements in subnational fiscal management and help keep debt on a sustainable path. In the medium term this could result in the development of new schemes for the Bank to work more directly with the states and municipios.

Table summarizing country system use

Use of country systems	2013 baseline	Estimated use in 2018	Actions envisaged
Budget	100%	100%	N/A
Treasury	100%	100%	N/A
Accounts and reports[82]	7%	7%	Simplify financial reports
Internal auditing	100%	100%	Support for enhancing supervision
External control	100%	100%	
Information system	100%	100%	N/A
Individual consultants	0%	0%	Support for reviewing and improving consulting services
Shopping	0%	100%	Implementing advanced use of country system.
Partial NCB	0%	100%	
Advanced NCB	0%	100%	

5.3 In the environmental and social safeguards area, the Bank will pay particular attention to progress on implementing environmental and social country systems, starting with multiple works projects, and with development banks, in order to finance specific projects and minor infrastructure works via eligible entities at the federal and subnational levels. Specific demand may arise in these projects for diagnosis of the country systems applied and identification of shortcomings, so as to strengthen them, and build capacity with an emphasis on social issues, for example, resettlement, indigenous peoples, and gender, and on environmental topics, where weaknesses are identified in the application of acceptable equivalent standards.

5.4 **Innovative services.** In addition to having diversified financing instruments, subnational entities are able to borrow on local markets and commit federal revenue-sharing funds as collateral and guarantees. Development banks and private banks both have facilities for access to finance. In order to continue working with institutions of this kind, and ensure its offering is competitive, the Bank will continue its close dialogue with the government to continue progress at the federal program level and directly with subnational governments within the legal framework in force. Considering the modifications deriving from the reforms presented by the government, the Bank will work on developing financing instruments for the states and municipios, development banks, and commercial banks, with and without sovereign guarantees, and on analyzing the possibility of working on the development of local cash balances. The use of the Bank's new instruments will be considered, such as guarantees and "shared risk facilities." It

[82] The accounting systems are used 100%. Reports are used in operations where disbursements involve converting currency to Mexican pesos and their reports are generated automatically from the executing agency's system.

will also explore the possibility of having a flexible framework for processing operations with this kind of entity.

5.5 **Technical support.** Mexico's budgetary and financing framework enables streamlined and flexible programming, thus allowing the country to mobilize the Bank's loan proceeds very rapidly. However, there is demand for technical advice and additional dialogue that is not necessarily related to loan operations. This makes it necessary to have the human resources and technical assistance to accompany the Bank's sector dialogue. The new "fee for services" facility may provide support on this front. Budgetary and technical cooperation resources are also needed for client support, to complement the Bank's financial program in the country.

5.6 **Donor coordination.** The IDB will continue working in coordination with other multilateral agencies, such as the World Bank[83] and the International Fund for Agricultural Development (IFAD), and with bilateral agencies such as the French Development Agency (AFD) and the German government development bank (KfW), to develop forums for exchange on the country's public policy challenges and opportunities to work together.

VI. RISKS

6.1 **Macroeconomic risks.** Risks associated with an economic slowdown could exist, due to: (i) external factors relating to a loss of dynamism by the United States' economy, weakening of the world economy, high volatility on international financial markets, in conjunction with an increased aversion primarily due to the normalization of monetary policy in developed countries. At the same time, the behavior of oil and raw material prices may have an impact on the current account and even lead to inflationary pressures; and (ii) internal factors relating to possible difficulties approving the new reforms, such as in the energy sector, and modification of the secondary regulations for the reforms recently passed. The Bank's resources will partially mitigate Mexico's financing needs. However, the impact on development indicators will depend, above all, on the political consensus on fiscal issues and sustaining a sound macroeconomic policy framework.

6.2 **Political risks.** The feasibility of the Mexican government's structural reform agenda, on which much of the Bank's strategy is based, will depend on the continuation of the political agreements reached, such as Pacto por México.

6.3 **Risks associated with institutional management**. Technical weaknesses in institutional management frameworks, particularly as regards coordination and at the subnational level, may impact fulfillment of the strategy objectives.

[83] The IDB and the World Bank have held a series of meetings to exchange points of view on the challenges facing the country between 2013 and 2018, such as Foro México 2013.

Consequently, the country strategy provides for actions to strengthen public management at the federal and subnational levels in all its priority areas.

6.4 **Natural disaster risks.** Mexico is highly vulnerable to natural disasters due both to geological and hydrometeorological threats. This will tend to be exacerbated by the impact of climate change. If a natural disaster were to occur it could also have an impact on the achievement of the outcomes envisaged in the strategy, or lead to a reprogramming of the strategy's priorities. At the same time, the intervention areas proposed in the strategy in relation to natural disaster risk prevention and mitigation and climate change adaptation will help mitigate this risk.

