Equitable growth depends upon the efficiency and depth of the financial system. Neither the public sector nor the private sector can function without it. The government finances have improved over the last sexenio; however, some vulnerability remain in terms of reliance on oil revenues and indebtedness levels that could still be lowered in order to raise the sovereign credit rating.

The government’s efforts to consolidate macroeconomic and financial stability and enhance the role of the financial system in efficiently financing the private sector and allocating risks to those better able to bear them have succeeded in solving many of the weaknesses of the financial system that were identified in 2001 during the FSAP\(^1\). Looking ahead, it seems that the major challenge will be to finalize some of the reforms already in progress and to focus on new goals related to markets development, competition, and access to financial services now that concerns for stability have eased.

1. This report includes chapters that discuss government spending and policies in a variety of sectors, and chapters that discuss the business environment for private sector investment and innovation. **Both the public sector and private sector depend upon a lifeline of finance in order to conduct their activities.** Particularly in Mexico, there has been a close relationship between finance for the public sector and finance for the private sector. In Mexico, this relationship is driven by four factors:

(i) Overall macroeconomic stability, heavily dependent on the state of public finances, is a pre-condition for correct functioning of the markets to provide financing to the private sector. Past economic crises trace their origins to the public sector’s inability to balance its finances. The last such crisis decimated the financial sector and led to a decrease in private sector financing that still has not recovered the levels of the early 1990s. Though today Mexico has a solid and resilient financial system, it provides a very low level of finance to the private sector as a share of GDP when compared to other regional and international competitors of the country;

(ii) The risk that international investors associate with the government’s financial condition also determines the costs of financing of Mexican private firms accersing funds from overseas;

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\(^1\) FSAP stands for Financial Sector Assessment Program. **The Financial Sector Assessment Program** is a joint IMF-World Bank initiative launched in 1999 to provide member countries that request participation with a comprehensive assessment of their financial systems. Participation in the program is voluntary.
A key economic sector – the oil and gas sector – is dominated by a government owned enterprise whose finances are tied to the government’s finance; and

The government, through its own financial institutions, continues to have an important, though diminishing role, in financing subnational government activities and private sector activities – such as housing – in Mexico.

Public Finance

Introduction

2. The public sector budget is possibly the most direct and powerful policy instrument through which a government may have an impact on society as it involves decisions on the level, composition and efficiency of public expenditure, taxation, and the financing of any shortfall between overall public sector revenue and expenditures. Fiscal policy objectives are thus often framed in terms of its contribution to macroeconomic stability, economic growth and income distribution or poverty reduction. From the broad range of interrelated topics this involves, we propose to frame our discussion around the fiscal policy issues of public debt and fiscal sustainability, the management of volatile and uncertain oil revenue and the distributional impact of public finance in view of the recent progress made and the challenges posed for the formulation of fiscal policy in Mexico in the near future.

3. Fiscal discipline and the management of additional oil revenue have been at the core of the annual budget discussions and fiscal policy as implemented over the past few years. This is also reflected in the recently adopted federal budget and fiscal responsibility law that will govern fiscal policy discussions beginning with the 2007 budget. Together with Congress the incoming administration will have to frame its fiscal policy in terms of this law and will have to take decisions and provide interpretations in line with the broader concepts of the law. This section briefly reviews the recent fiscal policy performance and discusses the major fiscal policy issues in view of this performance and the federal budget and fiscal responsibility law.

Recent Fiscal Policy Performance

4. Over the past six years, fiscal policy has been strongly focused on fiscal consolidation as part of an economic policy oriented to strengthen and maintain macroeconomic stability. In tandem with a monetary policy implemented within the framework of inflation targeting, important progress in the attainment of macroeconomic stability has been made as evidenced by indicators such as a consumer price inflation (year-end) brought down from 9 percent in 2000 to about 4 percent in 2006, a depreciation of the nominal peso/dollar exchange rate by a modest 16 percent over the six-year period and domestic annual interest rates that are down from an average 15 percent in 2000 to slightly over 7 percent currently.
5. Fiscal consolidation has taken place in terms of an important, gradual reduction of the traditional budget deficit as well as the broader Public Sector Borrowing Requirements (PSBR) deficit definition (Table 1). The latter concept was introduced by the current administration to account for off-budget public sector expenditures such as part of the interest due on liabilities acquired from the 1995 banking crisis, private sector financed investments in the energy sector (PIDIREGAS) and financial intermediation by government-owned development banks. The PSBR data used in this note also excludes non-recurring revenue.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Mexico: Fiscal Balances 2000-2006 (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Budgetary public sector</td>
<td>-1.2</td>
</tr>
<tr>
<td>PSBR</td>
<td>-3.9</td>
</tr>
</tbody>
</table>

Source: SHCP and Bank staff calculations.

6. The term fiscal consolidation is used here to describe the fiscal deficit reduction that has taken place over the past six years. This does not imply that the participation of the budgetary public sector in the economy diminished. As can be observed from the next table, the budgetary public sector actually managed to expand total expenditure by 1.5 percent of GDP while at the same time reducing its deficit by a similar amount (Table 2).

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Public Finance Mexico 2000-2006 (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Budgetary revenue</td>
<td>21.5</td>
</tr>
<tr>
<td>Oil</td>
<td>7.0</td>
</tr>
<tr>
<td>Non-oil</td>
<td>14.5</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>9.4</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>5.1</td>
</tr>
<tr>
<td>Budgetary expenditure</td>
<td>22.7</td>
</tr>
<tr>
<td>Current</td>
<td>13.0</td>
</tr>
<tr>
<td>Capital</td>
<td>2.7</td>
</tr>
<tr>
<td>Revenue sharing</td>
<td>3.2</td>
</tr>
<tr>
<td>Interest</td>
<td>3.7</td>
</tr>
<tr>
<td>Budgetary Balance</td>
<td>-1.2</td>
</tr>
</tbody>
</table>

Source: SHCP and Bank staff calculations

7. Additional oil revenue, resulting from increased and higher-than-budgeted international oil prices over the past four years, is commonly thought of as the driving force of this fiscal performance. Rearranging the terms of the last table one is able to observe that extra oil revenue has been responsible for less than half of the fiscal space generated over the past six years (Table 3). Other important contributors to the creation of fiscal space were lower interest expenditures, a reflection of progress obtained in strengthening overall macroeconomic stability, and higher tax collection, which can mainly be attributed to a higher collection of value added taxes thanks to, among others, improved tax administration.
Table 3  Sources and uses of fiscal space 2000-2006

<table>
<thead>
<tr>
<th></th>
<th>change (% of GDP)</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal space sources</td>
<td>4.0</td>
<td>100.0</td>
</tr>
<tr>
<td>oil</td>
<td>1.8</td>
<td>45.7</td>
</tr>
<tr>
<td>tax</td>
<td>0.8</td>
<td>18.6</td>
</tr>
<tr>
<td>non-tax</td>
<td>0.5</td>
<td>11.4</td>
</tr>
<tr>
<td>interest expenditure</td>
<td>1.0</td>
<td>24.3</td>
</tr>
<tr>
<td>uses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>non-interest expenditure</td>
<td>2.5</td>
<td>62.0</td>
</tr>
<tr>
<td>current</td>
<td>1.1</td>
<td>26.0</td>
</tr>
<tr>
<td>capital</td>
<td>0.9</td>
<td>22.6</td>
</tr>
<tr>
<td>revenue sharing</td>
<td>0.5</td>
<td>13.5</td>
</tr>
<tr>
<td>deficit reduction</td>
<td>1.5</td>
<td>38.0</td>
</tr>
</tbody>
</table>

Source: SHCP and Bank staff calculations.

8. **The overall fiscal space has been used to increase public sector expenditure and improve the public sector balance, with somewhat more emphasis on the expansion of expenditure.** The increase in expenditure and, in particular, the increase in current expenditure, including revenue shared with subnational government which also tends to be largely dedicated to current expenses, often raises concerns about the “quality” of the public sector expansion and its ability to adjust spending downward in case of a downturn in revenue. In this regard, an increase of capital expenditure is often preferred to current expenditure as capital expenditure may contribute, more and more directly, to the build-up of public sector net-worth, and perhaps more importantly, capital expenditure is easier to cut in times of a sudden drop in revenue. Improvement in the public sector balance or deficit reduction contributes directly to strengthening of public sector net-worth as it translates in a lower build-up of debt and can, eventually, be reversed.

9. **From the sources and uses of fiscal space presented in the table above, one may conclude that the public sector managed to increase its “savings” by more than the increase in oil revenue through a combination of increased capital expenditure and deficit reduction, with emphasis on the latter.** This observation should not lead to a complacent view on the current fiscal policy stance as the initial target for the increase of public sector savings presented in the *Programa Nacional de Financiamiento del Desarrollo*, in absence of the current oil windfall, was of similar size. Furthermore, the current federal budget and fiscal responsibility law requires a budgetary balance or zero deficit which implies any reduction of oil revenue in the near future will require adjustment in parts of the budget.

Public debt and fiscal sustainability

10. **A major policy objective in an emerging market economy like Mexico over the past few years has been to strengthen macroeconomic and financial stability.** By establishing a continued track record of prudent fiscal management, Mexico enhanced the credibility of its commitment to a sustainable and declining public debt path. The improved market perception of public sector solvency has led to better access to financial
markets which is reflected in superior sovereign credit ratings, lower sovereign spreads and longer public debt maturities. Improved access to financial markets is not only beneficial to the public sector, which will face lower debt service requirements, but also to the private sector, for the terms at which it can access finance, and to the development of domestic financial intermediation.

11. Over the past few years Mexico has been able to attain low and decreasing budget deficits and has decreased its gross public debt-to-GDP ratio from 49.3 percent in 2000 to an estimated 42 percent by the end of 2006. The zero budget deficit requirement in the federal budget and fiscal responsibility law is yet another example of a broad awareness among policymakers about the role of sound and sustainable public finances in strengthening macroeconomic and financial stability as a necessary condition for economic growth.

12. In a broad sense, fiscal sustainability is defined by the public sector’s intertemporal budget constraint that requires the public sector to generate a net present value of future non-interest or primary surpluses higher or equal to the current level of debt. This broad definition does not, however, establish clear criteria on the maximum or optimal level of public debt, nor by when gradual repayment of debt, through the generation of sufficiently large primary surpluses, should start. To make this concept operational, the literature tends to consider a fiscal policy stance sustainable if it does not entail an ever-increasing public debt to GDP ratio. Or, in other words, a fiscal deficit that keeps the public debt to GDP ratio at or below its existing level is often used as a critical measure of the public sector’s solvency. Comparing the fiscal performance of Mexico in terms of fiscal deficits and the debt/GDP ratio with the requirements the literature poses on these indicators one may conclude that substantial progress was made in assuring the public sector’s solvency and its movement to a sustainable built-up of public debt. Such a conclusion is confirmed by several other additional indicators such as the country’s sovereign credit rating, the country risk spread and domestic interest rates that have all experienced a steady improvement.

13. Going forward, Mexico faces important challenges to maintain longer-term fiscal sustainability. A rapid reduction of proven oil reserves may require additional investment in the oil industry, imply higher production cost and reduce the (net) revenue generated by oil. At the same time, the public sector faces important public expenditure pressures in public health, education, pensions, poverty reduction programs and the provision of public infrastructure. The prospect of lower (net) oil revenue and increasing public expenditure both point to the need to gradually increase tax revenue and, where possible, consolidate and increase the efficiency of public expenditure. An increase of tax revenue should thus be the main focus of improvements in the area of tax policy and administration. And while the efficiency of public expenditure should be an area of permanent concern, the incoming administration may have a more immediate opportunity in the consolidation of public expenditure addressing the issue of public sector workers pensions.

14. Within this overall favorable picture of public debt and fiscal sustainability some additional considerations are worth taking into account. These include: (i) the definition
of the fiscal balance, (ii) the level of public debt, and (iii) the structural strength of the country’s public finances.

**Fiscal balance**

15. Fiscal policy and budget discussions in Mexico tend to focus, almost exclusively, on the traditionally defined budgetary balance as the important policy variable for fiscal and public debt sustainability and the contribution of the fiscal policy stance to attain macroeconomic stability. A recent example is the federal budget and fiscal responsibility law that requires a zero budget balance. This stands in contrast to the literature and several other countries where the primary surplus is the main policy variable in deciding on the overall fiscal policy. The primary surplus may be a more revealing variable, particularly in situations of high and volatile inflation.

