Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: PGD226.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A

PROPOSED LOAN

IN THE AMOUNT OF US$ 750 MILLION

UNITED MEXICAN STATES
FOR THE

Mexico Strengthening Economic Sustainability Development Policy Financing

December 18, 2020

Macroeconomics, Trade And Investment Global Practice
Latin America And Caribbean Region

United Mexican States

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of December 15, 2020)

Currency Unit

MXN 20.23= US$ 1

ABBREVIATIONS AND ACRONYMS

AFORES	Administradoras de Fondos para el Retiro
ATCC	Anexo Transversal de Cambio Climatico
CAD	Current Account Deficit
CISE	Committee of Inclusive and Sustainable Economy
CNBV	National Banking and Assets Commission (*Comisión Nacional Bancaria y de Valores*)
CPF	Country Partnership Framework
CPI	Consumer Price Index
DPF	Development Policy Financing
DRM	Monetary Regulation Deposit (*Depósito de Regulación Monetaria*)
ENIF	National Financial Inclusion Survey (*Encuesta Nacional de Inclusión Financiera*)
FDI	Foreign Direct Investment
FCL	Flexible Credit Line
FIGI	Financial Inclusion Global Initiative
FM	Financial Management
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GRS	Grievance Redress Service
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFPE	Electronic Payment Funds Institutions (*Instituciones de Fondos de Pagos Electrónicos*)
IMF	International Monetary Fund
INEGI	National Geography and Statistics Institute (*Instituto Nacional de Estadística y Geografía*)
LAC	Latin America and the Caribbean
MSME	Micro, Small and Medium Enterprises
MXN	Mexican Peso
NDC	Nationally Determined Contribution
OECD	Organization for Economic Co-operation and Development
PEMEX	Petróleos Mexicanos
PPP	Purchasing Power Parity
PSBR	Public-Sector Borrowing Requirements
PSIA	Poverty and Social Impact Analysis
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
SHCP	Ministry of Finance (*Secretaría de Hacienda y Crédito Público*)
SINAGER	National System for Regulatory Governance
SME	Small and Medium Enterprises
USD	United States Dollar
USMCA	United States-Mexico-Canada Agreement
VAT	Value Added Tax
WB	World Bank
WBG	World Bank Group

Regional Vice President:	Carlos Felipe Jaramillo
Country Director:	Pablo Saavedra
Regional Director:	Robert R. Taliercio
Practice Manager:	Jorge A. de Thompson R. Araujo
Task Team Leaders:	Stefano Curto, Eduardo Olaberria

UNITED MEXICAN STATES

MEXICO STRENGHTENING ECONOMIC SUSTAINABILITY DPF

TABLE OF CONTENTS

This operation was prepared by an IBRD team led by Stefano Curto (Senior Economist, ELCMU), Eduardo Olaberria (Senior Economist, ELCMU) and consisting of: Alejandro Espinosa-Wang (Senior Private Sector Specialist, ELCFN), Tanja K. Goodwin (Senior Economist, ELCDR), Patricia Caraballo (Senior Financial Sector Specialist, ELCFN), Gustavo Demarco (Lead Economist, HSJDR), Ignacio Apella (Social Protection Economist, HLCSP), Jose Ernesto Lopez Cordova (Lead Economist, ETIFE), Aylin Isik-Dikmelik (Senior Economist, HLCSP) Clemente Avila Parra (Social Protection Economist, HLCSP) Maria Concepcion Steta Gandara (Senior Social Protection Specialist, HLCSP), Henry Forero (Senior Public Sector Specialist, ELCG2), Maria Guadalupe Toscano Nicolas (Public Sector Mgmt. Specialist ELCG2), Laura Elisa Aguirre Tellez (Public Sector Analyst, ELCG2), James Robert Ezequiel Sampi Bravo (Economist, ELCMU), Jozef Draaisma (Senior Country Economist, ELCMU), Santiago Justel (Economist, ELCMU), Gabriela Inchauste (Lead Economist, ELCPV), Antonio Leonardo Blasco (Senior Financial Management Specialist, ELCG1), Diana Martinez Ramirez (Team Assistant, LCC1C), Gabriela Grinsteins (Counsel, LEGLE), Luis Anibal Cano (Operations Officer, LCC1C), Maja Murisic (Senior Environmental Specialist, SLCEN), Maria Virginia Hormazabal (Finance Officer, WFACS), Renata Pantoja (Financial Analyst, WFACS), Tuuli J. Bernardini (Senior Environmental Specialist, SLCEN), Francisco Rodriguez (Senior Procurement Specialist), Patricia Chacon Holt (Program Assistant, ELCMU), and Beatriz Elena Franco (Program Assistant, LCC1A).

The operation was prepared under the overall guidance of Pablo Saavedra (Country Director, LCC1C), Robert Taliercio (Regional Director, ELCDR), and Jorge Thompson Araujo (Practice Manager, ELCMU).

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic
P174150	No

Proposed Development Objective(s)

To facilitate economic resilience and support fiscal and environmental sustainability

Organizations

Borrower:	UNITED MEXICAN STATES
Implementing Agency:	MINISTRY OF FINANCE AND PUBLIC CREDIT (SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO)

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**750.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	750.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Target
Reduction in Regulatory cost percentage of 2019)	0% (Dec. 2019)	9% (Dec. 2021)
Commercial bank credit to SMEs as a percentage of GDP	2.64 % (Dec. 2019)	Same as 2019 baseline (Dec. 2021)
Number of data suppliers of Open Data APIs	Zero (Dec. 2019)	46 (Dec. 2021)
Budget allocations linked to climate-change objectives and targets under a new methodology percentage of budget registered in the ATCC federal budget[1])	Zero % (Dec. 2019)	100 % (Dec. 2021)
Amount of bonds issued under the SDG Framework	Zero (Dec. 2019)	Euro 750 mil. (Dec. 2021)
Additional number of people that are eligible to access a minimum pension	Zero (Dec. 2019)	300,000 (Dec. 2021)
Women as a percentage of total beneficiaries of guaranteed pension	25% (Dec. 2019)	27% (Dec. 2021)

[1] AT-CC refers to an annex to the Federal Expenditure Budget named Climate-Change Crosscutting Annex (*Anexo Transversal de Cambio Climatico, AT-CC* in Spanish). Climate-change objectives and targets are those established in the Climate Change National Plan (objectives) and in the performance indicators matrix (targets) of every budgetary program, which jointly aim to respond to the national and international commitments established in this development agenda.

IBRD PROGRAM DOCUMENT FOR A PROPOSED LOAN TO THE UNITED MEXICAN STATES

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Financing (DPF) supports part of the authorities' program to facilitate economic resilience and support fiscal and environmental sustainability.** Beyond the health consequences and human life loss, the COVID-19 pandemic has brought demand and supply shocks to the global economy with deep impacts on firms, employment, and households. Through the channels of trade (including the U.S output drop and oil prices collapse), finance (flight to liquidity in U.S dollars and other foreign denominated securities), investment (high uncertainty), and coupled with massive disruptions on the supply side to flatten the contagion curve domestically, it is expected that Mexico's output will drop significantly in 2020. Like in other emerging economies, the recovery path is likely to be complex and with uncertainties, and it will need to be supported by critical economic and institutional reforms. In this context, the Program Development objective of this operation is to help facilitate economic resilience and support fiscal and environmental sustainability. This DPF is aligned with the strategic framework for the World Bank Group's (WBG) COVID-19 crisis response outlined in the Approach Paper (AP), specifically with its pillars 3 and 4. The policies supported by this operation are also fully aligned with the objectives set in the Country Partnership Framework (CPF) discussed by the Board of Executive Directors in February 2020, specifically with its objectives 1, 2, 3 and 7; and its ***institutional building*** features.