RESULTS MATRIX[84]

2013-2018 National Development Plan	Priority Area	Sectors	IDB strategic objectives	Projected outcomes of the country strategy	Indicators[85]	Baseline (Source,* base year)
Promote sustained productivity growth through a climate of economic stability and by fostering equal opportunities.	A. Productivity	Public management	Support the strengthening of public management at the federal and subnational levels	Improved state's collection of own revenues	Subnational own revenues as a % of GDP	0.7% of GDP (SHCP, 2012)
				Improve the efficiency of financial management systems	SEP-PRODEV[86]	3.8 of 5.0 maximum (2012)
		Financial system	Increase the level of finance to the real economy	Improved depth and efficiency of Mexico's financial and capital markets	Rating of the 8th pillar (Financial market development) of the World Economic Forum "Global Competitiveness Index"	4.19 (2013-2014) Ref: World Economic Forum. The Global Competitiveness Report 2013–2014
				Increased bank financing to the nonfinancial private sector by development banks[87]	Share of financing to the nonfinancial private sector as a percentage of total bank lending[88]	8.6% (August 2013, BANXICO)

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[84] The indicative targets will be revised or replaced, as appropriate, through the country programming documents developed during the country strategy period.

[85] During strategy implementation, the Bank will work on identifying and including gender and diversity indicators in its programs.

[86] The PRODEV evaluation system analyzes countries' capacity in five key MfDR areas: (1) strategic planning; (2) results-based budgeting; (3) financial management, auditing and procurement; (4) program and project management; and (5) monitoring and evaluation. The MfDR SEP index encompasses 140 variables or indicators measure a country's capacity to progress on the institutionalization of MfDR. The system uses a scale of 0-5, where 5 is the maximum score. Overall scores are calculated as a weighted average of the scores in each area.

[87] It includes indicators of access to credit for low-income housing, MSMEs, energy efficiency, the agricultural sector, transportation infrastructure, water, energy, and communications.

[88] It corresponds to real-term annual growth of the share of resources devoted to private sector financing out of the total lending granted by development banks in various sectors of economic activity: housing, infrastructure, renewable energy and agriculture. This amount is published at the end of each month by Banco de México.

2013-2018 National Development Plan	Priority Area	Sectors	IDB strategic objectives	Projected outcomes of the country strategy	Indicators[89]	Baseline (Source,* base year)
Promote sustained growth in productivity in a climate of economic stability and by creating equal opportunity	A. Productivity	Labor markets	Promote better job placement	Increase in labor intermediation services and economic support	Number of job seekers served through the different windows (in-person job orientation, Employment Portal, job fairs, training scholarships) of the National Employment Service's (SNE) Employment Support Programs and Placement Services	3,077,713 (SNE records, first half of 2013) *
				Increased employability of graduates from preparatory technical education	Percentage of graduates from technical education schools who join the workforce within six months of graduation	45% (ENILEMS, 2012)
		Business competivieness	Support the development of a logistics and telecommunications systems and promote innovation and entrepreneurship	Lower country cost and better integration of Mexican companies into global value chains	Global Competitiveness Ranking	Rank 55 (Global Competitiveness Ranking, 2013-2014)
				Increased economic impact of ICTs	Networked Readiness Index	Rank 71 (Networked Readiness Index WEF, 2012)
				Increased innovative capacity in Mexican products and processes	Private investment in R&D as a percentage of total R&D investment	37% of investment in R&D is financed by the private sector (2011)

[89] During strategy implementation, the Bank will work on identifying and including gender and diversity indicators in its programs.

2013-2018 National Development Plan	Priority Area	Sectors	IDB strategic objectives	Projected outcomes of the country strategy	Indicators[90]	Baseline (Source,* base year)
Guarantee the effective exercise of social rights and provide a social safety net ensuring access to the right to health and insuring against income vulnerability, and developing Mexicans' human potential through education.	B. Social development	Social protection	Help break the intergenerational cycle of poverty by fostering the building of capacities associated with nutrition, health, and education.	Reduction in the number of deficiencies of the population in extreme poverty	Average number of deficiencies among the population in extreme poverty.[91]	3.7 (CONEVAL, 2012)
		Health	Strengthen and integrate health promotion and prevention, and disease control actions, and make universal access to health services a reality.	Reduction in health service access deficiencies	Percentage of population facing health service access deficiencies[92]	21.5 (CONEVAL, 2012)

[90] During strategy implementation the Bank will work on identifying and including gender and diversity indicators in its programs.

[91] The definition of deficiencies is that in CONEVAL's concept of multidimensional poverty, which includes areas such as education, health, food, housing, and social security.