16. With inflation largely under control, the distinction between the overall balance and the primary balance may become less relevant. In the case of Mexico, however, the traditionally defined budget balance does not include several off-budget expenditure items, some of which have surged over the past decade as a result of political decisions and accounting practices. As mentioned before, the Mexican government started to publish a broader concept of the public sector balance, PSBR, including the off-budget expenditure items such as part of the interest due on liabilities acquired from the 1995 banking crisis, private sector financed investments in the energy sector (PIDIREGAS) and financial intermediation by government-owned development banks. As these off-budget expenditures are generally related to liabilities that are fully guaranteed by the federal government, the more relevant concept to judge the fiscal stance would be the PSBR and its counterpart in terms of public debt, the Saldo Histórico de Requerimientos Financieros.

![Figure 1: Evolution of the Fiscal Balance](source: SHCP and Bank staff calculations.)
17. Other, additional fiscal indicators may be needed to reveal the nature and sustainability of a fiscal policy and avoid the optical illusion that a single indicator may provide or that accounting tricks may provoke. These include indicators such as the non-oil fiscal balance, taking out oil revenue due to the depletion of an exhaustible asset and the volatile behavior of oil prices, and the structural balance, taking out temporary impact on public sector revenues and expenditures resulting from the position of the country’s economy in the business cycle.

Level of public debt

18. An increase in public debt in emerging market economies as well as some high profile and costly debt defaults or distressed debt restructuring in the late 1990s and early part of the current decade has raised concerns about debt sustainability and the level of debt these countries can service. The surge in the public debt-to-GDP ratio in the majority of the emerging market economies has been largely a result of interest and exchange rate movements and the recognition of off-balance and contingent liabilities. In this sense, Mexico has not been the exception as a large part of the current public debt has resulted from the 1995 financial crisis.

19. As mentioned above, the fiscal sustainability or solvency requirement does not provide any guidance on the maximum or optimal level of debt though several empirical studies attempt to determine thresholds for the debt-to-GDP ratio of emerging market economies (IMF 2003). These show that the median public debt-to-GDP ratio in the year before default was about 50 percent of GDP. Another exercise shows that the increase in the primary surplus weakens as the debt-to-GDP ratio rises in emerging market economies, and the increase stops altogether when debt exceeds 50 percent of GDP. Whereas an analysis of expected future primary balance based on performance in the past estimates a median level of debt of 25 percent of GDP in order to be consistent with the expected future primary balances.

20. Even though the estimation of thresholds for the public debt-to-GDP ratio is not without controversy and there is a lot of variation due to country specific conditions, the thresholds observed for emerging market economies are considerably below those for industrial countries and lower than the current debt-to-GDP ratios observed in a large number of cases. Despite the progress obtained in the reduction of the debt-to-GDP ratio in Mexico, with a gross debt at 42 percent of GDP by the end of 2006 the next administration has a strong case to pursue a further reduction of the debt-to-GDP ratio in order to reduce vulnerability to adverse shocks and enhance macroeconomic and financial stability.

Structural problems of public finance

21. In its most comprehensive way, fiscal sustainability analysis implies the calculation of the public sector’s net worth taking into account the present value of all future streams of public sector payments and receipts. The depletion of oil reserves, cyclical fluctuations of national income and its impact on public finances, contingent liabilities and the quality of fiscal adjustment (i.e., whether or not overly
22. **While there are a lot of issues that impact future public revenue and expenditure streams, we will limit the discussion here to the depletion of oil reserves, taxation and public sector workers’ pensions.** The reason for this choice is the size of the issues at stake that need to be taken into account in the formulation of public policy and, in the latter case, the possibility for policy action in the short term.

23. The economic rent obtained by the government from the exploitation of a nonrenewable resource differs from other revenue in that it partly represents a depletion of wealth. Considerations of long-run fiscal sustainability would generally imply saving a portion of the nonrenewable resource revenue in order to at least maintain the level of the public sector’s net worth. Such saving could take place either through increased public investment, held as financial assets or by diminishing public sector debt. In order to incorporate these considerations in fiscal policy formulation in Mexico, **the budget discussions may benefit from including a limit or target on some definition of a non-oil fiscal balance.**

24. **Oil reserves are down to less than 11 years of production supporting the depletion of wealth argument for increased public sector saving and the concern about longer term sources of public sector revenue.** The amount of proven reserves fell significantly as a result of increased production and a more rigorous classification of reserves in 2003. Increased investments in exploration and development by PEMEX have not yet been able to stop the decline in proven reserves. As a result, current levels of production may not be sustained or the oil industry may require additional investment and experience higher production cost, in both cases leading to a reduction the (net) revenue generated by the exploitation of crude oil.\(^2\) A higher level of uncertainty on the future level and cost of oil production is thus added to the longer standing issue of price volatility.

25. **Mexico needs higher tax revenues to cover the public expenditure that a more equitable and growing society demands.** In addition to the depletion of oil reserves that may require additional non-oil public sector revenue to substitute for oil revenue in the medium and longer term, there exists a broader consensus that the level of public expenditure in Mexico may be too low for the physical infrastructure and human capital needs of the country. The level of taxation in a country eventually reflects the collective preferences for public goods and services vis-à-vis private consumption and although there is no unique way to establish how high taxes should be, international comparisons may provide an indication of whether an adequate level of public services is

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\(^2\) See Chapter 10 for a more detailed discussion of the oil sector.
being provided. In this regard, tax revenues in Mexico have lagged behind those in all other OECD countries and behind nearly all Latin American countries.

26. **Mexico’s tax structure contains many of the instruments of a modern tax policy as well as rates that are generally in line with its major international comparators.** The tax system underperforms, however, in its ability to raise adequate revenues as a result of many exemptions and special regimes that erode the base of the most important taxes, i.e., the VAT and the corporate and personal income taxes. In addition, tax administration has been the weakest part of Mexico’s tax system which is reflected in high levels of evasion, cumbersome filing and payment processes and a complex tax code with frequent changes that creates confusion amongst taxpayers and makes the task of tax administration more difficult. The latest version of the World Bank’s Doing Business report reveals that Mexico has low tax rates but high compliance costs relative to Latin American and OECD comparators.

<table>
<thead>
<tr>
<th>Region or Economy</th>
<th>Payments (number)</th>
<th>Time (hours)</th>
<th>Profit tax (%)</th>
<th>Labor tax and contributions (%)</th>
<th>Other taxes (%)</th>
<th>Total tax rate (% profit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>41.3</td>
<td>430.5</td>
<td>22.8</td>
<td>14.5</td>
<td>11.8</td>
<td>49.1</td>
</tr>
<tr>
<td>OECD</td>
<td>15.3</td>
<td>202.9</td>
<td>20.7</td>
<td>23.7</td>
<td>3.5</td>
<td>47.8</td>
</tr>
<tr>
<td><strong>Mexico</strong></td>
<td><strong>49</strong></td>
<td><strong>552</strong></td>
<td><strong>5.3</strong></td>
<td><strong>30.2</strong></td>
<td><strong>1.6</strong></td>
<td><strong>37.1</strong></td>
</tr>
</tbody>
</table>

Source: Doing Business 2007. Note: tax percentages above are as a percent of commercial profits.

27. **A broadening of the bases for the value-added tax, the corporate income tax and the personal income tax is the generally recommended orientation for tax reform in Mexico even though political agreement on this has proven elusive.** Higher-than expected oil revenue has made up for part of the revenue that was to be raised by such a tax reform though the uncertain and generally temporary nature of this windfall as well as the longer term issue of resource depletion has not removed the need for a tax reform that manages to increase public sector revenue in a sustained way in the medium term.

28. **Strengthening tax administration to facilitate voluntary compliance and to reduce tax evasion making intensive use of information technology has been the main orientation of a Bank supported project with the SAT over the past few years.** The successful implementation of this institutional development program has already contributed to an increase in tax collection and the number of taxpayers while reducing tax administration costs. Further improvements in the relationship between taxpayers and

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3 See e.g. Banco de México “Un Comparativo Internacional de la Recaudación Tributaria,” 2003
tax administrations and a continuous attack on tax evasion may not only increase tax collection but also improve the perceived fairness of the system and the public attitude toward taxation and the public sector.

29. **A reform of the public sector workers’ pension system could significantly reduce the rapidly increasing amount of government transfers in the medium term.** The current federal system of public sector workers’ pensions (ISSSTE) already requires an additional annual government transfer, on top of employer and employee contributions, of about 0.5 percent of GDP. Demographic change and a substantial imbalance between contributions and retirement benefits will increase these additional transfers to about 1.0 percent of GDP annually over the next decade. A reform proposal, including the introduction of a funded defined contribution scheme and a gradual increase of the retirement age, has been elaborated and discussions with the unions seem well advanced. The proposed reform also provides the option of current workers to change to the defined contribution scheme providing them with a recognition bond for past service.

30. **Estimates on the impact of the reform suggest a reduction of the overall government liability from 45 to 23 percent of GDP.** By introducing a funded component, contributions from and for workers included under this component are no longer available to pay current pensions which will increase the required government transfers during a transition period. In the case of ISSSTE estimates suggest a transition period of 4-5 years during government transfers to the system will actually be higher (Table 4). Though after this period additional government transfers are projected to diminish (as a percentage of GDP) as a growing number of retirees will draw their pensions from their accumulated savings. In addition, the recognition bond will increase the explicit public debt by about 13 percent of GDP. Financial markets are expected to be able to digest such an increase in the debt-to-GDP ratio as these bonds are replacing a larger contingent liability.\(^4\)

31. **Other public sector entities should be encouraged to reform their overly generous pension schemes.** In addition to the federal government’s ISSSTE, there exist a large number of other pension systems and schemes in different public enterprises and entities, including state governments, which face similar problems of a large imbalance between contributions and benefits. Even though this is primarily a responsibility of these entities, the federal government may design some schemes of assistance that provide the right incentives to reform.

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\(^4\) There are some other issues regarding the proposed reform from the perspective of financial supervision of the private pension system, and these are discussed in the private finance section below.

\(^5\) This chapter was written in November 2006. In March 2007, a reform that broadly follows the features described here was approved by Congress. The data in Table 4 do not reflect the latest information.
Table 4   Government transfer to ISSSTE

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Without Reform</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>billion pesos (2003)</td>
<td>21.2</td>
<td>25.1</td>
<td>29.6</td>
<td>34.9</td>
<td>45.4</td>
<td>72.0</td>
<td>133.8</td>
<td>254.0</td>
<td>299.8</td>
</tr>
<tr>
<td>% GDP</td>
<td>0.31%</td>
<td>0.35%</td>
<td>0.40%</td>
<td>0.46%</td>
<td>0.55%</td>
<td>0.77%</td>
<td>1.08%</td>
<td>1.03%</td>
<td>0.86%</td>
</tr>
<tr>
<td>With Reform</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>billion pesos (2003)</td>
<td>38.0</td>
<td>39.0</td>
<td>39.6</td>
<td>41.7</td>
<td>47.1</td>
<td>59.5</td>
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<td></td>
</tr>
<tr>
<td>% GDP</td>
<td>0.53%</td>
<td>0.53%</td>
<td>0.52%</td>
<td>0.51%</td>
<td>0.50%</td>
<td>0.48%</td>
<td>0.22%</td>
<td>0.14%</td>
<td></td>
</tr>
</tbody>
</table>

Source: SHCP and Bank staff calculations.

Management of oil revenue

32. **Management of oil revenue.** High international oil prices have played an important role in attaining the fiscal targets in Mexico over the past few years. The volatility of oil prices as well as the exhaustible nature of this source of revenue calls for caution in the dealing with such an unstable and uncertain revenue flow. The high proportion of public revenue generated from the oil sector in Mexico make the management of oil sector revenue a particularly relevant fiscal policy issue.

33. **Policy discussions on the oil revenue management have largely been focused on dealing with short term revenue variation due to international oil price volatility.** The economic rationale to focus on shorter-term oil revenue stabilization is to mitigate the need for costly, sudden adjustments of public investment and expenditure plans.

34. **Public finance benefited over the past few years from the surge in oil prices though the unpredictable and often large fluctuations in oil prices pose important challenges for the formulation and implementation of fiscal policy.** Such challenges involve the estimation of the budget revenue and decisions on what to do in case of an excess or a shortfall of revenue in relation to the estimate. The issue is mainly one of efficient use of public resources as cutting expenditures upon a sharp downturn of revenue may be quite costly.