2. **The pandemic has had significant human, poverty, and employment costs.** The official statistics as of early December 2020 show that more than 1.2 million people contracted the virus and over 100,000 died (Figure 1). Since mid-March the government implemented measures to control the spread of the virus, including the suspension of all non-essential economic activities, move to at-home work and schooling nationwide, and a broad social distancing initiative. The government established a "traffic light" system for a gradual activity reactivation, which commenced in mid-May, but significant uncertainties remain ahead until the availability of a vaccine. The overall impact of the crisis has been significant on jobs. Total employment fell drastically in the early months of the pandemic. Since then it recovered gradually, but with 5 million less jobs by July 2020 compared to the previous year, more than 1 million of them lost in the formal sector. Poverty reduction was limited for decades before the crisis compared to peer countries, as growth rates were insufficient to support significant progress.[2] Similarly the annualized growth rate of the median per capita income was low.[3] The contraction in economic activity will likely lead to a large impact in monetary poverty, increasing the (US$5.5 line) poverty rate from 21 percent in 2019 to at least 27 percent in 2020 (or close to 8 million of new poor by this measure), with only a gradual reduction in 2021-2 (Figure 2).

3. **The authorities have implemented measures to face crisis.** Aside from the health response, the authorities have launched a set of monetary, financial, fiscal, economic and social measures to mitigate

[2] The official poverty rate fell from 46.1 to 41.9 percent of the population between 2010-18 due to increased labor income and a reduction in social deprivations. Monetary poverty amounted to 23 percent in 2018 using the upper middle-income poverty line (US$5.5 a day, 2011 purchasing power parity (PPPs)). Mexico's median per capita income in 2018 was US$3,295 (in 2011 PPP terms) equivalent to US$1,990 in nominal U.S. dollars.

[3] Mexico's median per capita income in 2018 was US$3,295 (in 2011 PPP terms) equivalent to US$1,990 in nominal U.S. dollars.

the impact of the crisis. On the monetary-financial side, currency swap lines, liquidity facilities, a regulatory forbearance, and other important measures were adopted. The fiscal response has been more limited, probably too tight for the large shock received by the economy and households. The authorities' expressed rationale is that they are trying to strike a balance between short-term larger fiscal imbalances and a sustainable fiscal framework over the medium term, considering that risks remain high and fiscal space for further action may be needed in the months ahead. The support applied was targeted to support vulnerable households, workers, and Micro, Small and Medium Enterprises (MSMEs). Box 1 presents a list of the measures taken as of September 2020.

4. **The current juncture and the recovery period ahead present a good opportunity to re-think policies conducive to growth, inclusion and sustainability.** Economic growth in Mexico has been low over the last three decades, and the country's income per capita has not converged to that of higher-income economies (Figure 3). In fact, per capita income is likely to continue to be below its 2008 level in the next few years (Figure 4). The Mexico Systematic Country Diagnostic (SCD) explained the low growth and limited poverty reduction experienced over the last decades, pointing toward a number of constrains. Among them, it underscored constraints in product and factor markets and public resource allocation and institutional policy coordination. The SCD also highlighted fiscal and environmental sustainability challenges that would hamper development and poverty reduction ahead. In this context, it is critical to tackle potential bottlenecks to the recovery that have also shown in the past to deter broad based growth and sustainability. All these challenges are hard to face, and some sectoral policies, particularly in the energy renewable sector, raised concerns. The private sector would need to be a key engine for the recovery.

5. **As economic activity slowly starts to resume, the authorities' efforts are progressively moving toward implementing reforms to support economic resilience and support fiscal and environmental sustainability.** In this context, the program supported by this operation focuses on a positive agenda forward. But understanding the reforms supported are a first step and that a broader reform agenda to address Mexico's multiple development challenges lies ahead.

- **The first pillar of the DPF aims to support the authorities' program of facilitating economic resilience.** It is difficult to foresee a solid recovery after the economic crisis without the oxygen of financial access and a fluid financial intermediation across the economy, which is even more critical considering the pre-existing impediments in access to finance to MSMEs and individuals in Mexico. As bridge to the recovery phase, the operation supports policies to facilitate credit for working capital and investments to Small and Medium Enterprises (SMEs) beyond the short-term. It also supports important policies to continue fostering digital finance, which has been critical in times of social distancing and it is becoming an essential tool for the "new normal" in the economy. Reducing the hidden taxes represented by unnecessary regulatory burden and red tape will help firms' growth, so they can also drive a strong jobs recovery. The operation supports policies and institutional reforms in the areas of business entry, inspections, and firms' services, to reduce regulatory and enforcement costs for firms, which affect firms' entry and operation, particularly for MSMEs that provide the bulk of the jobs in the country and for firms ***in the poorer states in the south***. The reforms also include dealing systematically with the large stock of regulation and red tape pilled-up at the sub-national level over the years. These reforms contain strong ***institutional building features*** to enhance transparency and accountability and to reduce uncertainty stemming from regulatory enforcement agencies. Some of these reforms will also help reduce gender gaps.

- **The second pillar supports the authorities' efforts to support fiscal and environmental sustainability.** The economic recovery represents an opportunity to steer policies to underpin a more fiscally and environmentally sustainable and climate resilient path. ***Climate vulnerability*** is a critical driver of increasing poverty, particularly is the ***states in the south*** of Mexico. In any country, one of those mechanisms is to have a more climate-change conscious use of public budget resources. The reforms supported include the establishment of climate change budget allocations tagging, which through enhanced prioritization and accountability can have significant effects on this critical challenge over the medium and long terms. They also include the establishment of a new framework and institutional process to issue Sustainable Development Goal (SDG) Sovereign Bonds, with proceeds linked to sustainable expenditures in support of the fulfillment of the most pressing SDGs. There are extensive linkages between climate action and the 2030 Agenda in Mexico, as almost 40 percent of the SDG targets are related to measures to mitigate or adapt to climate change[4]. Low levels of pension benefits (low replacement rates) and limited inclusion in the pension system in Latin America have been traditionally addressed at the cost of large additional pressures on public finances. The authorities' pensions reforms supported in this operation include a gradual increase in contributions to improve replacement rates to enable long term sustainability to the system. At the same time, it enables an expansion of access for pensioners by reducing the minimum number of contributions, with a design that does not generate additional fiscal costs. These reforms will also likely help reduce structural causes of gender gaps in pensions, as women are relatively more affected than men by the requirement of minimum number of contributions.