[92] The definition of deficiencies is that in CONEVAL's concept of multidimensional poverty, and in the specific case of health it includes the percentage of the population that is not covered by the Seguro Popular, IMSS, ISSSTE or state ISSSTE, PEMEX, Defense or the Navy, other occupational medical services, private medical insurance, or the population belonging to other institutions.

2013-2018 National Development Plan	Priority Area	Sectors	IDB strategic objectives	Projected outcomes of the country strategy	Indicators[93]	Baseline (Source,* base year)
Ensure balanced economic growth favoring all regions by fostering productivity in rural areas and generating sustainable urban areas with environments that inhibit the causes of crime and violence, and minimize vulnerability to climate change.	C. Regional development	Urban development	Promote the orderly, safe, and sustainable growth of cities	The biggest cities become denser	% of public subsidies assigned for housing in existing urban areas	0 (CONAVI, 2013)
				Reducing the qualitative gap in the housing stock	% of substandard housing[94]	32% (IDB, 2011)
				Support institutional strengthening of the federal and state authorities in their programs and strategies geared to improving mobility.	Number of government agencies supported by programs, studies, and initiatives supporting the development of mobility plans and projects.	0 (IDB, 2013)
				Local governments have local capacity to design and implement crime and violence prevention policies.	% of municipios with an action plan drawn up, with lines of intervention and annual targets in line with the national program[95]	0 (SEGOB, 2013)
		Rural development	Raise productivity in the agricultural sector and improve the coverage of water services for people living in rural areas	Increased agricultural sector total factor productivity	Total factor productivity (calculated as the geometric average of the five past years)	-0.45% (2011; based on data from INEGI)
				Increased water supply and sanitation coverage in rural communities	Rural water coverage	80.3% (2012)

93 During strategy implementation, the Bank will work on identifying and including gender and diversity indicators in its programs.

94 Source: Data from the Encuesta Nacional de Ingreso y Gasto de los Hogares [National Survey of Household Income and Expenditure] (ENIGH). Reported annually.

95 Source: Department of the Interior (SEGOB). Reported annually.

2013-2018 National Development Plan	Priority Area	Sectors	IDB strategic objectives	Projected outcomes of the country strategy	Indicators[96]	Baseline (Source,* base year)
		Climate change	Support the implementation of national climate change policy mechanisms fostering adaptation measures taking a long-term approach	Reducing vulnerability to climate change impacts with Bank-supported adaptation activities	Number of highly vulnerable municipios covered by planning of financing instruments promoted by the Bank at the regional level.	18 (IDB, 2013)

96 During strategy implementation, the Bank will work on identifying and including gender and diversity indicators in its programs.

Country Systems Matrix[97]

Strategic objectives	Expected outcomes during the strategy	Indicator	Baseline	Indicative targets	Frequency
Support to the government in improving country systems	The individual consultants and consulting firms subsystem is revised and improved	Subsystem 100% revised and improved at the federal level	0%	Review and amendment of regulations on consulting services	At strategy end
	Support the Civil Service Department (SFP) in the transfer of financial and procurement functions to the Department of Finance and Public Credit (SHCP) and others as designated.	Agreements formalized	0%	100%	At strategy end
Use of country fiduciary systems	Increase the use of the following country procurement systems: - Shopping - Partial and advanced NCB[98]	0%	100%	100%	Annual
	Increase the use of financial reports	Number of loans presenting reports directly from the country system	7%	10%	Annual

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97 Outcome indicators measurable for the strategy period.

98 At present, loans with disbursements in local currency present reports directly from the country system. The 7% is calculated on the basis of the approved amount, which corresponds to 3 of 19 loan operations.