![Figure 2: Oil Revenue Share of Public Sector Revenues, 1998-2005](image)

35. Despite the large share of oil revenue in Mexico’s public finances, the impact of oil price fluctuations on the budget is mitigated by domestic energy pricing policies. Domestic gasoline and diesel prices are being kept constant in real terms, thereby greatly moderating the variation of public sector oil revenue in case of oil price fluctuations. While an important buffer in case of a sudden downturn of oil prices, this
policy has greatly diminished the excise tax revenue on gasoline and diesel to the point of turning it into a subsidy. A modification of the domestic pricing policy may be considered as part of a strategy to increase public revenue on a more permanent basis.

36. **Revenue stabilization funds to smooth expenditure adjustment are often advocated** and have been employed in Mexico as of 2000 through provisions on the distribution of excess revenue in the annual budget laws. The amount of resources accumulated through this mechanism has been limited due to changes in operating rules, a withdrawal of funds following low oil prices of early 2002, and the recent annual purchase of oil price hedging instruments. Revenue stabilization funds have been introduced in the federal budget and fiscal responsibility law giving the legislation a more permanent character.

37. **The strategy of employing oil price hedges to guarantee oil revenue should be continued and may benefit from a stronger public communication and increased transparency.** Much of the excess revenue transferred to the stabilization fund in 2004 and 2005 has been used for the purchase of oil price hedges in order to guarantee the federal government’s budgeted revenue from the export of crude oil. The combination of a generally conservative budget estimate and an increasing oil price has implied a loss of money relative to the status quo of no risk management. As the political costs for policymakers from such losses may outweigh the benefits to be obtained at the time of an important price decline, broader support for this generally considered first-best solution for dealing with oil price volatility may benefit from a strengthened communication strategy and increased transparency. Advantages to be obtained from increased openness about the country’s hedging strategy in domestic political economy terms should be weighed against concerns about the possible adverse alteration of market conditions when market participants know the details of the strategy employed by a major player such as Mexico.

38. **Related to the management of a volatile public revenue source is the broader concept of the impact of fiscal policy on the level of economic activity.** Not unlike other emerging economies, Mexico’s fiscal policies have not been oriented towards a smoothing of the fluctuations in the business cycle and may instead have strengthened such fluctuations in detriment of longer-term economic growth. Automatic stabilizers have been weak as oil makes up an important part of total revenue and the oil price has been somewhat negatively correlated with the business cycle. Moreover, the need to re-establish credibility in prudent fiscal management after several economic, financial and fiscal crises has been an important and compelling reason for this pro-cyclical fiscal policy performance. The latter may become less relevant as further progress in enhancing credibility is attained thereby allowing to include business cycle considerations in the formulation of fiscal policy.
39. Public finance may have many objectives, including the redistribution of income and poverty reduction. Concerns about income distribution are often part of both public revenue and public expenditure policies. **Experience in many countries has shown that social spending, rather than heavily progressive taxation, is more effective in reducing poverty and income inequality.** That is why we propose to concentrate our attention on the distributional impact of public expenditure in these paragraphs.

40. The distributional impact of public expenditure on households of different income levels can be estimated, at least for some types of public spending, by the use that different income groups make of public goods and services. Such a benefit incidence analysis consists of the estimation of concentration coefficients for the distribution of public goods and services. These concentration coefficients range from -1 to 1, in which a negative value of the concentration coefficient indicates that spending is absolute progressive or pro-poor, i.e. lower income groups make use of or benefit more than proportionally from the government spending. A positive value indicates, on the contrary, that spending is regressive in absolute terms or that higher income groups tend to benefit more from the particular government spending. Where spending is absolutely regressive but less so than the distribution of private spending or income it is typically described as relatively progressive.

41. As presented in Figure 3 below, concentration coefficients have been estimated for a selected group of public expenditures on the basis of the income and expenditure surveys ENIGH of 2002 and 2004 and in line with the methodology employed in the Bank’s Public Expenditure Review and Poverty Assessment (2004).

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6 The most common measure of incidence of spending is the concentration coefficient, which is a gini estimation obtained from a quasi-lorenz curve derived from the share of a particular spending category ranked by the per capita household spending of individuals.
42. **While the impact of total public spending on the programs included in this analysis tends to be roughly proportional, there is an enormous variation in the incidence with some programs highly equalizing and others highly disequalizing.** From the ranking of different programs in figure 3 it becomes clear that public sector worker social security programs (health and pensions) are highly regressive. Tertiary education, hospital health and social security provided for formal private sector workers are also regressive in absolute terms, though less than autonomous spending or income. On the other extreme, the most “pro-poor” expenditure program clearly is *Oportunidades*, whereas pre-school and primary education can be categorized as broadly progressive public expenditure.

43. **The pattern revealed below has not changed much over the last sexenio.** This should not be surprising given that the targeting mechanism have not changed much over the period. The effects of new programs like *Seguro Popular* in the health sector are too recent for the household survey data used below.⁷

44. The incidence of public expenditure should be taken into account when allocating scarce budget resources favoring adequate targeting of expenditures when feasible. At the same time in a country with a high income inequality such as Mexico a proportional distribution of public expenditure may already have a significant equalizing impact on access to goods and services by different (pre-tax and transfer) income groups.

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⁷ Please see Chapter 4 for a more detailed discussion of health sector spending.
Figure 4: Distribution of Government Spending

Concentration Coefficients for 2002 and 2004

Conclusions

45. **Mexico has made substantial progress in achieving an improved fiscal position.** Both public deficits and public indebtedness have declined over the sexenio. Markets have validated this performance by awarding sovereign credit ratings that qualify government debt as investment grade. Debt management has reduced vulnerabilities to rollover and currency risks by extending the average maturity of debt and lowering the foreign currency share of public debt.

46. **Budget discussions will start to take place within the framework of the fiscal responsibility law aimed at imposing fiscal discipline** through a zero budget balance requirement, a formula for the determination of the budgeted oil price and mechanisms to distribute and save part of additional revenue. Main challenges are the implementation of the law in line with its fiscal discipline objective, continuity of the law in time and additional regulation that may be needed in areas such as the operation of the revenue stabilization funds. The latter includes a stronger and more permanent policy of oil price hedging including increased transparency and public communication on such a strategy.

47. **A number of vulnerabilities remain.** The public sector depends quite substantially on oil revenues, while proven oil reserves—in terms of years of production—have declined. Higher tax revenues as a result of tax base broadening may not only substitute for falling oil revenue in the medium term but also cover additional public expenditure that a more equitable and growing society demands. On the public expenditure side, proposals for a consolidation of rapidly increasing outlays in the public employee pension system through the transfer to a funded defined contribution system are well advanced. While the political economy of such a reform might be complex, the economics of how this would both improve the long-term public finances and also improve the equity of public spending are imminently clear.

48. **Finally, the quality of government spending is a broader concern.** The various chapters of this report examine spending in the social sectors and infrastructure, and the problem of the quality of spending needs to be addressed on a sector-by-sector basis. In some cases, reforming the roles of the various levels of government or changing the design of intergovernmental transfers is the key to improving quality. Improving accountability and transparency of government spending is an area of concern in virtually all sectors. The details of these issues are covered in more detail in other sector-specific chapters of this report.
Private Finance

Introduction

49. A decade after the crisis, Mexico has a stable financial sector but while some segments of the economy/population benefit from financial services as sophisticated of those of any OECD country, others do not have access to even basic savings accounts. Following the crisis of the mid 1990s, government policies concentrated on cleaning up non performing loans of banks’ balance sheets and generating the macroeconomic stability necessary to attract foreign capital into the financial sector. The success of these policies has left Mexico with a well-capitalized banking sector using risk management practices at international standard levels. Today, the local capital markets provide the entire range of financial products including increasingly complex derivative instruments and securitization bonds. On the other hand, in terms of GDP, total financing by banks to the private sector has dropped to about a third of the level it was at its peak shortly before the crisis. While the capital markets have taken some of the slack, total debt financing to the private sector has continued to shrink even during the last five years (i.e., well after the end of the crisis). The dearth of financing vehicles also implies a lack of savings mechanisms for households and of adequate investment and hedging instruments for individuals and firms, thus restraining growth and reducing employment opportunities. Even in Mexico City, only 24 percent of households report having a basic savings account.

50. Most of the key challenges, which at the time concentrated on solidifying financial sector stability, in the sector identified in 2001 by the Financial Sector Assessment Program (FSAP) have already been addressed. The 2001 FSAP found that sound macroeconomic policies, bank restructuring, and strengthened economic links with the United States made the Mexican economy and its financial system more resilient to shocks and provided a favorable environment for its development. At the same time, the assessment identified some issues that needed to be addressed by the regulatory authorities. These were: (i) relatively low bank financing to the private sector; (ii) the absence of clear rules to prevent a troubled institution from having access to the liquidity support of the Bank of Mexico (BOM); (iii) the lack of a prompt corrective action system to minimize the risk of bank failures; (iv) the need to reform the framework for bank resolution; (v) deficiencies in the strategic role, operations, and financial performance of development banks; (vi) the necessity to overhaul the framework for housing finance; (vii) the need to strengthen financial sector supervision; and (viii) the lack of adequate autonomy for regulatory agencies coupled with the need to improve the coordination of supervisory activities, the regulatory field for financial services across institutions, and the disclosure practices of some entities. During 2001-2006 the Government sought to consolidate macroeconomic and financial stability and enhance the role of the financial system in efficiently financing the private sector and allocating risks to those better able
to bear them. In doing so, they have addressed many of the weaknesses identified by the 2001 FSAP. A summary of the reforms introduced between 2001 and 2006 is presented in Annex 1. The main challenge over the next six years will be to ensure that the benefits of this more solid financial sector reaches more broadly the population.

Overall Private Sector Financing

51. The quantity of formal financing to the private sector has continued to be stalled in terms of GDP over the past five years (see Figure 5). With the exception of consumer lending, which has been growing significantly and consistently since 2000, the earlier part of this period is characterized by deleveraging by firms and bad loan write-offs by banks. The strong recovery in commercial and mortgage financing (especially over the last year) is partly masked by the concurrent contraction of restructured loans (both performing and non-performing). Mexico’s level of private sector financing remains low compared to other countries in the region (see Figure 6).

52. Loan quality has improved considerably. Loan origination standards have risen, nonperforming loans have declined (from over 3 percent of total gross loans in 2000 to below 1 percent in 2005), and debt contracts in local currency with longer maturities and durations have expanded.

53. Financing supply has shifted toward domestic non-bank providers. As a matter of fact, private sector financing by banks dropped from a peak of 39.9 percent of GDP in 1994 – a level which was probably associated with an irrational bubble – to 11.5 percent of GDP in 2004. Public sector involvement in private sector financing remains important. Development banks have substituted first-tier with second-tier lending, and they have significantly increased the volume of partial guarantees aimed at promoting lending to underserved market segments. Non-deposit taking credit institutions (Sofoles) and the Institute of the National Housing Fund for the Workers (INFONAVIT) dominate the mortgage market, although there has been a recent resurgence of mortgages financed by commercial banks.

54. Domestic capital markets have played a relatively limited role in the recovery of private sector financing. Domestic capital markets, including equity and debt issuance, developed quickly during the first half of the 1990s when they went from financing less than 1 percent of private investment to more than 6 percent in 1993 before contracting as result of the crisis. Since then, domestic equity markets have played a limited role, while the private debt markets have started to recover since 2003 and have supported the development of financing and investment alternatives for non-bank financial institutions and pension funds. On the other hand, in part thanks to a more stable macroeconomic environment, the government has been able to develop the local public debt market, reducing its dependence on foreign debt. This has helped to develop

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8 Key objectives of this reform program were to: (1) promote domestic savings, particularly lower-income and long-term savings; (2) further strengthen financial system regulation and supervision; (3) accelerate the modernization of the financial services industry; (4) facilitate the reactivation of bank credit; (5) deepen domestic stock and bond markets; (6) modernize development banks; and (7) consolidate the pension system.
a benchmark yield curve which should help to facilitate the pricing and, therefore, expansion of private sector issuances.

55. **Supplier finance has made up for some of the needs not addressed by the financial sector.** According to a BOM survey of corporate financing patterns (see Figure 7), supplier credit has expanded at the expense of commercial bank financing in recent years.