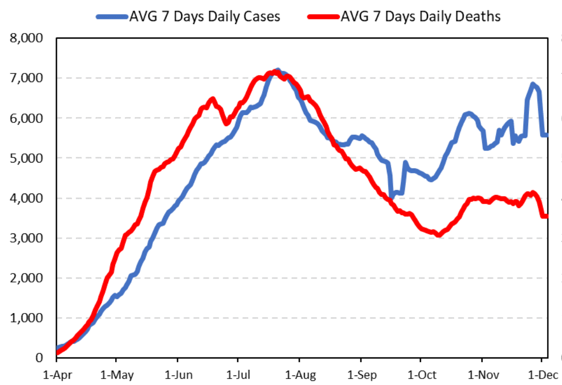
6. **There were significant inputs from IFC on private sector issues, and collaboration with other IFI's and bi-lateral development partners.** Development partners and IFIs involved in the authorities' reforms supported included the Foreign, Commonwealth and Development Office of the United Kingdom (**FCDO**), the French Development Agency (**ADF**), the Inter-American Development Bank (**IADB**), and the Development Bank of Latin America (**CAF**). ***IFC*** provided inputs and advice on benefits to the private sector stemming from the proposed policies. The operation has been designed as a stand-alone DPF to provide the needed flexibility for supporting reforms in this complex and difficult time.

7. **The macroeconomic policy framework is adequate for this proposed operation despite prevailing economic conditions**. In the context of the expected global fall in output, Mexico's GDP is expected to contract substantially in 2020. The current account deficit, which narrowed markedly during 2019 and into 2020, will remain moderate and continue to be financed by Foreign Direct Investment (FDI) over 2020-22. Mexico has an independent Central Bank and a flexible exchange rate regime that has been the first line of defense against the external shocks experienced over the last months. Inflation converged toward the 3 percent target in 2019 and is likely to stay within the Central Bank's bounds of tolerance (2-4 percent) over the medium-term. The country is judiciously using its monetary policy and the Central Bank's balance-sheet space to respond in the context of the volatile global capital markets. The financial sector entered the crisis well-capitalized and the authorities took critical measures to ensure stability and

[4] The co-benefits approach to an integrated implementation of the 2030 Agenda and the Paris Agreement in Mexico. Link: https://www.gob.mx/cms/uploads/attachment/file/346964/Spinning_The_Web_Interactive-2__2_.pdf

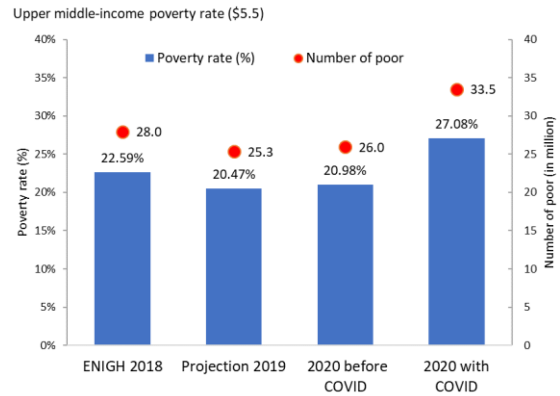
liquidity, but it will require close monitoring. Fiscal consolidation over the last years enabled Mexico to achieve public debt stabilization over 2017-19, ahead of most emerging economies. In the current context, a re-prioritization of spending is expected to attend to health needs, protect social assistance, and target investments with high fiscal multipliers, while net revenues will decline with the output drop, even after the cushion stemming from the stabilization fund and the receipts/payouts of the oil-price hedge contracted. Public debt remains sustainable (and relatively resilient to different shocks) despite the large one-off increase expected for 2020.

Figure 1. Evolution of COVID-19 cases.



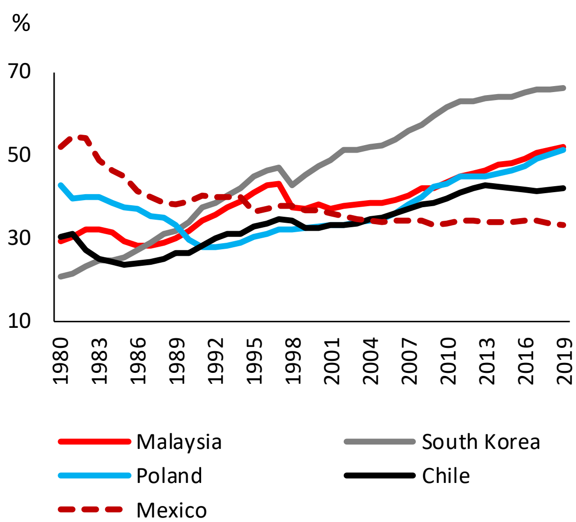
Sources: Secretaria de Salud de México.

Figure 2. Poverty under different scenarios



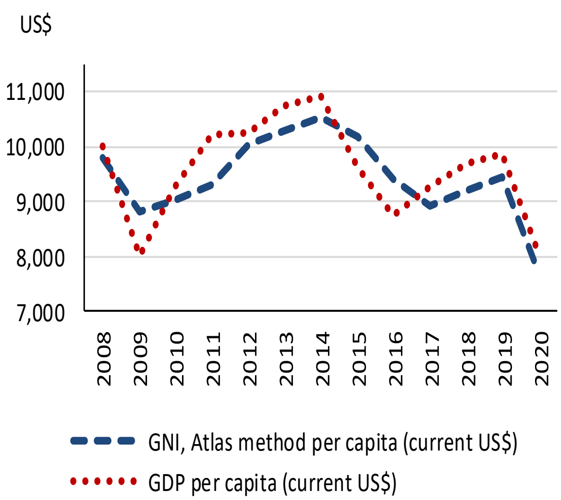
Sources: Total Economy Database; World Bank calculations

Figure 3. Per capita income as a share of U.S.



Sources: World Development Indicators, World Bank.

Figure 4. Per capita GDP dynamics 2008-2020



Sources: World Bank calculations.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