MAIN ECONOMIC AND SOCIAL INDICATORS

Economic and social indicators for Mexico

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Real GDP growth	5.2	3.3	1.2	-6.0	5.3	3.9	3.9
GDP (US$ billions)	952	1,036	1,104	886	1,035	1,160	1,178
GDP per capita (US$)	8971	9625	10111	7996	9214	10179	10191
Real GDP per capita (Mex$)	80383	81835	81643	75701	78577	80482	82463
Gross capital formation (% of GDP)	26.2	26.5	26.9	23.8	23.9	25.1	24.7
Gross national savings (% of GDP)	25.5	25.3	25.2	23.1	23.7	24.2	23.9
National unemployment rate (average, %)	3.6	3.7	4.0	5.5	5.4	5.2	5.0
Inflation (end of period, %)	4.1	3.8	6.5	3.6	4.4	3.8	3.6
Exchange rate (average Mex$/US$)	10.9	10.9	11.1	13.5	12.6	12.4	13.2
Real effective exchange rate (1990=100, increase = depreciation)	72.7	74.8	78.2	88.6	81.6	81.6	81.6
Current account (% of GDP)	-0.6	-1.3	-1.7	-0.7	-0.2	-0.8	-0.8
Capital account (% of GDP)	0.7	2.1	3.0	2.0	4.3	4.3	4.0
Foreign direct investment (% of GDP)	2.1	3.0	2.5	1.9	2.1	1.9	1.1
Portfolio investment (% of GDP)	0.6	0.7	0.2	0.9	2.3	2.2	4.8
International reserves (US$ billions, end of period)	76.3	87.2	95.3	99.9	120.6	149.2	167.1
Consolidated public sector balance (% of GDP)	-1.0	-1.2	-1.1	-4.8	-4.4	-3.4	-2.8
Consolidated public sector primary balance (% of GDP)	1.7	1.4	1.2	-2.1	-1.8	-1.0	-1.2
Gross consolidated public sector debt (% of GDP)	38.5	37.9	43.2	44.5	43.9	43.8	43.1
Net consolidated public sector debt (% of GDP)	30.3	29.4	34.3	36.8	36.9	38.0	38.0
SOCIAL INDICATORS							
Population (millions)	106.1	107.7	109.2	110.8	112.3	113.9	115.6
Life expectancy (years)	74.0	74.1	74.0	74.0	74.0	74.1	74.3
Households in "poverty of food" category (%)	13.8		18.4		18.8		
Households in "poverty of capacities" category (%)	20.7		25.3		26.7		
Households in "poverty of assets" category (%)	42.7		47.7		51.3		
Intentional homicide (per 100,000 inhabitants)	10.9	9.6	11.6				
Telephone lines (per 100 inhabitants)	18.4	18.3	18.5	18.1	17.7	17.6	
Mobile telephone subscriptions (per 100 inhabitants)	51.4	60.9	68.1	74.0	81.0	82.0	
Internet users (per 100 inhabitants)	19.5	20.8	21.7	26.3	31.0	36.2	

Sources: IMF (World Economic Outlook, March 2013), World Bank (World Development Indicators, 2013), Banxico, Department of Finance, CONAPO, and CONEVAL.

MACROECONOMIC CONTEXT

1. **The Mexican economy has been losing dynamism due to the weak recovery in external markets.** From 2009 onwards Mexico rapidly recovered its rate of expansion and gross domestic product grew by 5.5% in 2010, and 3.9% in both 2011 and 2012. However, in the second quarter of 2012 the economy began a slowdown that became more marked in the second quarter of 2013, and growth registered a change of 1.5%. The factors explaining this performance include weak external demand and slower domestic growth, the components of which also slowed, particularly gross fixed investment and government consumption. GDP is below potential. Inflationary expectations have dropped. There is no evidence of demand pressure in factor markets and job creation has slowed. This situation led the economic authorities to cut their growth estimates for 2013 from 3.5% to 1.8%.

2. **Nevertheless, the short-term performance of the economy remains subject to risk factors, primarily external ones.** In particular, these include monetary and fiscal policy actions in the United States; the possibility of a fresh outbreak of financial instability in the euro zone; and dependence on the sustainability of growth in China and other emerging economies. The biggest internal risk factor is the possibility of capital outflows, following the considerable capital influx in recent years. Growth is expected to pick up in 2014 (3.9%) with the improved outlook for the U.S. economy and the materialization of the structural reforms being brought in with the 2013-2018 National Development Plan. Moreover, the Growth Acceleration Program, which was presented as part of the Economic Policy Criteria for 2014, is expected to be approved.

3. **The economic slowdown is making the return to budgetary equilibrium planned for 2013 more difficult.** As part of the gradual withdrawal of the countercyclical stimulus that began during the 2009 financial crisis, the fiscal deficit has been shrinking over the last three years, and in 2012 it reached 2.6% of GDP (including Pemex investment). This brought down the gross debt of the federal public sector by 1.5% of GDP between 2009 and 2012, when it came to 43.1% of GDP. It has also improved its profile, in particular the share of external debt in the total decreased, and both the tenors and costs of placing domestic debt improved. However, as a result of the marked slowdown seen in the Mexican economy in 2013, the Federal Government estimated that achieving the fiscal equilibrium envisaged in the Ley Federal de Presupuesto y Responsabilidad Hacendaria [Federal Budget and Fiscal Responsibility Law] (LFPRH) for 2013 would further exacerbate the drop in economic activity. Therefore, in its budget proposal for 2014 the government put forward a two-pronged macroeconomic strategy based on: (i) fiscal policy allowing for temporary but decreasing deficits from 2013 to 2016 as a countercyclical policy and to finance the structural reforms being promoted; and (ii) the social and fiscal reform initiative, which envisages amendments to the LFPRH, whereby Congress was asked to approve a tax deficit of 0.4% of GDP for 2013, in contrast with the fiscal equilibrium initially approved.