56. **The prospects for continued private sector financing growth are positive.** This favorable assessment is based on the improvements in the legal, regulatory, and accounting frameworks; well-capitalized, well-managed, and profitable banks; expansion of the institutional investor base; dynamism in the local markets for debt and asset-backed securities; vigorous financial innovation throughout the financial industry; and, so far, low leverage among firms. However, financing prospects are not necessarily uniformly positive across all market segments. Since large Mexican firms are able to directly tap international capital markets and have more established relationships with the local banks, it has been the small and medium-sized firms that have borne the brunt of this adjustment (See Figure 8). However, the emergence of a strong and profitable commercial banking sector provides a good foundation to revitalize financial intermediation going forward. Cross-border opportunities stemming from emigrants’ remittances and the expansion of credit to underserved domestic segments will likely remain a priority for banks, which are eager to reach credit penetration levels that are comparable with those of regional peers. This is also desirable given the relatively small proportion of the population that is currently served by commercial banks.\(^9\) In that respect, the likely entry of new, mostly niche banks in 2005-2006 is a welcome development.

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\(^9\) Branch penetration is relatively low (around 12,500 inhabitants per commercial bank branch), while it is estimated that around 20-25 million people, or less than 50 percent of the economically active population, hold commercial bank accounts.
Figure 5: Total Debt Financing (Domestic and Foreign) to the Non-Financial Private Sector (percentage of GDP)

Note: Equity financing, FIRA and Financiera Rural lending, mortgage loans by FOVISSSTE, and asset-backed securities are excluded. Commercial, housing and consumer financing include only performing loans. Domestic bond issuance is treated as part of domestic commercial financing and only includes outstanding bonds issued by non-financial private sector firms. Foreign commercial financing consists of cross-border bank lending and bond issuance abroad.

Figure 6: Domestic Credit to Private Sector and GDP Per Capita (2004)

Source World Bank World Development Indicators and GDF Database
Effective competition in payment services and credit markets are important for minimizing costs of financial services. Technological innovations in communications, information management systems, and payment systems allow for significant reductions in start-up and operation costs of financial intermediaries. This has translated into considerable efficiency gains in the Mexican financial system. Although substantial improvements were achieved in competition and efficiency, especially in the large-value payments area, the retail payments sector is still underdeveloped compared with other countries in the region or in the same stage of development. In the retail
payments area, competition seems to be focused on aspects related to access to the infrastructure (which reduces efficiency) rather than on fees, prices, and quality of service. This tends to limit the achievement of economies of scale and network externalities, reduces consumer mobility, and leads to relatively high fees and low services.

58. **Available indicators on prices are inconclusive to assess changes in credit affordability, although there remains a significant divergence in rates for like credit products across lenders.** Limited availability of historical interest rate time series by credit product and the questionable reliability of existing ones, constrain any conclusive evaluation of affordability.10 Available data suggest that, after an initial decline in early 2001, real interbank interest rates (used to price commercial loans) and credit card rates have not declined significantly. However, longer maturities and durations have become much more available in the debt markets. At the same time, there is strong market consensus that mortgage interest rates have fallen and mortgage maturities have increased considerably since 2000, but an official interest rate series has only recently began to be published. Different lenders (banks, Sofoles, and department stores) charge widely disparate interest rates on similar types of consumer credit, suggesting market segmentation (i.e., limitations on alternative financing sources for low-income versus higher-income households) or insufficient consumer awareness on rates, despite the requirement on lenders to disclose the so-called CAT (total annual cost of credit).

**Figure 9: Real Interest Rates and Comparison of Effective Rates (CAT)**

Sources: BOM, CONDUSEF, SHCP, and Infosel.
Note: CAT (*Costo Anual Total*) is the effective interest rate used for comparative purposes that includes all direct annualized costs of a loan excluding taxes and third party expenses (e.g., notary fees).

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10 For example, the quoted real interest rate on credit cards has remained fairly stable and relatively high in the last few years. However, the ‘headline’ rate does not capture the evolution in credit card commissions and masks the diversity in credit card types and terms that currently exist in the market.
59. The authorities may wish to consider the following recommendations to facilitate deeper and broader financing of the private sector. A short-term policy measure would be to promote greater use of the credit bureau for SMEs—in particular by ensuring that the credit history of all SME loans is captured appropriately by the credit bureau.\(^\text{11}\) The authorities should promote further improvements in the governance structure of the credit bureaus, to ensure open access subject to basic privacy safeguards. Additionally, the authorities should collect and disclose standardized credit affordability indicators (i.e. interest rate time series by type of loan product and by provider) as well as accessibility indicators (i.e. loan volumes by products, firm size, economic sector and state).\(^\text{12}\) Improved data collection and analysis would help understand the connection between developments in the real sector and financing patterns, the role of financing sources outside the formal domestic financial system, and the nature of competition issues in different credit markets (e.g., via a more detailed chart of accounts that would capture bank costs and revenues by loan product). Also, the authorities should evaluate the effectiveness of development banks’ support of SME finance, including with respect to the design and targeting of partial guarantees. Longer-term policy recommendations would include further strengthening of public registries of commerce and property and the reduction in their user cost (notaries); stronger and more consistent enforcement of creditor rights across different state jurisdictions; and further simplification of the regulatory environment related to SME lending without compromising prudence. The feasibility of tapping capital markets via innovative SME-loan securitizations should also be assessed in light of the ongoing growth in institutional investor assets.

60. Additional reforms to continue fostering competition in payment services should be considered. The authorities could consider further measures to foster a better balance between competition and cooperation in the payment services sector. These measures would aim at: (1) reducing the role of bank branches in bill payments and remittances, and enhancing the role of nonbank service providers, such as department stores, especially in rural areas; (2) enlarging employees’ freedom to choose the bank where they can receive wage payments electronically; (3) eliminating barriers to the provision of services using common platforms, such as direct debits and payroll schemes via CECOBAN (the inter bank clearing center); (4) ensuring interoperability between retail payment networks and/or seeking to integrate the different service providers; (5) fostering the adoption of CHIP-NIP technology to promote the use of debit cards in point-of-service (POS) terminals; (6) changing the law to give EFTs (Electronic Funds Transfers) the status of legal tender and coordinating with the MOF the substitution of checks with EFTs for social benefits, pensions, and salaries; (7) allowing more financial intermediaries to be direct participants in SPEI; (8) promoting public trust in the use of electronic payments through education and consumer protection programs; and (9) fostering efficient and fair conflict resolution schemes with respect to payment services.

\(^\text{11}\) For instance, loans to SMEs that involve invoice discounting are currently recorded by banks in the credit bureau as loans to large corporations to whom the SMEs act as suppliers.

\(^\text{12}\) One issue that will need to be addressed in this connection is the institutional responsibility/mandate for the creation and publication of such indicators. Some indicators of this type are already produced by BOM and CONDUSEF.
61. **Promoting more competition in credit markets could also have a positive impact on credit supply.** The analysis of competition in different credit markets is hindered by lack of data as most of the framework for Mexican bank accounting, reporting, and statistics was designed for prudential and stability purposes, rather than to facilitate the study of efficiency and competition. To be sure, the Mexican banking system is much more transparent now, and information on loan amounts by type, aggregate financial income, aggregate fees, and aggregate costs is readily and publicly available. For instance, the BOM publishes through its website detailed comparisons of costs of mortgage, consumption, and deposit products. However, finer distinctions are needed to discriminate costs, income, and risks by credit product, so as to follow the patterns of competition in different credit markets. Finer information is also needed to discriminate between market power factors and excessive risk taking behind lending spreads and credit allocation. Competition seems to be higher in markets for credit contracts that depend relatively less on the quality of the local contract enforcement institutions. This is clear in the large corporate segment of commercial lending, where the credit market features creditworthy and well-known borrowers, global players, and contestability from the securities markets. In the credit card market, the use of the local credit infrastructure is made unnecessary by the use of credit scoring systems (based on the credit bureau information) and the absence of collateral requirements. However, competition in the credit card market occurs mainly through product differentiation and there appears to be insufficient price competition. The markets for mortgage and car loans, amenable to credit scoring methods, have benefited from an increase in nonbank financial intermediaries (i.e., Sofoles) and greater transparency. Competition in these markets appears to be growing.\(^{13}\)

62. **Conversely, there is significantly less competition in credit markets where the use of the local credit infrastructure cannot be avoided.** The market for SME lending is a salient example. Players in this market are mostly local, global knowledge and loan technologies are less useful, the costs of gathering information are high, and scoring methods are less applicable due to SME heterogeneity. Credit contract enforcement and collateral repossesion processes cannot avoid the local judiciary and are further hampered by deficiencies in movable property registries and informality. This said, financial innovation, which is often geared toward coping with deficiencies in the local credit infrastructure or avoiding regulatory costs, can help boost competition despite such deficiencies. For example, credit cards for micro enterprises or electronic factoring of SME claims on large corporations are arguably examples of this type of innovation in Mexico. Credit cards for micro enterprises treat the firm as a consumer to avoid regulatory costs and the credit infrastructure. Electronic factoring allows the booking of SME receivables as loan exposure to the large corporation that buys products from SMEs. The recommendations discussed in the previous section—regarding the financing

\(^{13}\) A modernization of the legal framework for Sofoles and leasing and factoring companies was very recently approved. The changes aim at enhancing efficiency in the supply of credit products through competition. Among other things, this reform allows Sofoles to become multi-purpose societies (i.e., Sofomes). It also permits any non-deposit taking company to carry out credit activities as well as leasing and factoring operations, without having to be subject to banking prudential norms. If the non-deposit taking company is related to a bank group, however, it must comply with all prudential norms applicable to banks.
of the private sector—apply also to fostering greater competition and efficiency in credit markets.

Access to basic financial services to lower income segments

63. **Access to financial services in Mexico is limited and costly.** The penetration rate is low and participation rate in formal financial markets are below those in other LAC countries of lower per capita income. In fact, in Mexico City, only 23.6 percent of the population reported that they had savings in a bank. “Unbanked” individuals (i.e. those who do not have a deposit account in a formal-sector deposit institution or have not received credit from it) in Mexico are characterized by lower incomes and education levels than the population at large. The unbanked tend to rely on cash transactions, services provided by commercial outlets, informal forms of saving and borrowing, and government programs to obtain financial services. Their lack of access to formal financing entails high transaction costs for them, particularly in areas relating to payments for utility services, remittances from abroad, cashing of checks by non-bank account holders, high interest rates on alternative credit, and low earnings on savings.14 Moreover, limited access to the formal financial system can also create costs for the economy as a whole, slowing growth as the savings of unbanked individuals fail to be channeled to productive investment opportunities.

64. **Although most unbanked individuals do not try to open bank accounts, they believe they need one.** They cite lack of sufficient resources, minimum balance requirements, and lack of trust in banks as reasons for not attempting to open a bank account. Regarding credit, most people whose applications for a bank loan were denied believed that this was due to the risks associated with the loan.15 On the other hand, most individuals who do not apply for credits believe that they do not need them or prefer to finance their purchases out of their income flows.

65. **Two policy actions to improve access have been particularly innovative and promising.** The first consisted in strengthening “popular” banks (which traditionally served moderate income households, providing credit and deposit facilities) by improving their supervision and creating BANSEFI (Banco del Ahorro Nacional y Servicios Financieros, *National Savings and Financial Services Bank*) to coordinate the reorganization of all popular financial intermediaries and to serve as a development agency for these institutions (see discussion below under *Development Banks*). BANSEFI has created a commercial alliance among several popular savings and credit institutions called L@Red de la Gente (The People’s Network) to share branches and facilitate the distribution of financial products through a common technological platform, helping to generate homogeneous products that are offered under an umbrella trademark, significantly reducing distribution and marketing costs. The network also distributes government programs and operates with traditional money transfer companies that use its network to distribute remittances, thereby increasing the revenues of member institutions.

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14 Accumulated costs of being unbanked can run up to 15 percent of median income in Mexico (without including credit costs).
15 These risks were caused by lack of credit history, insufficient or unsteady earnings and lack of collateral or an outside guarantee.
through distribution fees and helping to attract new customers. Second, the government is also seeking to address lack of competition in the banking system, which likely contributes to high bank fees and the high percentages of people outside the banking system through programs seeking to increase price transparency of financial services through Condusef (Comisión Nacional para la Protección y Defensa de Usuarios de Servicios Financieros) which facilitates price comparisons for retail banking products and supports basic financial literacy programs. In addition to continuing to foster increased competition in the financial sector, as discussed above, the government should continue strengthening BANSEFI and Condusef and the implementation of the Ley de Ahorro y Crédito Popular which is supporting the strengthening of the popular banking sector (see discussion below under Development Banks).