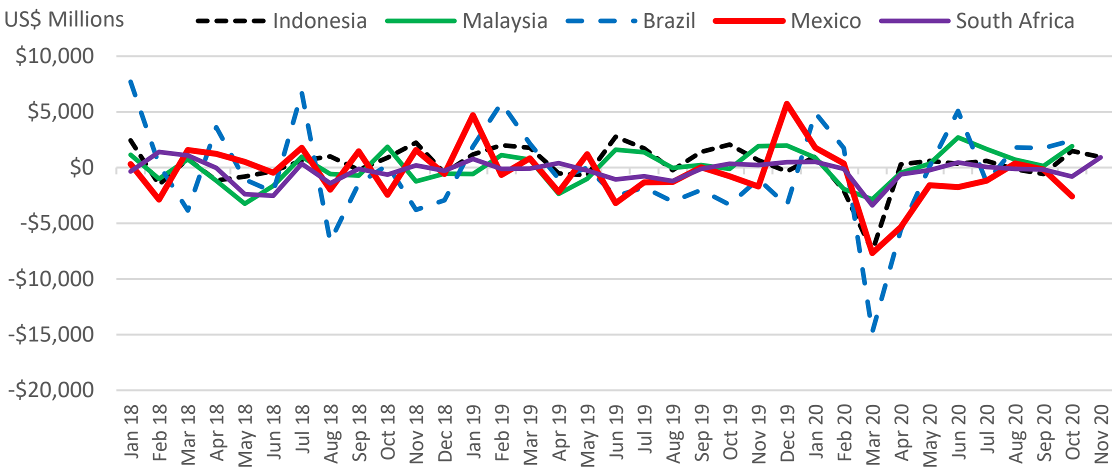
8. **Economic growth halted in 2019 and is expected to drop significantly in 2020 as the global recession unfolds due to the COVID-19 pandemic.** The expansion of economic activity at a moderate annual rate of 2.1 percent during 2017-8, turned into a marginal contraction of -0.3 percent in 2019. Private consumption growth dipped, whereas a change in public sector priorities and programs led to a slowdown of government consumption. Investment also slowed in 2019, which had been weak since 2016. On the supply side, the decline in hydrocarbon production placed a drag on growth, even as the decline in production under way since its 2004 peak was arrested in the last quarter of 2019. The impact of the global pandemic is taking a heavy toll on the economy as economic activity contracted by 1.3 and 18.6 percent year on year, in the first and second quarters of 2020, respectively. The economic downturn bottomed out in June and has been largely concentrated in the industry and services sectors. Construction has been down by more than 30 percent from April to July, whereas activity in the hotel and restaurant sector has been down by 58 percent. The latter is also in line with a reduction in international tourist arrivals which was still down by nearly 70 percent in August this year.

9. **With a marginal import compression and on the back of strong remittances growth, the current account deficit (CAD) narrowed significantly in 2019 and into 2020.** The CAD continued to be fully financed by foreign direct investment, which in 2019 remained close to (albeit below) past years' levels. International reserves remained robust, at US$193 billion by end August 2020, and are sufficient to cover more than 6 months of imports and more than 300 percent of short-term external debt. At the end of 2019 the country also renewed a Flexible Credit Line (FCL) with the IMF for about US$61 billion. The trade balance for the first two quarters of 2020 was positive at US$2,659 million (as they were for the whole of 2019 as well).

10. **At the onset of the global pandemic, there was a sharp increase in risk aversion in international capital markets that triggered capital outflows from Mexico and other emerging economies.** During March of 2020, most emerging economies suffered capital outflows, with Mexico as one of the most affected economies (Figures 5 and 9). This continued in April, though at a declining pace. Emerging economies also took a hit in debt markets, with spreads soaring to over 700 bps at the end of April for Mexico (Figure 6). However, since the end of May the outlook for emerging economies on debt and capital markets gradually improved, including for Mexico.

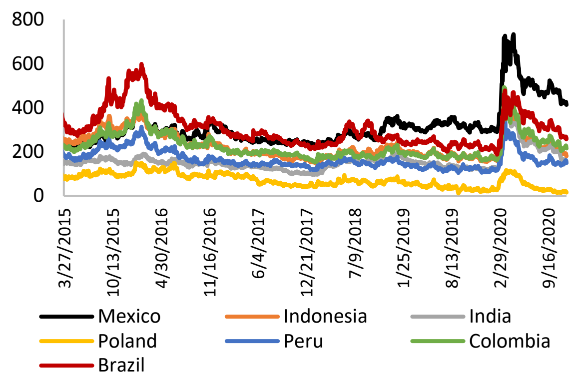
11. **Mexico has a flexible exchange rate regime that has been the first line of defense against external shocks.** Over the first quarter of 2020, the peso was hard hit by the shocks and volatility experienced by capital markets, which prompted a rapid depreciation of the peso against the US dollar (Figure 7). This took place as non-resident holders of domestic currency securities, investors hedging positions with Mexican peso, and other investors have been unwinding their positions to seek dollar liquidity. The Central Bank enabled a swap program with the U.S. Federal Reserve for around US$60 billion, and together with the Ministry of Finance provided swap facilities to market participants and enabled more liquidity for the financial sector (see Box 1 on the initial response from the authorities). Since the end of March, the peso appreciated about 15 percent against the USD.

Figure 5: Net non-resident purchases of Emerging Market (EM) bonds (portfolio debt flows) in USD millions



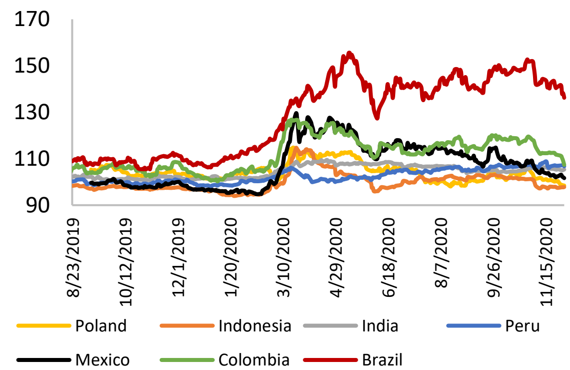
Source: Institute of International Finance, WB staff calculations

Figure 6. Emerging market bond index global spreads



Source: Bloomberg.

Figure 7. Exchange rate indices (1/1/2019=100)



Source: Banxico.

Figure 8. Mexico and US growth rate

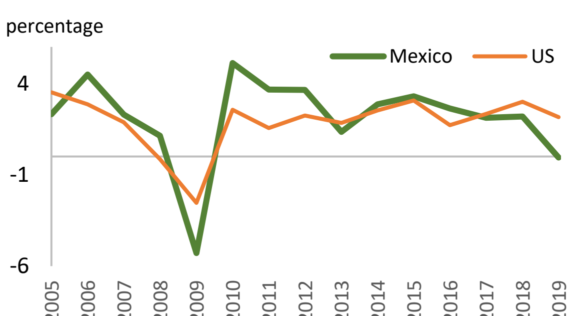
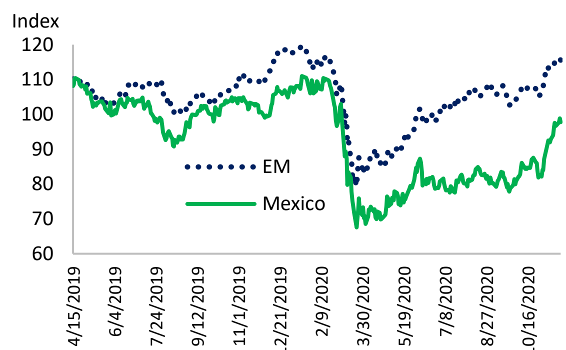


Figure 9. Mexico and EM capital flow index (1/1/2019=100)



12. Inflation pressures remained subdued. Even with the significant minimum wage increase enacted at the beginning of 2019 and 2020, inflation converged to the Central Bank's 3.0 percent target by late-2019. Headline inflation has fluctuated in recent months, going from 3.7 percent in February to 2.1 percent in April and then back to 3.6 percent in July. The recent uptick in inflation is not generalized, however, as it has mainly been driven by increases in the prices of processed food and beverages. With mid-term inflation expectations within the Central Bank´s band of tolerance (3 percent plus/minus 1 percent), and in the context of policy easing measures in the U.S. and Europe, the Central Bank reduced the policy rate from 8.25 percent to 4.5 percent between August 2019 and August 2020.