4. **Although fiscal policy is expected to remain expansionary over the coming years while the growth stimulus of the structural reforms takes effect, the solidity of the public finances is not being compromised.** To this end, the Social and Fiscal Reform provided for the introduction of a structural balance rule, which would imply expanding public spending at the bottom of the economic cycle and generating savings when the economy grows faster than its potential rate by setting a cap on current expenditure. Moreover, the debt sustainability analyses show Mexico to have no solvency or sustainability problems, and even if the most adverse macroeconomic scenarios materialize, the fiscal accounts will have institutional enforcement mechanisms such as the budgetary equilibrium rule and the improvement to the stabilization and contingency fund saving mechanisms.

5. **Mexico's external accounts remain in good health and the mechanisms limiting the degree of external exposure have been strengthened.** The economy's external sector has come to be characterized by its low current account deficit (0.8% of GDP in 2012) and positive balances on the capital account (4.3% of GDP in 2012), the latter encouraged by significant inflows of external capital. Similarly, international reserves have reached record new highs (US$170,927 billion in September 2013), which together with the availability of a flexible IMF credit line (US$73 billion) has resulted in a high level of liquidity sufficient to ensure that the country is able to meet its short-term financial obligations comfortably. Lastly, the free floating peso exchange rate has allowed the country to absorb external shocks without major economic disruptions.

6. **Monetary policy has moderated inflationary expectations and prices have steadily converged on the 3% target established by Banco de México.** The credibility of monetary policy management has resulted in a steady drop in inflation in recent years. Despite inflation's being affected by short-term shocks in early 2013, the medium-term indicators show that the trend towards deceleration was not upset by these disturbances. Overall annual inflation stood at 3.46% in the first half of September, which is within the permitted one-percentage point range of variation, and it is expected to continue to fall and reach the 3% target in 2014. In view of the moderation in the economy's growth rate and in the absence of inflationary expectations, Banco de México decided to loosen its monetary policy, lowering the benchmark interest rate by 0.5 percentage points in March and a further 0.25 points in September 2013 to situate it at 3.75%. According to the monetary authorities, this will remain consistent with the inflation target and the more pronounced economic slowdown.

7. **Mexico's financial system has been strengthened by more solid banking supervision and regulation and appropriate macroeconomic policy management.** In 2012, the credit to the private sector granted by commercial banks expanded in all categories. The banks' capitalization rates indicate adequate solvency positions, and their profitability and liquidity indicators are solid. This is all strengthened by the incorporation of the new Basel III provisions in 2013. Although domestic risks and latent risks associated with international financial markets remain, the various analyses of the financial sector's stability do not

indicate there to be any systemic threats to the sector. In short, Mexico has managed to keep its financial system stable and solid while fostering its growth, and although risks are identified as existing, their impact on its functioning is likely to be limited.

8. **It is expected that the government, jointly with "Pacto por México," will move forward significant structural reforms, which if implemented, would raise the Mexican economy's growth potential.** These reforms aim to rectify market and regulatory gaps that have held back productivity growth in recent years and represent bottlenecks to the expansion of fundamental sectors for development. Democratizing the higher income levels that these major changes could help bring about helps to overcome poverty and inequality. One of the key reforms to stimulate the Mexican economy's growth is the social and fiscal reform, the law on the financial discipline of federative and municipal entities, and energy sector reform. Both initiatives will improve the effectiveness of federal and subnational fiscal management by making substantive changes in non-oil revenues and the tax system applicable to Pemex, financing of the public sector, public spending efficiency, and making social security policies universal so as to promote formal employment. These initiatives are being debated in Congress and are expected to be passed before the end of 2013. At the same time the government launched initiatives aiming directly to increase productivity, such as reforming education, telecommunications, and finance, and has put major public policies into operation. Key initiatives are those targeting the population's most vulnerable groups, such as: the Cruzada Nacional Contra el Hambre [National Crusade against Hunger]; the Programa Nacional de Vivienda [National Housing Program]; the Cruzada Nacional para la Prevención Social y la Violencia [National Crusade on Violence and Social Prevention]; the Seguro de Vida para Jefas de Familia [Life insurance for female heads of household] and the Pensión para los Adultos Mayores de 65 años [Pensions for adults over 65]; and others to stimulate productivity and competitiveness, such as the major impetus given to the Pacific Alliance trading bloc, the Estrategia Nacional de Energía 2013-2017 [2013-2017 National Energy Strategy] and the creation of the Instituto Nacional del Emprendedor [National Institute for Entrepreneurs] (INADEM).

INDICATIVE LENDING FRAMEWORK

Financial scenario: The Bank will seek to achieve increasing levels of approvals and disbursements over the course of the country strategy, reaching an average of US$1.740 billion in approvals and US$1.500 billion in disbursements. This would keep debt with the Bank at an average ratio of 0.7% of GDP and 5.3% of the country's total external debt over the strategy period.