Development Banks.

66. **Substantial progress has taken place over the last five years in reforming the system of development banks and funds (DBs).** The 2001 FSAP emphasized that DBs suffer from an inherent tension between their social policy mandate (i.e., to foster access to financial services for households and firms that are costlier and riskier to serve) and the objective of avoiding losses in their bank-like activities. To overcome this tension, the 2001 FSAP team recommended a reform strategy based on separating subsidies from finance, consolidating DBs, and gradually transforming them into development agencies (DAs). Since then, progress has been remarkable. DBs are now regulated and supervised with the same rigor as private banks. DB governance and accountability, managerial professionalism, and transparency have greatly improved. DBs must now pursue their mandates subject to the explicit requirement of preserving their capital in real terms. Interest rate subsidies in DB loans have been reduced while an increasing share of subsidies is financed through the government’s budget. Lending by DBs has significantly shifted from the first tier (or direct lending) to the second tier (or lending through private financial institutions), bringing a higher number of private financial intermediaries to the system. The coverage of partial guarantees has been declining, from levels of 80 percent or more to about 50 percent on average. As a result

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16 The Mexican *Sistema Financiero de Fomento* includes development banks and trust funds (*fideicomisos*). At present, the main components of this system are: Financiera Rural and FIRA, both oriented towards the rural sector; NAFIN, which works mainly with SMEs; BANCOMEXT, charged with promoting and financing exports; BANOBRAIS, which finances subsovereign entities; BANSEFI, which focuses on technical assistance and other risk-free, centralized services to popular savings and credit institutions; SHF, which spearheads the development of the housing finance markets and provide second-tier funding to mortgage lenders (until 2009).

17 Finance-oriented DAs promote financial access for underserved sectors and market development through market-friendly instruments that do not distort market prices or discourage private sector activity. DAs are subject to high standards of transparency and accountability. They typically provide or mobilize TA and may administer matching grants and subsidies that are financed by the government’s budget. They may also provide partial guarantees (subject to appropriate pricing and risk management), support the development of market infrastructures, and/or catalyze or coordinate structured finance packages. Their lending, if any, tends to be second tier and funded out of their initial endowment (capital) or budgetary appropriations (i.e., DAs do not normally issue deposits or other forms of liabilities).
of all this, DBs in recent years have been consistently reporting strong capital positions and positive results in their income statements.\(^{18}\)

67. **The depth and breadth of reform in other respects has been very uneven across DBs.** Greatest progress in integrating objectives, mandates, functions, and instruments has been registered in the cases of Financiera Rural, FIRA\(^{19}\), BANSEFI, and SHF, all of which operate largely as development agencies. The salient features of SHF are discussed under the Housing Finance section of this note. Financiera Rural (created after the liquidation of Banrural) and FIRA have well-defined mandates and are prohibited from issuing deposits and, in the case of Financiera Rural, any other form of liabilities. They fund their lending activities (which are exclusively second tier in the case of FIRA) out of their endowments and loan collections. They promote capacity building among their target clientele via matching grants used by recipients to hire technical assistance. Financiera Rural lends at market prices and so does FIRA in its loans to large farmers; however, FIRA’s lending to the poorest farmers is still at subsidized interest rates. FIRA also offers partial guarantees at subsidized prices, although it is implementing a program to phase out the subsidy element therein.\(^{20}\) More recently, FIRA has engaged in innovative investment bank-like activities—coordinating large structured finance operations by aligning incentives and distributing risks among participants, and offering interest rate and currency swaps, all at market prices. BANSEFI, created in 2001, has the mandate of promoting popular savings (a function inherited from its predecessor, PAHNAL) and of spearheading the cooperative development of the Popular Savings and Credit sector (composed of over 400 Cajas Populares).\(^{21}\) To this end, BANSEFI administers a one-off government investment subsidy to finance technical assistance to raise the sector’s governance, transparency, and management capacity to standards required for licensing by the CNBV. This subsidy is also used to finance the initial setup of a common network and infrastructure that could capture economies of scale, lowering costs for the Caja sector. Together with ongoing internal reforms, BANSEFI is thus becoming a Caja de Cajas, capable of offering centralized, efficient services to licensed Cajas. The BANSEFI-led program has made substantial progress in meeting its objectives, although there have been delays in the process of authorizing Cajas. SHF, FIRA, Financiera Rural, and BANSEFI define their mandates dynamically—they move on to new activities once the market they were promoting becomes self sustaining. For example, efforts are underway to sell BANSEFI to the

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\(^{18}\) The only exception is BANCOMEXT, which continues to make losses on account of its export promotion activities (see below).

\(^{19}\) FIRA stands for Fideicomisos Instituidos en Relación con la Agricultura, which are fiduciary funds housed in the Bank of Mexico.

\(^{20}\) The nonpayment culture (moral hazard) fostered in the past by Banrural’s poor loan origination and collection practices had compelled FIRA to sometimes offer subsidized incentives and guarantees to induce banks to lend to agriculture. The current sound lending practices of Financiera Rural have substantially reduced moral hazard in agricultural lending and, as a result, the distortionary impact of subsidies in FIRA guarantees has become increasingly evident and should be corrected as a matter of priority.

\(^{21}\) In its function of savings promotion, BANSEFI acts as a narrow bank—collecting small savings via its numerous branches (around 500) and investing then almost exclusively in Mexican Treasury securities. Although allowed by its law, BANSEFI has been careful not to use its branches to provide credit, as this would stifle the development of the Cajas, nullifying its principal mandate. The ambitious BANSEFI-led program of strengthening the Cajas sector is underpinned by the 2001 Law of Popular Savings and Credit.
Cajas; SHF will—as noted—cease second-tier lending as of 2009; and market-based lending by Financiera Rural is attracting banks back to the rural sector.

68. **In the case of other DBs, mandates remain unclear and their initial raison d'être is losing relevance in the face of rapid financial market development; however, NAFIN has shown notable managerial improvements and instrument innovation.** NAFIN, BANCOMEXT, and BANOBRAS are constrained by a static mandate in their Organic Laws. Their initial niches (financing of SMEs, exports, and sub-sovereigns, respectively) are being eroded: they can hardly sustain their traditional cost-of-funds advantage vis-à-vis the large, international commercial banks or the capital markets. Absent a legal reform, the degree of change in these DBs has largely been a function of management quality. NAFIN has made greater progress in repositioning itself and developing new instruments—for instance, it created an internet-based market for SME receivables that has become an example of innovative practices in the region. The loss of cost-of-funds advantage in export finance has led BANCOMEXT to gradually return to first-tier lending since 1998, away from its second-tier lending objective, although in the last two years efforts have been made to shift back to second-tier lending and establish a new business plan to operate as an “Eximbank.” While the advantages of keeping the export promotion function in BANCOMEXT (rather than in, say, the Ministry of Foreign Trade) can be debated, it is clear that such a function should be financed by the government’s budget (rather than via the current cross-subsidization within BANCOMEXT’s activities). BANOBRAS is also losing its traditional competitive edge in cost of lending to sub-sovereigns. Moreover, as the most creditworthy state and local governments increasingly access private financial markets, BANOBRAS is being left with the weakest sub-sovereigns, which creates major challenges for it to meet its mandate while preserving its capital.22

69. **The process of reform needs to be consolidated.** Going forward and in the shorter run, the reform of DBs should focus on avoiding reversals in the progress achieved so far, while further rationalizing their operations. There is a particular need to rationalize the numerous financial subsidies and guarantee programs through DBs and line ministries, as this multiplicity is leading to poor targeting, duplications, and “double-dipping” by beneficiaries. Annex 2 illustrates the potential for duplication by showing the number of SME support government subsidy and financing vehicles. Over the longer term, the DB system should be further consolidated, mandates reformed and made dynamic in some cases, and major improvements introduced in the way in which DBs performance is measured and rewarded. All of this would require substantial legal reform. Subject to a clear definition of objectives and mandate, a DA oriented towards SMEs should replace NAFIN and BANCOMEXT, while the latter’s export promotion functions should be transparently financed by the government’s budget. Similarly, as FIRA moves to full market pricing of all of its financial products, the case in favor of consolidating FIRA and Financiera Rural in a single, rural-oriented DA will grow stronger. The authorities should in the short run reform BANOBRAS’ instruments and operations, so to better match its mandate; in the longer run, consideration should be

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22 Although BANOBRAS does also resort to a form of intercept of states’ untied federal transfers as a means of lowering the risk of non-payment, as do commercial banks.
given to transforming BANOBRAS into a DA oriented toward capacity building in state
and local governments. Finally, as the DB system evolves towards a DA model, there
will be a growing need to reform the way in which DB performance is measured and
evaluated using internationally accepted practices. The current criterion—of measuring
performance in terms of the volume of loan disbursements—is bound to become
increasingly less relevant. New criteria should focus on the impact of DA market-friendly
interventions. As such interventions will increasingly involve nonlending market-friendly
instruments, their impact should be assessed in terms of their catalytic role in fostering a sustainable
broadening of access to financial markets for underserved sectors.

Banking system stability

70. The financial system has increased its resilience to adverse shocks, helped by
good macroeconomic policies, sound oversight, and a favorable external
environment. Capital adequacy, provisioning, and profitability (as well as other
financial soundness indicators) are strong and are considered to be sufficient to sustain
severe shocks and adverse scenarios regarding commercial credit and market risks. The
local currency bond and derivatives markets have developed considerably, helping to
minimize currency mismatches in the system and allowing better management of market
risks respectively. The strong growth in credit to the consumer segment (consumption
and mortgages) creates the need to strengthen monitoring of the credit risk associated
with this segment. There is also a need to continue ongoing efforts to monitor liquidity
risks associated with interbank exposures and to continue to stress test for event risk.

71. In terms of the banking system’s safety net, significant progress was made in
prompt corrective actions and new legislation on bank resolution was recently
approved, but some challenges remain. The prompt corrective regime is consonant
with international practices. The recent approval of a new legal framework for bank
resolution is a significant step forward, but aspects concerning the resolution of “too-big-
to-fail” banks need close attention. The deposit insurance agency (IPAB – Institute for
the Protection of Bank Savings) has substantially contributed to reestablishing financial
system soundness, but it is still saddled with having to manage the debt related to the
debtor support programs derived from the 1995 crisis. The servicing of this debt is
preventing IPAB from being able to accumulate the deposit insurance fund and
weakening its credibility. Regarding the framework for the resolution of large banks and
the implementation of the recently approved Bank Resolution Law, it is advisable to: (i)
amend the statutes of banks promptly to enable the so-called “conditioned capital
restoration plan” and, (ii) develop suitable internal regulations and guidelines with regard
to the determination of the size of the haircut to be applied to uninsured creditors. A
legal reform of the banks’ bankruptcy framework is pending for cases where bank
liquidations procedures are required. Additionally, it would be convenient to seek a
suitable formula to alleviate the financial condition of IPAB, including the transferring of
its debt to the federal government (which would require legal reform). The deposit
insurance framework needs to be better aligned with international practices regarding
coverage, base, and risk-based premiums. The BOM should formalize internal procedures
for contingency planning and the lender-of-last-resort function. There is also the need to
establish a framework and operational guidelines for the resolution of financial groups,
taking into account the fact that most of the systemically important groups are foreign-owned. Contingency planning exercises to prepare for the possible failure of an individual institution, a systemically important financial group, or a systemic crisis is also recommended. A small number of high-level officials from the SHCP, BOM, CNBV, CNSF, CONSAR, and the IPAB should participate, from time to time, in detailed contingency planning scenarios (or “fire drills”) to more clearly solve coordination problems and identify shortcomings in the legal, regulatory, and procedural frameworks. These exercises are key to ensuring preparedness to better deal with difficult decisions in the event of an individual or systemic bank instability.