13. The financial sector entered the economic fallout of the pandemic well capitalized. Growth of bank credit to the non-financial private sector had moderated in 2019, reaching a real annual rate just below 5 percent. Credit expansion was driven by corporate sector and mortgage lending, while consumer lending contracted in real terms. The banking system has a strong return on equity (12.4 percent as of June 2020) and is well capitalized (with a capital adequacy ratio of 16.4 percent).[5] At 2 percent in June 2020, the non-performing loans (NPL) ratio was relatively low and has been stable around that level since 2016. At the onset of the crisis, the authorities established a regulatory forbearance program through commercial banks. Under this program, temporary special accounting criteria applies to consumer, corporate and mortgage loans that were current in their payments as of February 28th, 2020. Financial institutions will continue to classify the loans as current for up to six months even without payment and will not report the payment deferral as late payment to the credit reporting systems. This regulatory forbearance measure included a sunset clause, inclusion only of borrowers in good standing at the beginning of the program, adequate loan restructuring processes, and constant monitoring of borrowers, with the aim to help avoid a wave of defaults in the short term, while offering immediate relief to the real sector and additional time to banks and borrowers. At the end of the period a process of loan restructuring commenced. However, the impact of the economic recession in 2020 will likely continue to put pressure on the banks' balance sheets that will need to be closely monitored by regulators even as liquidity has been made available. Structurally, the sector is characterized by significant concentration: the five largest banks account for close to 70 percent of assets.

14. Fiscal consolidation between 2017-19 enabled pre-pandemic public debt stabilization. Prior to the crisis, Mexico was first among emerging markets in stabilizing public debt as a share of GDP (44.8 percent on net terms as reported by the authorities or 53.7 percent in gross terms). Expenditure rationalization measures applied throughout 2019 together with the use of resources from its revenue stabilization fund, broadly enabled the authorities to compensate for lower than expected revenue collection during 2019. In this context, the Public-Sector Borrowing Requirements (PSBR) ended up at 2.3 percent of GDP with a primary fiscal surplus of the budgetary non-financial public sector at just above 1 percent of GDP. Amid worsening economic conditions and dragged by the vulnerabilities of the state oil company PEMEX, the rating of sovereign debt was downgraded, but it remains investment grade. Raising oil production and refining at the cost of operational losses may place additional burdens on the federal budget.

15. The administration presented its 2020 budget with a primary surplus, but fiscal balances deteriorated over the year in the context of the economic shock. Despite the drastic impact of the output drop on fiscal revenues, the authorities were able over the first two quarters of the year to maintain

[5] Bank of Mexico and National Banking and Securities Commission (CNBV).

collection levels similar to those in 2019, particularly for income taxes, owing to the settlement of past tax liabilities disputed in the courts with large multinational and national firms. Tax administration efforts for the Value Added Tax (VAT) and other taxes were also strengthened through the electronic invoice control system and a crackdown on fake sale invoices. But the fiscal deficit is expected to widen in 2020 (see section 2.2), even after accounting for the utilization of the resources from the revenue stabilization fund and the receipt of the payments of oil hedge contracted by the authorities. On the spending side, a re-prioritization of spending has been taking place in 2020 away from wages, operating expenses and financial capital transfers, and toward health needs, social assistance to vulnerable groups, and on-going investments.

16. **Markets have been closely following the implementation of measures to remedy the weak short and medium-term financial position of PEMEX.** Over the last 15 months they included a lower transfer obligation and tax burden on the company vis-a-vis the federal budget, as well as the reprofiling of its debt obligations, to enable better cash flows. Still, PEMEX recorded losses of US$ 17.5 bn in 2019 and of US$26.9 billion in the first two quarters of 2020; the latter mostly due to the currency depreciation effect. The Mexican-Mix oil price declined to an average of US$55.6/barrel in 2019 and the annual volume of crude oil production by PEMEX dropped by 7.7 percent. In the first two quarters of 2020, the Mexican-Mix oil price dropped to US$34/barrel by end June 2020 amid the global oil production tensions. On April 17, 2020 Moody’s downgraded PEMEX debt to below investment grade, following a similar move of Fitch ratings in the summer of 2019. All PEMEX debt was reprofiled with an extended maturity and reduced payments in the short term. PEMEX debt is part of the public debt figures reported for the consolidated public sector (Tables 1 and 2).

17. **Despite the economic stagnation, both labor income growth and job creation increased in 2019, but those gains were rapidly offset during the first half of 2020.** Labor incomes grew by 5.9 percent in real terms supported by an increase in minimum wages. Most job growth took place in commerce, while there were job losses in construction, financial services and the extractive industries. However, during the first half of 2020 there was close to one million formal jobs, or close to three times the number of jobs created in 2019.

Table 1: Mexico Key Macroeconomic Indicators, 2017-2023

				Projected			
	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Real sector	Annual percentage change, unless otherwise indicated						
Real GDP	2.1	2.2	-0.3	-9.0	3.7	2.6	2.2
Contributions:							
Consumption	2.2	1.9	0.1	-8.0	3.5	2.3	2.0
Investment	-0.2	0.2	-1.0	-3.2	1.6	0.8	0.8
Net exports	-0.7	0.0	0.9	2.2	-1.4	-0.5	-0.6
Unemployment rate	4.0	4.0	4.2	..	..	..	..
GDP deflator	6.7	4.9	3.3	3.2	3.4	3.6	3.5
CPI (period average)	6.0	4.9	3.6	3.5	3.5	3.5	3.5
Fiscal accounts	Percent of GDP, unless otherwise indicated						
Revenues	22.6	21.7	22.2	22.9	22.5	22.2	21.8
Expenditures	23.6	23.9	24.6	27.9	26.1	25.3	24.6
Fiscal balance	-1.1	-2.2	-2.3	-5.0	-3.6	-3.1	-2.8
Net public debt	45.7	44.9	44.8	55.2	55.0	54.9	54.7
Gross public debt	54.0	53.6	53.7	64.0	63.4	63.0	62.6
Monetary accounts	Annual percentage change, unless otherwise indicated						
Base money	8.8	8.3	4.1	9.9	5.5	5.2	5.2
Policy interest rate	7.25	8.25	7.25	..	..	..	..
External sector	Percent of GDP, unless otherwise indicated						
Current account balance	-1.8	-2.1	-0.4	1.0	-0.4	-1.1	-1.8
Imports (% change, real)	6.4	5.9	-0.9	-17.0	15.0	7.0	5.4
Exports (% change, real)	4.2	5.9	1.4	-10.8	10.1	5.4	3.7
Foreign direct investment	2.6	2.2	1.9	1.5	1.9	2.1	2.0
Gross reserves (US$ billion)	172.8	174.6	180.7	192.7	194.6	191.8	180.3
In months of imports	4.5	4.1	4.4	5.8	4.9	4.4	3.8
% of short-term ext. debt	329.6	285.6	288.3	367.6	348.9	326.6	292.8
Terms of trade (% change)	2.6	0.0	2.2	-2.2	0.2	0.3	0.2
Exchange rate MXN/US$)	18.93	19.24	18.86	..	..	..	..