Financial Scenario 2013-2018 (US$ millions)

	2010	2011	2012	2013[2]	2014	2015	2016	2017	2018
Approvals[1]	**2,800.0**	**1,520.0**	**1,117.2**	**1,850.0**	**1,500.0**	**1,500.0**	**1,700.0**	**2,000.0**	**2,000.0**
Disbursements	**2,286.9**	**1,567.5**	**1,241.8**	**1,800.0**	**1,800.0**	**1,100.0**	**1,350.0**	**1,500.0**	**1,500.0**
Repayments	516.4	506.4	449.1	235.0	407.3	1,588.2	513.6	1,017.7	570.5
Net lending flow[3]	**1,770.5**	**1,061.1**	**792.7**	**1,565.0**	**1,392.7**	**(488.2)**	**836.4**	**482.3**	**929.5**
Subscriptions and contributions	8.3	8.1	60.6	22.0	n/a	n/a	n/a	n/a	n/a
Net capital flow	**1,762.2**	**1,053.0**	**732.1**	**1,543.0**	**1,392.7**	**(488.2)**	**836.4**	**482.3**	**929.5**
Interest and fees	293.7	393.7	400.7	222.8	432.1	398.3	353.9	317.9	291.5
Net cash flow	**1,468.5**	**659.3**	**331.4**	**1,320.2**	**960.6**	**(886.4)**	**482.6**	**164.3**	**638.0**
Debt with IDB[4]									
Public sector debt with IDB (US$ millions)	**8,779**	**9,810**	**10,580**	**11,900**	**12,861**	**11,975**	**12,457**	**12,621**	**13,259**
IDB debt/GDP (%)	0.85	0.85	0.90	0.93	0.96	0.85	0.84	0.81	0.80
IDB debt/external public debt (%)	7.95	8.43	8.42	7.2	7.4	6.5	6.4	6.1	6.1
IDB debt/external multilateral debt (%)	41.54	41.87	41.80	43.9	43.9	43.9	43.9	43.9	43.9

1/ Estimates, amounts subject to availability of the Bank's financial capital.
2/ Projected amounts to 30 September 2013
3/ Source: SHCP. Historical figures. Projections with own estimates and figures from the IMF.
4/ The increase in debt repayments in 2015 corresponds to the repayment of loans 2067/OC-ME and 2173/OC-ME with SHF for a total of US$1 billion. Both were in effect in 2009 and in 2015 repayment will start once the five-year grace period has ended.

Average Financial Scenario 2013-2018 (US$ millions)

	2011	2012	2013 2/	Average 2013-2018
Approvals 1/	**1,520.0**	**1,117.2**	**1,850.0**	**1,758.3**
Disbursements	**1,567.5**	**1,241.8**	**1,800.0**	**1,508.3**
Repayments	506.4	449.1	235.0	**722.0**
Net lending flow 4/	**1,061.1**	**792.7**	**1,565.0**	**786.3**
Subscriptions and contributions	8.1	60.6	22.0	**n/a**
Net capital flow	**1,053.0**	**732.1**	**1,543.0**	**782.6**
Interests and fees	393.7	400.7	222.8	**336.1**
Net cash flow	**659.3**	**331.4**	**1,320.2**	**446.5**
Debt with IDB3/				
Public sector debt with IDB (US$ millions)	**9,810**	**10,580**	**11,900**	**12,512**
IDB debt/GDP (%)	0.85	0.90	0.93	**0.87**
IDB debt/external public debt (%)	8.43	8.42	7.2	**6.6**
IDB debt/external multilateral debt (%)	41.87	41.80	43.9	**43.9**

1/ Estimates, amounts subject to availability of the Bank's financial capital.
2/ Projected amounts.
3/ Source: SHCP.
4/ The increase in debt repayments in 2015 corresponds to the repayment of loans 2067/OC-ME and 2173/OC-ME with SHF for a total of US$1 billion. Both were in effect in 2009 and in 2015 repayment will start once the five-year grace period has ended.