72. **There have been major improvements in the compliance with the Basel Core Principles for Effective Banking Supervision.** The legal and regulatory framework was strengthened, progress was made toward risk-based supervision, and the internal organization and professionalism of the National Banking and Securities Commission (CNBV) were improved. Notwithstanding these advancements, some issues still need to be resolved. The main pending issues that require further attention in banking supervision are the need to grant further autonomy to the CNBV and strengthen consolidated supervision. A reallocation of powers and responsibilities would be necessary for the Commission to have complete operational autonomy over the entire life cycle of regulated entities (licensing, regulation and supervision, and removal of the license). The Commissions’ budgets are dependent on, and merged with, the general government budgetary process administered by the SHCP. And the heads of the Commissions are appointed by the Executive Branch, via the Minister of Finance. The authorities consider the full political and budgetary autonomy (subject to adequate accountability) of the Commissions as a desirable and healthy objective. As regards the consolidated supervision of financial conglomerates, there remain important shortfalls to its full-fledged application. In particular, capital adequacy requirements are set only at the level of individual entities, and not at a consolidated group level, which creates opportunities for arbitrage. Also, simultaneous inspections fall short of truly joint inspections and the figure of lead supervisor does not formally exist. To be sure, conglomerate risks are mitigated by the civil-code based Mexican legal framework which sets out with great precision the permissible activities for each type of financial entity. This creates segmentations that, while hindering synergies and financial innovation, limit conglomerate risks. However, as groups increasingly follow a group-wide strategy, the scope for such risks inevitably widens. Progress towards full-fledged consolidated supervision is hampered by a complex silo-based regulatory/ supervisory architecture (Table 5). Moving towards full-fledged consolidated supervision requires legal reforms: giving the regulator the power to presume the existence of a group, setting capital requirements for the group in addition to its individual entities, strengthening the role and powers of the lead supervisor for the group who should be able to oversee the holding company and the individual entities, eliminating barriers to exchange information, and

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23 The law specifies that a holding company will be supervised by the agency in charge of supervising the preponderant entity of the financial group, as determined by the SHCP. However, the holding company is characterized by a very simple balance sheet and performs no significant financial activity other than being the legal holder of the stock of its members. The agency in charge of supervising the holding company does not have lead responsibility in supervising the members of the financial conglomerate.
allowing for joint—rather than the simultaneous—inspection visits. Increased financial sector conglomeration can increase the risk of regulatory arbitrage. The authorities should move steadily to achieve a clearer delineation of responsibilities among all the sector supervisory agencies (the CNBV, the National Insurance and Securities Commission–CNSF and the Pension Fund Commission–CONSAR).

Table 5: Institutional Architecture for Financial Regulation and Supervision

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Capital Markets

73. **Mexican authorities have taken important steps to bolster the country’s capital markets in recent years.** On the demand side for financial instruments, institutional and retail investor base has been expanding, but still has great potential for further growth. This is a result of the introduction of private pension funds through 1997 reform, as well as the revamping of legislative framework for collective investment schemes in 2001, which led to an equally important mutual funds industry. To respond to this demand, efforts have been done to bolster the domestic equities, fixed income and derivatives markets.

74. **As part of the efforts to invigorate small equity markets and risk capital activity, an innovative Securities Market Law was approved by Congress in 2005.** The bill aims to improve corporate governance and transparency among listed companies, as well as making supervisory functions stronger, clearer and more agile. More importantly, the bill would create a new legal form for private enterprises, to facilitate private equity investment. The investment promotion limited company or Sociedad Anónima Promotora de Inversión (SAPI), has enhanced protection of minority shareholders rights, in exception to the General Law of Corporations, to allow shareholder agreements essential for private equity transactions. If a SAPI lists on the market, it would enjoy a three-year grace period to converge to normal public companies’ standards. It is hoped that these legislative efforts will help address the structural issues of the Mexican equities market. Indeed, it remains relatively small and illiquid, and is not a major source of financing for most companies. Of the eight largest economies in the
Americas, Mexico has the second smallest stock market, relative to GDP. The free float is limited and trading volumes are also low. While a surge in the index has raised market capitalization over the last few years, the equity market has been shrinking by other measures. Larger companies have increasingly preferred to list on international markets. Similarly, private equity activity remains limited, where estimates show that Mexico accounts for only around 0.1 percent of the overall risk capital investments globally and 10% of Latin America’s total.

The domestic debt market witnessed a remarkable development of the benchmark local currency yield curve and derivatives, based on federal debt instruments, while future challenges lie in attracting more private issuers. In the last few years, the federal government followed a proactive debt management strategy, to reduce the vulnerability of its debt to interest rate and foreign exchange risks, by tapping increasingly in the local currency debt market. The local currency yield curve, non-existent in 2000, has lengthened to 20 years by 2005, establishing a benchmark that facilitates private and sub-sovereign issuance, but with a challenge to the government in terms of limiting possible crowding out effect to the same private sector. Another positive consequence is the growth of a vigorous derivatives exchange, which allows the diversification and mitigation of risks, especially for interest rates. As for private debt, the instrument Certificado Bursátil, introduced in 2001, provided issuers with significant flexibility, and has been increasingly used by firms and sub-sovereign entities for structured solutions such as asset-backed securities. Looking forward, new issuers may be attracted through two recent legal changes. Firstly, the Credit Institutions Law was amended to allow common law companies to issue debt on the capital markets, in order to finance their credit activities. Secondly, draft amendments to the Insurance and Warrant Companies Laws aim at promoting infrastructure bond origination, by introducing the Financial Insurance figure.

Another important step would be to increase the range and liquidity of investment and risk management vehicles, while maintaining market integrity. This includes firstly the need to continue to advance on regulations to attract new bond issuers such as de-regulated financial intermediaries (Sofomes), and usage of financial insurance for infrastructure bonds. Secondly, further foster the development of the risk capital industry, by coordinating public banks’ activities in this area through the creation of a risk capital fund of funds. Thirdly, update the regulation of over-the-counter derivatives activities, and regulate how other classes of institutional investors can use them. Finally, further foster secondary market activity in the bond market, for instance through stronger primary dealers quoting obligations.

With regards to the mutual funds industry, the CNBV rules governing the sector limit the investment flexibility of mutual fund operators. The CNBV rules list categories of mutual funds and require every fund to be included in a given category. The funds must adhere to standards for that category. For example, all funds in a class may be required to invest a minimum amount of its portfolio in certain types of assets or limit its annual portfolio turnover rate. These restrictions make it difficult for funds to significantly out- or under-perform others in the same category, limiting competition and inhibiting investor choice. When developing the secondary regulation for the New
Securities Market Law, the CNBV should consider replacing this system of prudential-based regulation with a disclosure-based system that would enable fund managers to demonstrate their acumen and allow investors a full range of choice in investment strategy and the amount of investment risk they want to assume.

78. **The CNBV must begin to consider how to suitably monitor the OTC market for corporate securities, should the SAPI market develop as expected.** The new Securities Market Law created two new corporate entities (the SAPI and the SAPI B), to facilitate the ability of small- and medium-sized companies to access private venture capital and to transition into publicly listed companies. It is difficult to predict the results of this innovation, but if this approach is successful and a significant number of SAPI companies are created and successfully issue securities, an OTC market would develop for these securities. The noted new Securities Market Law authorizes the CNBV to develop secondary regulations pertaining to the SAPI and the SAPI B and to implement its authority to license limited function securities firms. Timely completion of these responsibilities is key to demonstrate the efficiency and effectiveness of the CNBV. Therefore, the CNBV should closely monitor the progress and begin to consider how an OTC market could be developed and regulated without disrupting the flexibility of the SAPI market.

**Housing Finance**24

79. **The Federal Mortgage Society (SHF), a specialized development bank for housing, has led the reform effort that has produced major improvements in the housing finance market.** The market for mortgage-backed securities is emerging and an industry of private mortgage originators (Sofoles) has been established, although it is still largely funded by the SHF.

80. **INFONAVIT has widened its cooperation with the private sector and substantially improved its management, operations, and corporate governance, but it continues to suffer from an inherent conflict among its multiple mandates.** INFONAVIT is caught between its fiduciary duty as a defined-contribution pension fund, its first-tier mortgage lending function, and its social policy function as subsidy provider. This conflict has been mitigated, however, through modern management and operational improvements.25 This creates a unique opportunity for an important reform—to formally decouple the workers’ contributions to the INFONAVIT-administered pension fund from the funding of INFONAVIT-originated mortgage lending.26 In addition, INFONAVIT and FOVISSSTE are unduly restricted by law in the design of their mortgage products and continue to distort mortgage markets through interest rate subsidies in their housing loans to lower-income households. INFONAVIT charges wage inflation plus 9 percentage points on mortgage loans to individuals earning more than the equivalent of five minimum wages, translating to a nominal interest rate that is higher than some banks

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24 See chapter 11 for a broader discussion of the housing sector in Mexico and chapter 4 on how housing subsidies are bundled with social protection programs.

25 FOVISSSTE’s operational improvements, though not trivial, pale in comparison to INFONAVIT’s.

26 INFONAVIT is formally an Afore and the pension fund it administers is a Siefores. The housing loans made by INFONAVIT are treated as investments of the Siefores.
and a bit lower than Sofoles. However, the wage-indexation feature of these loans—which is mandated by law—is not market compatible as the political risk therein is impossible to measure and manage. For households earning less than the equivalent of four minimum wages, INFONAVIT charges wage inflation plus four percentage points (FOVISSSTE charges wage inflation plus four to six percentage points, depending on the income of the household), which results in a below-market rate, given the costs and risks involved in lending to this market segment. These interest rate subsidies reduce income for INFONAVIT and FOVISSSTE affiliates, but in a way that is not apparent, as the loss of income is not reported on the financial statements. It is recommended that these entities switch from interest rate subsidies to upfront subsidies that equal the present value of the foregone interest stream over the expected life of the mortgages. This would increase transparency in their financial statements and eliminate the relative price distortion. In addition, to level the playing field for mortgage originators the tax exemptions enjoyed by INFONAVIT and FOVISSSTE should be eliminated (or extended to all other lenders). Also, their laws should be reformed to free them from the obligation to make wage-indexed loans and allow them flexibility to design suitable market-friendly mortgage products. Finally, INFONAVIT should expand its efforts to use its influence constructively, for instance by encouraging states to reform property registries and title transfer and registration procedures. This is particularly important for the development of a housing finance market for used houses, which is at present virtually nonexistent.

81. **Further steps should be taken toward establishing a centralized, integrated policy on housing finance subsidies for low-income households.** An estimated 4.2 million households live in substandard conditions and are not served by formal mortgage institutions. About 20 percent of these households have a member that is affiliated with either INFONAVIT or FOVISSSTE, but these institutions’ subsidies are inequitable and do not reach the informal sector.27 The streamlining or elimination of many subsidy programs and the creation of CONAFOVI to coordinate housing policy have been steps in the right direction, but they fall short of what is needed, not least because CONAFOVI lacks budgetary authority to manage a national system of subsidies and also lacks binding coordinating powers over INFONAVIT and FOVISSSTE. The Boards of INFONAVIT and FOVISSSTE should consider gradually moving towards upfront subsidies and market-based interest rates. Finally, legal reforms are needed to ensure that, in the future, INFONAVIT and FOVISSSTE target their housing credit lines only to low-income households.

82. **The start of a mortgage-backed securities market is an important and fundamental achievement but some questions have been raised over what appears to be less-than-satisfactory due diligence reviews on securitized portfolios.** Since 2003, issues of 15 mortgage-backed securities for a total of MEX$11.5 billion have come to market, involving mortgage loans initiated mainly by the larger Sofoles. While noteworthy, this represents only 0.7 percent of the balance of credits outstanding in the system at end-2005, and banks have not yet issued mortgage-backed securities, as they have no need for liquidity. Furthermore, given recent experience with the unsatisfactory

27 In 2005, for instance, INFONAVIT satisfied only 3.4 percent of its low-income affiliates (employed individuals that earn two to four monthly minimum wages).
work of auditors, credit-rating agencies and credit enhancers, the authorities should seek ways of encouraging the exercise of due diligence reviews as part of each transaction, which is all the more important in a nascent mortgage-backed securities market such as Mexico’s.\textsuperscript{28}

83. **Plans should be put in place to ensure an orderly consolidation of the mortgage Sofoles when the SHF phases out its second-tier credit line for moderate and upper-income lending.** While a shakeup can be expected in the mortgage Sofol industry, it is crucial not to postpone the sunset of the SHF’s credit line. Smaller institutions that lack adequate scale in their operations will have to change their business model, be acquired by a bank, or go out of business. After close to 10 years of transition, Sofoles that have not ceased to be dependent on the SHF credit line should be allowed to exit. Nonetheless, the shakeup might be softened if Congress approves the draft bill that proposes the full deregulation of nondeposit taking mortgage lenders that are not related to bank groups—as the implementation of such law would reduce costs and entry barriers. The materialization of the benefits of that law, however, will require effective market discipline, which in turn calls for suitable improvements in issuer disclosures.