Table 2: Mexico: Key Fiscal Indicators for the Public Sector, 2017-2023 (% of GDP)

				Projected			
	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Total Revenue	**22.6**	**21.7**	**22.2**	**22.9**	**22.5**	**22.2**	**21.8**
Federal Government	17.5	16.5	16.5	17.1	16.7	16.4	15.9
Tax revenue	13.0	13.0	13.2	14.0	14.0	14.0	14.0
Nontax revenue	4.5	3.4	3.3	3.1	2.7	2.4	1.9
Oil	2.0	2.3	1.8	0.9	0.9	1.1	1.1
Revenue Stabilization Fund/oil hedge*	0.0	0.0	0.5	1.0	0.0	0.0	0.0
Other**	2.5	1.1	1.0	1.2	1.8	1.3	0.8
Agencies and Public enterprises	5.1	5.3	5.7	5.8	5.8	5.8	5.8
PEMEX	1.8	1.9	2.2	2.1	2.1	2.1	2.1
CFE, IMSS, ISSSTE	3.3	3.4	3.5	3.7	3.7	3.7	3.7
Total Expenditure	**23.6**	**23.9**	**24.6**	**27.9**	**26.1**	**25.3**	**24.6**
Budget expenditure	23.6	23.8	23.9	26.0	25.6	24.8	24.1
Programmable	17.6	17.3	17.4	19.2	18.8	18.1	17.4
Current	14.0	14.2	14.4	15.8	15.4	15.0	14.5
Wages	5.2	5.2	5.0	5.7	5.4	5.1	4.8
Pensions	3.2	3.4	3.6	4.3	4.4	4.4	4.4
Subsidies and transfers	3.1	2.9	3.2	3.5	3.3	3.2	3.1
Other operating expenses	2.5	2.7	2.6	2.4	2.3	2.2	2.1
Capital	3.6	3.1	3.0	3.4	3.4	3.2	2.9
Physical capital	2.6	2.6	2.3	3.0	3.0	2.8	2.6
Financial capital	1.0	0.4	0.7	0.4	0.4	0.4	0.4
Nonprogrammable	6.0	6.5	6.4	6.8	6.8	6.7	6.7
Revenue sharing	3.5	3.6	3.6	3.7	3.6	3.6	3.6
Interest payments	2.4	2.6	2.7	3.1	3.0	3.0	3.0
Other	0.1	0.3	0.1	0.1	0.1	0.1	0.1
Primary Budget Balance	**1.3**	**0.5**	**1.1**	**-0.1**	**-0.1**	**0.3**	**0.7**
Budget Balance	**-1.1**	**-2.1**	**-1.6**	**-3.1**	**-3.1**	**-2.6**	**-2.3**
Adjustments to the budget balance***	0.0	0.1	0.7	1.8	0.5	0.5	0.5
Overall Fiscal Balance (PSBR)	**-1.1**	**-2.2**	**-2.3**	**-5.0**	**-3.6**	**-3.1**	**-2.8**
Gross Financing Needs	**7.5**	**7.6**	**9.0**	**12.8**	**11.1**	**10.1**	**9.6**
Overall fiscal balance (PSBR)	1.1	2.2	2.3	5.0	3.6	3.1	2.8
Amortizations	6.4	5.4	6.7	7.8	7.5	6.9	6.7
Net public debt****	45.7	44.9	44.8	55.2	55.0	54.9	54.7
Gross public debt	54.0	53.6	53.7	64.0	63.4	63.0	62.6

*Includes the payout of oil price hedge acquired by MoF
**Includes revenue from the sale of financial assets such as from trust fund to be extinguished and dividends from the central bank
***Includes the inflationary component of inflation-indexed debt, income from debt repurchase, as well as an adjustment for income derived from the net sale of financial assets and from the net acquisition of liabilities other than public debt.
****Net of cash balances and financial assets of non-financial public sector entities, including public sector trust funds

Table 3: Balance of Payments Financing Requirements and Sources, 2017-2023 (US$ billion)

				Projected			
	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
Financing requirements	**106.8**	**110.6**	**104.4**	**104.2**	**100.3**	**107.8**	**113.1**
Current account deficit	20.4	25.3	4.3	-10.7	4.7	12.3	22.1
External debt amortization	91.2	84.9	97.4	103.0	93.7	98.2	102.5
Medium and long term	38.1	32.4	36.3	40.3	41.3	42.4	43.8
Short term	53.1	52.4	61.1	62.7	52.5	55.8	58.7
Gross reserve accumulation	-4.8	0.5	2.6	12.0	1.8	-2.7	-11.5
Financing sources	**106.8**	**110.6**	**104.4**	**104.2**	**100.3**	**107.8**	**113.1**
FDI (net)	30.3	27.1	23.6	23.6	15.8	21.1	24.1
External debt disbursements	111.7	98.7	117.8	102.3	108.8	114.5	120.1
M/L term	59.3	37.5	55.1	49.8	53.0	55.8	58.5
Short term	52.4	61.1	62.7	52.5	55.8	58.7	61.6
Other capital flows (net)	-35.2	-15.2	-36.9	-21.7	-24.3	-27.8	-31.1

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **A significant contraction of the economy is expected for 2020.** The combination of the global recession (including a drop in U.S. output, Mexico's main trading partner), disruptions in global and domestic supply chains, measures to flatten the contagion curve, financial disruptions and investment risk aversion, among other, are likely to take heavy toll on the key components of aggregate demand. Growth is projected to contract by around 9 percent in 2020.

19. **Mexico's gradual recovery in 2021 and 2022 will partly depend on the rebound in the U.S. economy.** It is expected that it will take the country close to three years to recover the same income level it had in 2019. Against this backdrop, the ratification of the United States-Mexico-Canada Agreement (USMCA) together with a more open approach from the authorities toward private sector involvement in infrastructure sectors would enable a boost in domestic demand.

20. **The CAD is expected to turn into surplus in 2020, as imports are compressing at a higher rate than exports and remittances show resilience to the global shock.** However, as imports recover faster than exports in 2021 and 2022, a moderate CAD will return over the medium term. FDI will slow but would still be enough to cover the moderate CAD over the medium term. The ratification of the USMCA should ease uncertainties which limited export and FDI performance in 2017-9, particularly in the manufacturing sector, and be another engine of recovery into 2021-22. Volatility in financial markets over the next 12 months may tighten external finance, even as the international reserves level would comfortably cover imports and short-term external debt. Mexico also renewed its FCL with the IMF for about US$61 billion at the end of 2019 for two years.

21. **Inflationary pressures are expected to remain within the Central Bank's 2-4 percent band of tolerance over the medium term.** Even with a tempered increase in some prices in 2020 due to the pass-through effect of the exchange rate depreciation and supply side considerations, the widening output gap will eventually curb price increase pressures. Moreover, continued vigilance by the Central Bank, which

underpins the institution's long-established credibility in maintaining price stability, is expected to keep inflation within the tolerance band. The monetary policy trajectory in the U.S. (and Europe), as well as the level of risk aversion to EMs, including Mexico, is likely to determine the extent of the space for further monetary policy action during the rest of 2020 and 2021.