COMMENTS ON THE COUNTRY PROGRAM EVALUATION: MEXICO 2007-2011

Country program evaluation recommendations (OVE)	Incorporation into the 2013-2018 country strategy
Strengthen the relevance of the future program to the country's structural challenges	
1.1 Engage in dialogue with the Mexican government on the possibility of Bank support in the next six-year term to solve the fiscal challenges related to the aging of the population and to promote the integration of Mexican industry into the global economy.	Both topics were considered in the Bank's new country strategy with Mexico in the productivity area. Specifically, in the labor markets area, the strategy envisages actions to develop the regulatory framework and social security system so as to indirectly meet the fiscal costs associated with population aging. The topic of promoting the integration of Mexican industry in the global economy was addressed in the business competitiveness sector through support for developing the logistic infrastructure needed to leverage insertion in the global economy.
Redefine and specify the criteria for the Bank's private sector work and monitor investments in the sector to guarantee results and the Bank's value added	
1.2 In particular, the Bank should consider identifying clear and explicit criteria for private sector intervention. These should ensure consistency with the criteria that justify development bank support for private sector enterprises in Mexico and make it possible to prioritize Bank action in the sector, improving coordinated participation by the various windows in preparing the Bank's country strategy. In addition, for the design of non-sovereign guaranteed (NSG) operations, the Bank should consider developing evaluability criteria clearly associated with explicitly identified market failures, so that the objectives of these operations are clearly associated with development objectives and the country's development strategy.	The 2013-2018 country strategy envisages the coordinated intervention of the private-sector windows in the various strategic intervention areas, complementing sovereign guaranteed interventions in the financial sector, business competitiveness, health, urban and rural development, and climate change, as well as looking for additional business opportunities in other areas where they can provide financial and nonfinancial additionality.
1. Reduce transaction costs	
1.3 To reduce transaction costs, the Bank should make continued efforts to expand the use of country systems. In the specific case of federal government loans executed with transfers from the executing agency to the delegations or the states, using operating rules of the federal government program, the Bank should consider allowing the supporting documentation for the transfer from the central level to the delegation or state, as applicable, to serve as the expense voucher instead of requesting such	The country strategy envisages efforts to continue progress on the adoption of country systems in Mexico and so help reduce transaction costs. In relation to procurement, as part of the Strategy for Strengthening and Use of Country Systems (document GN-2538), and in response to the request by the Government of Mexico, the Guide for Acceptance of the Use of Country Procurement Systems (document GN-2538-6) was applied in 2012. The results showed that the Mexican procurement system made significant progress in

Country program evaluation recommendations (OVE)	Incorporation into the 2013-2018 country strategy
documentation from the end beneficiary. In addition, the Bank and the Board of Executive Directors should jointly explore innovative ways of making loans to the private sector in local currency without having to resort to swaps.	terms of transparency, efficiency, and compliance with the majority of international best practices. Thus in February 2013 the Board of Executive Directors of the Bank agreed to step up the use of Mexico's public procurement and contracting systems for the procurement of works, goods, and nonconsulting services through national competitive bidding, shopping, and single-source selection, all pursuant to the provisions of the country strategy update (document GN-2595-3). An implementation agreement is due to be signed with the Government of Mexico in the last quarter of 2013, envisaging the adoption of the country system for procurement's becoming fully operational. As regards financial management, with the agreement of the Department of Finance and Public Credit (SHCP), Management has implemented simplifications in expense reporting for various portfolio operations. These simplifications have helped bring down transaction costs and audit costs, as the reports submitted to the Bank will be reviewed using agreed procedures with operation-specific terms of reference agreed on with the Civil Service Department (SFP) and the executing agency. During the country strategy period, greater use of the country's and executing agency's control systems will continue to be assessed to enable improved implementation of the simplification of expense reporting to the Bank.
2. Explore effective ways of working with subnational governments	
1.4 In order to effectively support the country's development of its subnational governments, it is suggested that the preparation exercise for the next strategy should be used to further deepen dialogue with the government in order to find and implement alternative ways of working directly with subnational governments without having to resort to financial intermediaries (e.g. creation of a trust), or to otherwise reduce transaction costs related to the intermediation of Banco Nacional de Obras y Servicios Públicos (Banobras) (e.g. elimination of the inspection and supervision fee, duplicate processes, etc.), developing better mechanisms for collaboration between Banobras and the Bank and facilitating the delivery of technical assistance by the Bank to the subnational governments.	As established in paragraph 5.5 of the country strategy, the Bank will continue to work both at federal government program level and directly with subnational governments. In the case of subnational lending, constitutional restrictions apply. The investments required by states and municipios are therefore met through national development banks (Banobras, in particular). However, the Mexican government's recent structural reforms, which include a fiscal responsibility law for states and municipios and a higher degree of fiscal federalism, may open up opportunities for new mechanisms for serving states and municipios to be explored, and thereby reduce transaction costs and duplication of efforts.