**Pensions and insurance**

84. **The private pension industry is growing fast and supervision and regulation of the pensions and insurance industries meet international standards but the growth of the annuities industry has stalled.** In the defined-contribution pension area, policies aimed at lowering barriers to entry and facilitating migration to lower fee funds have made the market more contestable. Fees have decreased and, ceteris paribus, expected replacement rates have increased. A risk-based approach to supervising investment and operational risk has been introduced. Remaining issues include competition on returns and volatility of replacement rates. On the other hand, regulation and supervision of the insurance industry is of remarkably high quality. Nevertheless, in the area of disability insurance, recent legal reforms and practices by the Mexican Social Security Institute (IMSS) have resulted in disabled workers generally choosing benefits under the old system. As a result, the government faces a liability that was not foreseen under the 1997 pension reform, the development of the annuities industry has stalled, and the risk of insolvency among the annuity industry providers has increased.

85. **CONSAR may wish to consider some recommendations that do not require legal changes in support of its strategy to enhance competition on fees.** The ranking of Afores according to fees charged could be further simplified and individualized. The disclosure of rankings in a way that is relevant to each contributing worker can be generalized by requiring funds to include in individual pension account statements the peso amount that worker has paid in fees to his/her Afore during a given time period, as well as the peso amounts that he/she would have paid over the same period had he/she

\textsuperscript{28} For instance, serious deficiencies were found in a mortgage pool where the SHF was asked to provide mortgage insurance. Thirty percent of the loans suffered from documentation problems. The auditor had reviewed only a small sample of loans. The rating agency did not review any loan files, nor did the institutions that were offering credit enhancements. No firm was called upon to play a specialized diligence role.
moved to other pension funds. The authorities should examine the possibility of transferring to PROCESAR functions currently performed by Afores that are subject to scale economies (e.g., back-office accounts management) in order to further reduce costs and fees. CONSAR should step up efforts to promote competition on net (risk-adjusted) returns. CONSAR’s emphasis on promoting fee-based competition has so far been warranted because pension fund portfolios were until recently very similar: they were invested almost exclusively in government bonds and the dispersion in portfolio returns was insignificant. Pension funds are now allowed to invest, up to a limit, in equities and foreign assets and are also required to offer two funds, a relatively conservative one and a riskier one.29 Moreover, quantitative investment limits were lifted in tandem with the introduction of a new risk-based supervision framework covering investment and operational risk.30

86. **As a result of these regulatory and supervisory innovations, the diversity in portfolio composition and returns has been increasing.** These changed circumstances justify a shift in focus by CONSAR toward gradually promoting competition on net (ideally risk-adjusted) returns. Over the medium term, CONSAR should consider further relaxing the ceilings on pension fund investment in foreign assets and equities. As in other countries in the region—such as Chile and Colombia—the growth of pension funds in Mexico is outstripping the availability of suitable local assets. In addition, the current exposure of pension savings to the housing sector is high (in excess of 40 percent), if one considers INFONAVIT- administered pension funds and the exposure of the rest of the pension funds to debt issued by mortgage Sofoles. Replacement rates will increase as a result of lower fees and higher net returns but may still be insufficient to ensure adequate old-age incomes. The authorities should, therefore, explore additional policy actions to raise expected replacement rates for the generations after the current cohort (which has the option to choose pension benefits under the old pay-as-you-go system). In the longer term, consideration should be given to policies to address the tradeoff between increasing market discipline by facilitating switching, on the one hand, and maintaining stable replacement rates over time, on the other. In a pure DC system, individuals bear all the investment risks (market, credit, and inflation risks) during the accumulation phase and the annuitization risk (the risk of receiving a low stream of old-age income because the annuity is bought when interest rates are low) at the time of retirement. These two sets of risks do not necessarily offset each other, resulting in volatile replacement rates over time—i.e., different replacement rates for individuals that, over their working life, have similar earnings and make a similar effort in saving for retirement. This problem may be

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29 The riskier fund is allowed to invest up to 15 percent of assets in equities, and up to 20 percent of the portfolio in qualified foreign assets, and is the default option for individuals younger than 56 years of age. The more conservative fund is allowed to invest up to 20 percent of the portfolio in qualified foreign assets.

30 The operational risk supervision framework is of very recent vintage and, as a result, appears to be superimposed on the old compliance regulation framework—a feature that has to be removed to lower regulatory compliance costs and, hence, barriers to entry. The risk-based supervision approach to pension fund investment is more mature—it supplemented the regulations based on quantitative limits in place since the beginning of the system. The risk-based approach gives Afores flexibility to choose investment strategies while controlling market-risk exposure through an absolute limit on the Value-at-Risk (VaR) and curbing credit-risk exposure through the use of credit rating limits. This risk-based approach is consistent with the mutual fund nature of DC pension systems without guarantees and with best practices in developed countries.
exacerbated by policies that promote competition through transparent disclosure of net returns and freedom to switch to higher net return funds. Such competition would tend to accentuate the focus on short-term returns, shrinking the investment horizons of pension fund administrators. In other words, there may be a policy trade-off, inherent to all DC pension schemes, between promoting competition and maintaining stable replacement rates.

87. The pension and medical insurance components of the ISSSTE—the social security institute for public sector employees—have deficits and are in need of reform.\footnote{As noted earlier, this chapter was written in November 2006. ISSSTE reform was approved by Congress in March 2007.} During 1975 - 2000 the performance indicators of the institution have deteriorated rapidly.\footnote{The system dependency ratio decreased from 20 to 5.2, the average retirement age decreased from 62 to 55 and life expectancy increased from 64 to 75.} In addition to overall relative generosity, the ISSSTE has serious pension benefit design problems that promote early retirement and impair portability. As a result, the deficit of ISSSTE for its pension component increased to approximately MXN 37 billions for 2006. On the other hand, the medical fund of the institution also has a deficit that is projected to double every 5 years (in current pesos) and is largely due to the 1992 decision not to collect premiums from retirees and to average doubling expenditure every 10 years. During the last administration a reform package that proposed changes to the pension\footnote{The reform foresees the creation of a public AFORE (pension fund administrator) supervised by the Mexican Commission for the Retirement Savings Systems (CONSAR) to manage individual accounts of new entrants and current workers who opt to participate in the new afore. At the same time ISSSTE would be subject to a gradual parametric reform for workers who do not opt to join the new AFORE. The implicit pension debt related to current workers who opt to join the new public afore would be formalized through the issue of recognition bonds.} and medical\footnote{Proposed reforms include increasing contributions from the government to improve the financial viability of the scheme, building of new medical centers, improving the actuarial balance of the disability insurance, and increasing medical personnel but it is not clear whether a rationalization of the benefits is foreseen.} components was submitted to parliament.

88. The windfall stemming from the high prices of oil provides Mexico with an important window for reforming the scheme and absorbing the fiscal impact associated with the implicit debt to current workers. The reform of ISSSTE could be pursued at this stage. At the same time, there appears to be at least three key issues that need to be analyzed as part of this process:

(i) \textit{Pension financing mechanism}. The reform package of the pension component foresees only a defined contribution pension fund for new entrants. Defined contribution schemes provide direct risk sharing among generations while defined benefit schemes may provide risk sharing within generations. Since civil servants will always be exposed to both different and uncorrelated types of market risk (risk in earnings versus risk in returns on capital markets) a partial shift to an actuarially fair, fully funded pension scheme appears justified. However, a complete replacement of a PAYGO scheme with an actuarially fair, fully funded, scheme cannot be justified on
these grounds. It is possible to design hybrid schemes (combining the good risk sharing properties of DB and DC schemes) that will have the same fiscal impact of the current proposed reform. A complete replacement of a PAYGO scheme with an AFORE can only be justified from the political economy point of view when a high political risk exists of benefit manipulations that will put the scheme in actuarial imbalance.

(ii) **Governance of PENSIONISSTE and public pension fund management.** The reform package of the pension component foresees PENSIONISSTE investment policy focusing on social/developmental mandates such as housing, infrastructure (including energy). If political risk exists of benefit manipulation in a DB scheme, it can be assumed that the same political risk would affect assets management. The international, and more specifically, regional experience, shows that public pension funds in most countries are used, often in a non transparent way, for developmental and social objectives that are not necessarily consistent with the provision of adequate, affordable and sustainable retirement income to plan members. Reserves have been used to subsidize housing, state enterprises, and various types of economically targeted investments. The state ownership of PENSIONISSTE could unduly expose asset management to political intervention unless a strong governance mechanism, including outsourcing of asset management to private sector asset management through public competitions, is introduced; and…

(iii) **Impact on AFORE competition.** It is not clear how the public ownership of PENSIONISSTE will affect the competition in the AFORES’ market. On the one hand, state owned pension funds tend not to act as with profit institutions. The presence of a low fee alternative in the AFORE’s market could, in principle, prompt other AFPRES to lower their fees. However, it is often the case that state owned pension funds (the AFP Republica in Uruguay is one case) unduly subsidize their activities often at a loss. This reduces the contestability of the market by creating a barrier to entry. Such reduction in market competition is often associated with poor services to contributors, including asset management.
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———, 2004(b), Mexico Poverty Assessment.

Annex 1: Key Milestones in the Reform of the Mexican Financial Sector (2001-2006)

- **Credit Institutions Law and Financial Groups Law**: aimed at channeling a greater proportion of national savings through the financial system; fostering long-term savings; strengthening banking regulation and supervision; promoting transparency and competitiveness; fostering new financial products and services; strengthening the credit institutions’ corporate governance; and broadening the range of services offered.

- **Amendments to the Rules of Capitalization Requirements for Multiple Banking Institutions and Development Banks**: aimed at advancing the convergence between banking regulation and international standards.

- **Amendments to the Miscellany on Credit Collateral**: aimed at promoting bank lending by reducing transaction costs; widening the options to secure credit transactions; granting greater judicial certainty to creditors and borrowers; and promoting an orderly and sustainable recovery of defaulted bank loans.

- **Credit Information Institutions Law**: aimed at regulating the establishment and operation of credit information societies; and ensuring proper access to credit information, while respecting valid privacy concerns.

- **Credit Institutions Law**: established a prompt corrective regime consistent with international best practices.

- **Law of Transparency and Ordering of Financial Services**: regulates commission fees, interbanking fees and other aspects related with the provision of financial services; prohibits discriminatory practices between credit institutions and between users; establishes transparency requirements in contracts and check account balances, credit and debit cards; foresees transparency mechanisms to allow clients of credit institutions to know the carried out transactions and their fees; and establishes sanctions for breaches of the law.

- **Organic Law of the Federal Mortgage Association**: aimed at increasing the housing supply for wage earners and other workers; promoting the construction and acquisition of housing, preferably low income; and fostering mortgage securitization and increasing credit supply for housing construction and acquisition.

- **Popular Savings and Credit Law and Organic Law of the Bank of National Savings and Financial Services**: strengthened the institutional and regulatory framework of popular savings and credit activities, increasing access of low-income sectors and small enterprises to the formal financial sector; established the conditions to foster the development of a popular savings and credit system; created the Bank of National Savings and Financial Services, which offers training and consulting services to popular savings and credit entities, and promotes cost reduction through centralized provision of services subject to economies of scale.

- **Organic Law of the Financiera Rural**: aimed at supporting the development of agriculture, forestry, fishing and other rural activities. The *New Financiera Rural* replaced the former Rural Credit Bank (BANRURAL). *Financiera Rural* does not take deposits from or issue debt to the public, it is financed by the government through the budget with all appropriations, allocations, financing, and guarantees properly and explicitly accounted for in the budget and approved by Congress.

- **Amendments to the Securities Market Law (2001)**: aimed at promoting the development of the securities market by making it more transparent, efficient, and accessible. The 2001 amendments enhanced information, disclosure, minority stockholders rights; improved corporate governance practices; introduced a new versatile instrument (*certificado bursatil*), a security note that can be issued by private and public debtors; incorporated the central counterparty (establishing lender and borrower rights and obligations in securities transactions) to the market structure, reducing systemic risk in the securities market; introduced a consolidated regime applicable to public companies; redefined the functions and responsibilities within the corporate structure; introduced audit and corporate governance committees with independent board members; included clear mandates and fiduciary duties for board members, managers and external auditors, and further improved minority shareholders rights. It also promoted access to broad securities markets to small- and medium-size
firms through new corporate vehicles.