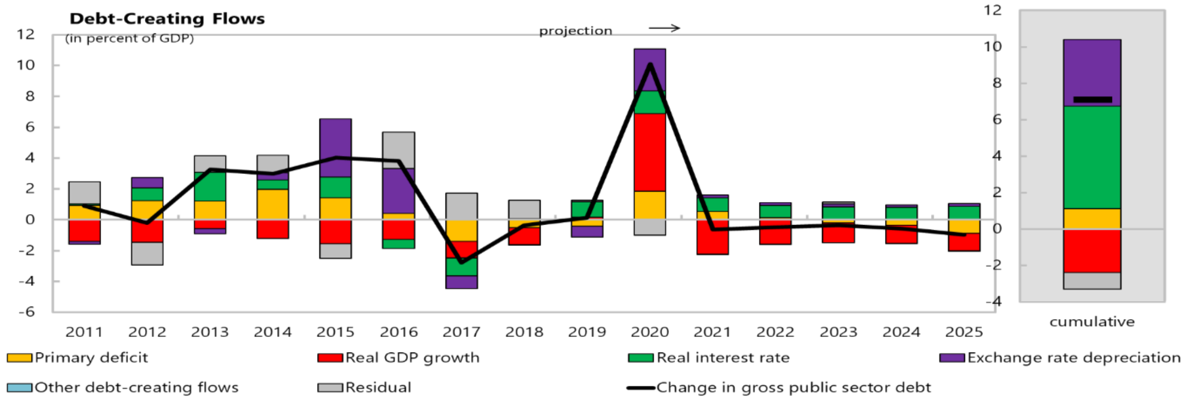
22. **Adherence to overall fiscal prudence is expected to continue.** Revenues will fall in 2020, but not as much as the economy, owing to stronger tax administration measures and tax settlements of past years (see section 2.1). An overall PSBR balance close to - 5 percent is expected for 2020. Bank staff projections assume an overall fiscal balance (PSBR) of -3.6 for 2021. This is close to that projected by the authorities, under which the somewhat optimistic revenue assumptions are likely to be compensated by the transfer of the Central Bank, as established in the budget law stemming from the earnings due to the revalorization of the reserves. The spending composition is expected to favor health, social protection, and investment spending as in 2020. State development banks have strong balance sheets to support liquidity and credit to SMEs and firms in the most affected sectors. Beyond 2020, revenue growth will be tamed in line the moderate output recovery, keeping the larger take of PEMEX vis a vis the federal government on the oil revenues. The situation of PEMEX is expected to worsen in 2020. This may require further relief from its tax and transfer obligations, as oil prices for the Mexican mix continue to be low. The state oil company would require a strong package of measures to reduce its operational losses and mitigate its medium-term financial vulnerabilities, including to avoid further negative effects on the sovereign rating.

23. **The medium term, including 2021-2022, will be challenging**. With a negative output gap widening, eroded fiscal buffers, and growing spending pressures—including the need for higher infrastructure investment to support growth— further fiscal space will be needed. This space will likely need to come from a needed tax reform. The pension reform supported by this operation will be critical in ensuring long term sustainability of the pension system while avoiding additional pressures on the fiscal side down the line.

24. **Since more than two thirds of public debt is denominated in local currency, and the sovereign benefits from a long maturity structure[6], rollover and foreign exchange risks are moderate.** Public debt is expected to have a large one-off increase due to the larger overall deficit in 2020, the lower GDP denominator, and the exchange rate depreciation effect on external debt, but it would stabilize again after that. Public debt is expected to reach nearly 56 percent of GDP (in net terms, as reported by the authorities) or nearly 64 percent of GDP in gross term in 2020, before stabilizing and beginning a gradual decline over the medium term. Fiscal gross financing needs would increase from 9.0 percent of GDP in 2019 to 13 percent of GDP in 2020 before declining to below 10 percent of GDP over the medium-term. ***Stress test scenarios suggest that public debt sustainability is relatively resilient to a range of different shocks.***

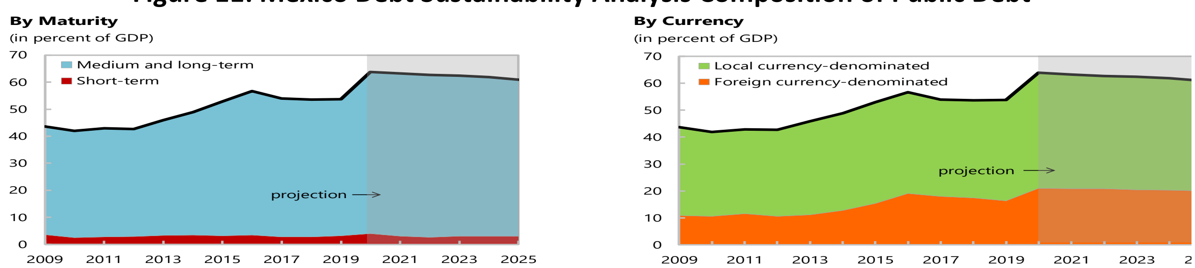
[6] The federal government debt denominated in pesos has an average maturity of about 8 years. The average maturity of FX bonds is 20.7 years.

Figure 10: Mexico Debt Sustainability Analysis Debt-Creating Flows (in percent of GDP)