Country program evaluation recommendations (OVE)	Incorporation into the 2013-2018 country strategy
Adopt a more strategic focus in developing the technical cooperation program	
1.5 To ensure that technical assistance acquires greater strategic relevance and to prioritize increasingly scarce resources, Management should consider engaging in a discussion, during its annual programming exercise, with the Ministry of Finance (SHCP) on the use and destination of technical assistance resources potentially available for Mexico, based on indicative figures and the usage trends of each fund that the Grants and Co-Financing Management Unit (GCM) would provide for such purpose. In addition, it should consider the possibility of requiring that technical assistance operations contain results indicators aligned with the Bank's strategic objectives for the country, with responsibility for monitoring progress to be shifted to the Mexican government.	During the strategy period, Management will coordinate closely with the SHCP to ensure prioritization and efficiency in the use of limited technical assistance resources, and the monitoring of the results of operations in priority areas identified in the country strategy, particularly those helping mitigate the implementation risks identified. Thus, jointly with the SHCP, Management will strengthen the current programming mechanisms to ensure the consistency and alignment of technical assistance with the country strategy's strategic areas, and also improve supervision and evaluation of these operations, in compliance with current technical cooperation guidelines.

SUMMARY OF THE DEVELOPMENT EFFECTIVENESS MATRIX

Country Strategy: Development Effectiveness Matrix
In August 2008, the Board of Executive Directors approved the Development Effectiveness Framework (document GN-2489) to increase the evaluability of all Bank development products. The Development Effectiveness Matrix for Country Strategies (DEM-CS) is a checklist of the elements that are necessary to evaluate a country strategy. It is based on the evaluation criteria developed by the Evaluation Cooperation Group of the Multilateral Development Banks in the "Good Practice Standards for Country Strategy and Program Evaluation."

Country Strategy: Mexico 2013-2018

STRATEGIC ALIGNMENT (measures two dimensions: (i) the extent to which the strategy's objectives are consistent with the country's development challenges and the government's priorities and plans; and (ii) the use of a mix of products (financial, knowledge, technical assistance) to attain the objectives, and identification of other cooperation agencies and their areas of action):

Consistency of strategic objectives: The strategy will focus on promoting productive, social, and territorial development through support to the following areas: (i) public management; (ii) the financial system; (iii) labor markets; (iv) business competitiveness; (v) social protection; (vi) health; (vii) urban development; (viii) rural development; and (ix) climate change. The Bank will intensify the dialogue with the energy, education, and citizen security sectors. Gender, diversity and integration will be addressed as crosscutting issues in the strategy. All (100%) of the areas selected address the country’s development challenges and are consistent with the priorities set by the Government of Mexico. Moreover, the work areas are the outcome of the dialogue between the country and the Bank.

Product mix and participation of other donors: The strategy proposes to use different Bank instruments, such as SG operations, NSG operations, and TC operations. The IDB will continue to work in coordination with other multilateral agencies, such as the World Bank and the International Fund for Agricultural Development (IFAD), and bilateral agencies such as the French Development Agency (AFD) and the German government development bank (KfW).

EFFECTIVENESS The extent to which the country strategy is likely to achieve its intended objectives, through an examination of four dimensions: (i) quality of the diagnoses on which the Bank's action rests in each area of work; (ii) the quality of the strategy results matrix; (iii) the use and strengthening of country systems; and (iv) the analysis of the lending framework:

Effectiveness dimensions	**%**
I. Sector diagnostics	
▪ Identifies the main problems based on empirical evidence	100
▪ Identifies the main beneficiaries	100
▪ Identifies and measures the factors that contribute to the problems identified	100
▪ Presents the policy framework and a sequence for Bank intervention	100
▪ The diagnostic corresponds to the objectives presented in the strategy	100
II. Results matrix	
▪ The expected outcomes are clearly defined	100
▪ The indicators are outcome indicators and are SMART	94
▪ The indicators have baselines	100

Twelve sector notes were submitted to support the strategy

- All the notes clearly identify the main sector problems based on empirical evidence.
- All the notes identify the potential beneficiaries in each area of intervention.
- All the notes raise or dimension the factors contributing to the problems identified.
- All the notes propose a policy framework and sequence for actions by the Bank.
- In all of the notes there is consistency between the note and the strategic objectives.

Results matrix:

- 100% of the strategic objectives have a clear definition of the expected outcomes.
- 94% of the indicators are outcome indicators and are SMART; the remaining 6% are output indicators.
- 100% of the indicators have baselines.

Country systems: All financial management and procurement subsystems have been assessed. All financial management and procurement subsystems will be used during the strategy period except that for hiring individual consultants.

Lending framework: The strategy contains an analysis of the country's financing requirements, and provides an estimated scenario for the amount of sovereign guaranteed lending. The lending envelope is consistent with the macroeconomic projections and the country’s financing strategy.

RISKS (measures three dimensions: (i) identification of factors that actually or may potentially affect the attainment of the proposed objectives; (ii) definition of mitigation measures, and (iii) monitoring mechanisms):

The strategy identifies risks associated with the Bank’s involvement in each of the strategic sectors and identifies mitigation measures. Political, institutional, and natural disaster risks are also considered at macroeconomic risk level.