- **Mutual Fund Law:** aimed at facilitating the access to the stock and debt market of a wider range of investors. It improved mutual funds corporate governance practices; allowed for a mutual fund to change from one mutual fund operator to another with the aim of promoting competition and reducing investment manipulations not associated to maximizing the investors’ returns; allowed for a more flexible investment regime; prohibited banks and investment banks to act as mutual fund operators but allowed them to carry out this function by establishing a subsidiary.

- **Amendments to the Law of Mutual Insurance Institutions and Associations and the Federal Sureties Institutions Law:** aimed at strengthening the institutional and regulatory framework for the activities of insurance institutions; increasing the efficiency of insurance institutions’ operations; consolidating the insurance sector’s legal framework with that in place for the financial sector; and developing best corporate practices among intermediaries. Recently, a new amendment introduced the Mortgage Credit Insurance (Seguros de Crédito a la Vivienda) and Financial Warranty Insurance (Seguros de Garantía Financiera).

- **Modernization of the legal framework for Sofoles, leasing, and factoring companies:** aimed at enhancing competition in the credit market, reducing administrative costs, and fostering the legal framework applying to financial leasing, factoring and credit. This reform included the liberalization of leasing and factoring activities. Any company will be able to carry out such activities, and there will be no need for authorization nor supervision from the financial authorities.

- **Amendments to the Income Tax Law:** established a fiscal regime that allows for the development of two investment vehicles, the FIBRAS (Fideicomiso de Infraestructura y Bienes Raíces), a vehicle similar to the Real Estate Investment Trusts in the United States, and private equity vehicles.

- **Amendments and Additions to the Retirement Savings System Law:** opened the possibility for more workers to access the benefits of the New Pension System, including workers not registered in the social security institute (workers affiliated with the social security system for public sector employees, state and municipal governments, and public universities or working independently); allowed complementary contributions for retirement for all workers; and allowed investing—up to a limit of 20 percent—in foreign securities.

- **Payment Systems Reforms:** revamped the legal framework by enacting a Payment Systems Law in order to ensure payment finality and improve the execution of collateral and the oversight powers of the BOM; eliminated remaining credit risks in the large value payment systems, in line with the BIS CPSIPS; established a requirement for any overdraft in the large-value electronic payments system to be settled on the same day by using bilateral credit lines provided by other banks; improved the quality of collateral associated with BOM’s credit; and consolidated the intraday credit into one payment system (from the previous three systems).

- **New Securities Market Law (2005):** established a regulatory framework in line with international standards covering several aspects of the market, such as disclosure of information to investors, minority rights, and sound corporate governance. This framework supports the access of mid-sized corporations into the securities market and consolidates the rules applicable to issuers, in order to improve their organization and operations, through modern corporate structures and revamped liabilities. The new law updates the legal framework applicable to securities firms and those financial entities that participate in this sector, such as securities depository entities and central counterparties, among others. The law also seeks to update the regime of criminal offences and redefine the powers of financial authorities in order to make their functioning more efficient. The CNBV is enabled to inform the general public on the existence of inquiries and sanctions imposed.

Source: “Institution Building in the Financial Sector,” G20, 2005; and FSAP Update team discussions with the Mexican authorities.
Annex 2: Subsidy and Financing Programs to Enterprising, Productive Projects, Small Business, as well as Intermediary of the Social Banking.

<table>
<thead>
<tr>
<th>Agency or Entity</th>
<th>Program</th>
<th>Objectives</th>
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<tbody>
<tr>
<td>Ministry of Economy</td>
<td>Fund to Support the Micro, Small and Medium Enterprise (PYME Fund)</td>
<td>To give temporary support to programs and projects of micro, small and medium enterprise. Promote the access to finance on micro, small and medium enterprise.</td>
</tr>
<tr>
<td>Ministry of Economy</td>
<td>National Financing Program of the Micro-entrepreneurs.</td>
<td>To give subsidy and financing for the establishment and consolidation for the sector of national micro financing.</td>
</tr>
<tr>
<td>The Secretariat of Economy (Seconomía)</td>
<td>National Fund to Support Enterprise in Solidarity (FONAES)</td>
<td>Offering subsidies to prompt the productive work and business of the rural population, peasants and indigenous and entrepreneurs of low income of the rural areas, by means of support to the formation of productive capital, business skills and the build up of financial intermediaries.</td>
</tr>
<tr>
<td>The Secretariat of Economy (Seconomía)</td>
<td>Fund for Micro Financing of Rural Women (FOMMUR)</td>
<td>Channeling micro credits to rural women, with business vocation, willing to prompt productive and profitable projects with associative capacity.</td>
</tr>
<tr>
<td>SRA</td>
<td>Women Program in the Agrarian Sector. (PROMUSAG)</td>
<td>Offering subsidies to productive projects to women of the agrarian sector.</td>
</tr>
<tr>
<td>SRA</td>
<td>Fund for the Support to Productive Projects (FAPPA).</td>
<td>Offering subsidies and support to productive projects of the agrarian subjects and group of peasants that inhabit in agrarian areas.</td>
</tr>
<tr>
<td>Sagarpa</td>
<td>Support Program to Access the Rural Financial System (PAASFJR )</td>
<td>Support the producers of the rural sector to access the credit resources to help them develop his activities and contribute to the development of an efficient rural system.</td>
</tr>
<tr>
<td>Sagarpa</td>
<td>Support Program to the Rural Investment Projects (PAIPR)</td>
<td>Grant subsidies to promote the investment in capital good of the rural population to execute productive projects of proper technology application, productive reconversion, collection, conditioning and transformation.</td>
</tr>
<tr>
<td>Agency or Entity</td>
<td>Program</td>
<td>Objectives</td>
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<td>Sagarpa</td>
<td>Regional Projects for Technical Assistance to the Rural Micro-financing (PATMIR)</td>
<td>Offering technical assistance and small subsidies to non-bank financial intermediaries to facilitate access to financial services to the inhabitants of marginalized rural regions.</td>
</tr>
<tr>
<td>Sagarpa</td>
<td>Rural Development Programs Sub-program of Development (PRODESCA)</td>
<td>Developing the capacities of the rural population eligible to identify areas of opportunities, formulate, execute and consolidate projects that can improve their productive, commercial, organizational and business processes.</td>
</tr>
<tr>
<td>Sagarpa</td>
<td>Strengthening Sub-programs of Rural Businesses and Organizations (PROFEMOR)</td>
<td>Incorporating to the Unit of Rural Production (UPR) and priority groups in an organized way to the appropriation of the added value in both senses of the productive academy, promoting synergies among the organizations, economic networks and the rural financial services, such as fortifying the processes of participation and self-management, that enable them to have a greater power of communication and positioning of their enterprises and organization.</td>
</tr>
<tr>
<td>Sagarpa</td>
<td>Support Programs to the Social Organizations of Agribusiness and Fishing grounds (PROSAP)</td>
<td>Offering subsidies to the social and economic organizations of the rural sector to formulate and execute productive projects.</td>
</tr>
<tr>
<td>STPS</td>
<td>Productive Investment Projects (PIP)</td>
<td>Offering subsidies by means of delivery of machinery, equipment and tools to unemployed people and sub-employed interested in developing a productive project.</td>
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<tr>
<td>FIRA</td>
<td>Credit Program by Administration. (PROCREA)</td>
<td>Facilitating the formal financing of businessmen with a credit requirement of small amount, through a private intermediary called Agent PROCREA.</td>
</tr>
<tr>
<td>FIRA</td>
<td>Comprehensive Technical Service (SATI)</td>
<td>Support credit operations to producers with an annual net income of 3,000 times lower</td>
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<tr>
<td>Agency or Entity</td>
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<td>than the minimum daily salary in the area, by means of professional advice in productive, administrative, financial and organizational aspects.</td>
</tr>
<tr>
<td>FIRA</td>
<td>System of Stimuli to the Bank (SIEBAN)</td>
<td>Compensating the commercial banking by giving access to formal credit to low income producers in need of small credits.</td>
</tr>
<tr>
<td>FIRA</td>
<td>System of Stimulus to the Credit Unions (SIESUC)</td>
<td>Consolidate and increase the operations between the Credit Unions, the Bank and the FIRA.</td>
</tr>
<tr>
<td>FIRA</td>
<td>Service of Guarantees</td>
<td>Facilitating the access of producers and businessmen to the credit of the Private Bank complementing the own guarantee of the business.</td>
</tr>
<tr>
<td>FINRURAL</td>
<td>Entidades Dispersoras Program Phase I</td>
<td>To give credits to entidades dispersoras of credit and/or financial intermediaries directed to the rural sector that were not contemplated in the LOFR, nor regulated by the CNBV</td>
</tr>
<tr>
<td>FINRURAL</td>
<td>Program to reduce transaction costs.</td>
<td>Offering subsidies to the intermediaries to reduce the transaction cost of their clients.</td>
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<tr>
<td>FINRURAL</td>
<td>Comprehensive Program of Formation, Qualification and Consulting for Producers and Rural Intermediaries.</td>
<td>Offering subsidies to the development of qualifications and consulting for producers and rural intermediaries.</td>
</tr>
<tr>
<td>NAFIN</td>
<td>Comprehensive Program for the Micro-Enterprise.</td>
<td>Providing financing, qualification and technical assistance to the smallest economic units of the country.</td>
</tr>
<tr>
<td>BANSEFI</td>
<td>Consolidation of the Institutions of the Saving and Popular Credit Sector.</td>
<td>Offering subsidy to the technical assistance to the society of saving and popular credit (SACPS) and to the personnel of the federations that group SACPS interested in receiving the supports to complying with the legal framework.</td>
</tr>
<tr>
<td>BANSEFI</td>
<td>Qualification for the Personnel of Federations and SACP's.</td>
<td>Subsides to form human resources required by the SACP's and federations to comply with the Law and the regulations.</td>
</tr>
<tr>
<td>BANSEFI</td>
<td>Strengthening Program to the Saving and Popular Credit and Rural Microfinance. Technological</td>
<td>To design, establish and operate an information system to support the saving and popular credit intermediaries in the generation and information dissemination, for own use and to comply with the</td>
</tr>
<tr>
<td>Agency or Entity</td>
<td>Program</td>
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<tr>
<td>BANSEFI</td>
<td>FOMIN, Component of Remittances of the Red of the People (La Red de la Gente)</td>
<td>To develop the connectivity between the systems in SACP's and BANSEFI, with the purpose to operate The Network of the People (La Red de la Gente), conformed by financial intermediaries that offer a variety of services with high quality and reduce costs to the societies and the end users, with national cover.</td>
</tr>
<tr>
<td>Sedesol</td>
<td>Program of Productive Options: (a) Support to the Word, (b) Productive Credit for Women, (c) Granting support and enterprise formation, (d) Saving with you, (e) Productive Integration, (f) Local Development Agents</td>
<td>Offering support to the poor population from a strategy that could generate productive options, contribute to the consolidation of producers, favoring the formation of agencies of local development, and contribute to the formation of a system of social financing.</td>
</tr>
<tr>
<td>Sedesol</td>
<td>Civic Initiative 3x1</td>
<td>Supporting the civil initiatives to make specific projects that involve improving de quality of life of 10 inhabitants through assembly of resource of the federation, states, municipalities of the same group of citizens organized, mainly the ones living abroad.</td>
</tr>
<tr>
<td>Nacional Comisión on the Arid Zones (CONAZA)</td>
<td>Program of Scientific Entailment and Transference of Technology</td>
<td>Offering subsidies for investigation projects to promote sustainable development and the improvement of the quality of the rural inhabitants living in extreme poverty in the arid and semi- arid zones of the country.</td>
</tr>
<tr>
<td>National Fund for the Promotion of the Local Crafts (FONART)</td>
<td>Granting of credit</td>
<td>Offering credits for the support of the cycle of production of the popular traditional local crafts</td>
</tr>
</tbody>
</table>

Fuente: Oficina de Políticas Publicas, Encuesta a dependencias y entidades del Gobierno Federal sobre Transferencias, Financiamientos y Apoyos a Emprendedores, Proyectos Productivos, Micronegocios e intermediarios Financieros, Presidencia de la Republica, México, Marzo de 2004