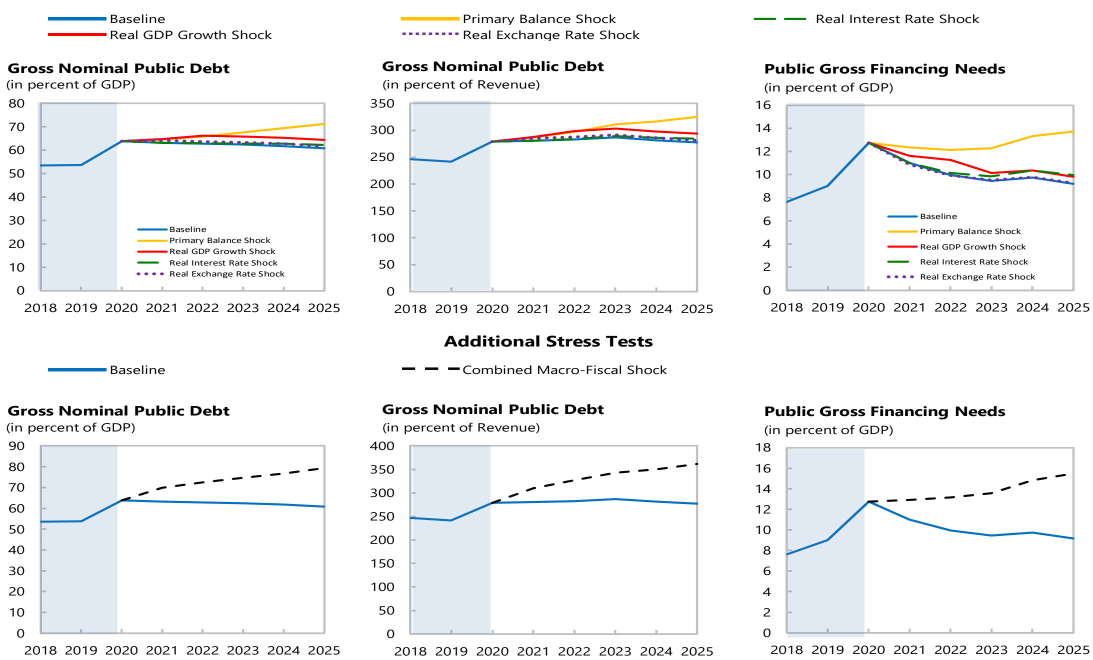
Source: World Bank staff estimations

Figure 11: Mexico Debt Sustainability Analysis Composition of Public Debt



Source: World Bank staff estimations

Figure 12: Mexico Debt Sustainability Analysis Stress Test



Source: World Bank staff estimations

25. **Mexico faces significant external and domestic risks.** Triggered by the pandemic, the global economic landscape has deteriorated drastically, and it is still evolving. There is a high degree of uncertainty as to the duration of the pandemic in different countries, including in Mexico, and to its economic, social, and health ramifications. On the health side, the lack of a vaccine, domestic constraints, and early opening of social and economic activities could translate into a longer period of social distancing policies needed, stubbornly high infection rates, and increases in out-of-pocket health expenditures for affected households, with longer-lasting negative impacts on households' income. On the economic front, there is uncertainty about when the transmission channels of the crisis, e.g., trade, finance, commodity prices (oil chiefly in the case of Mexico) would start to normalize globally, having significant impact on the shape of the recovery. The recovery over 2021-22 could be slower than expected, particularly if the approach toward private sector involvement in some sectors is not adjusted. Moreover, the vulnerabilities represented by PEMEX may be heightened, and further measures to enable financial soundness and sustainability in the state company would be needed to avoid further credit rating downgrades on the company and its impact on the sovereign credit rating. The expected recovery hinges on the containment of the pandemic and on a more favorable external environment. A stronger impact of the economic crisis on employment and labor incomes, formal and especially informal, could further undermine the economy through tamed consumption, and could hamper the recovery as the costs of formal jobs re-matching may be high, affecting productivity growth. A deterioration of the fiscal position due the combination of the above factors may raise financing costs for the sovereign, as capital markets are already penalizing Mexico's debt, with an EMBIG bond spread (that includes PEMEX) above countries in the same rating category.

26. **There are also important mitigation factors.** The flexible exchange rate will continue to be the first line of defense against external shocks. Moreover, the independent Central Bank of Mexico still has monetary policy and balance-sheet space to respond in the context of the volatile global capital markets. The financial sector entered the crisis well-capitalized, but it will require close monitoring. Mexico has a strong track record of responsible fiscal policy, which has been maintained under the current administration, even as it may been too tight in the context of the shock. The authorities' rationale is that they are also striking a balance between short-term larger fiscal imbalances with a sustainable fiscal framework over the medium term, given that risks remain on the downside in 2021 and additional fiscal support to the economy may be needed. On the upside, the USMCA agreement (that started on July 1, 2020) will reduce one source of uncertainty and help support future investment and export demand, which could further strengthen Mexico's recovery if the U.S rebound in 2021 remains strong.

27. **The macroeconomic policy framework is deemed adequate for this operation and public debt is sustainable despite the deterioration of global and domestic economic conditions.** The country is judiciously using its monetary policy and the Central Bank's balance-sheet space to respond in the context of the volatile global capital markets. Mexico has an independent Central Bank and a flexible exchange rate regime that has been the first line of defense against the external shocks experienced over the last months. The financial sector entered the crisis well-capitalized and the authorities took critical measures to ensure stability and liquidity. The fiscal response has been more limited, perhaps tight for the situation, but targeted to support vulnerable households, workers, and MSMEs. Public debt remains sustainable (and relatively resilient to different shocks) despite the large one-off increase expected for 2020.

2.3. IMF RELATIONS

28. **On November 2, 2020, the Executive Board of the International Monetary Fund (IMF) had the Article IV consultation with Mexico.** On November 18, 2020, it also had the review of the two-year precautionary FCL arrangement approved on November 22,2019 for SDR 44.6 billion (about US$61 billion). This is a successor arrangement to the 2017 FCL to an initial amount equivalent to SDR 62.4 billion (about US$88 billion) that was reduced in November 2018 to SDR 53.5 billion (about US$74 billion) with a subsequent reduction in the current arrangement at the request of the Mexican authorities. The IMF and the World Bank (WB) maintain close collaboration on macroeconomic and structural issues, which has been further intensified.

3. GOVERNMENT PROGRAM

29. **The authorities have implemented a sequenced policy response to mitigate the impact of the crisis and support economic recovery.** Aside from the health response, the authorities have launched a set of monetary, financial, fiscal, economic and social measures to mitigate the impact of the crisis.

30. **On the monetary-financial sector side, the response was geared to enable liquidity in the financial system and support to SMEs**. The Central Bank had a quick response with a number of instruments that included lowering the policy rate, establishing a swap-line with the U.S. Federal Reserve, and enabling more liquidity in the system through lower reserve requirements and lower rates to access its liquidity facility; and more recently through the establishment of a number additional credit facilities. In order to support MSMEs and individuals who face difficulties in paying their existing loans during the pandemic, the Mexican Government (through the banking regulator), implemented a temporary and time-bound measure to defer loan principle and interest payments for up to 6 months. The temporary special accounting criteria applies to consumer, corporate and mortgage loans that were current in their payments as of February 28th, 2020. Financial institutions will continue to classify the loans as current for up to six months even without payment and will not report the payment deferral as late payment to the credit reporting systems.

31. **The fiscal response has been limited, even tight for the situation.** The authorities' rationale is that they are also striking a balance between short-term larger fiscal imbalances with a sustainable fiscal framework over the medium term, given that risks remain on the down-side in 2021 and additional fiscal space needs to be preserved in case it is needed in the months ahead. Nonetheless, the limited support has been targeted to vulnerable households, workers, and MSMEs. They included support for vulnerable groups of the population, including protection of public spending for health services and for priority social programs. The authorities expanded coverage and advanced payments of social pensions and disability benefits for more than 8+ million beneficiaries (and the households where they live in)[7] to make the necessary purchases up front and smooth their consumption. Similarly, they expanded support to the program of children of working mothers to cushion the shock on this vulnerable group. Relief programs also included micro credit programs to support formal MSMEs, formal employees, and independent formal workers. To support the informal sector, they established and expanded credit programs to

[7] For instance, an estimated 4.9 million informal workers, reside in households that includes a beneficiary of social pensions for elderly.

support informal micro firms and individual informal entrepreneurs. Moreover, the 2019-2024 National Development Plan and the specific sectoral plans that implement it, had already proposed a reorientation of public spending toward new and expanded social programs that have been fully deployed during the crisis. Additionally, fiscal authorities mandated a more rapid VAT refund to firms and a faster timetable of payments to government suppliers and a deferent in the payment of the personal income tax was also established. The authorities are prioritizing their limited capital spending to on-going (initiated) infrastructure projects and short-cycle completion projects (including at the sub-national level), in order to enable a faster use of resources and higher fiscal multipliers.

Box 1: The authorities' economic response to the pandemic up to November 15, 2020

Monetary/Financial:

- Banco de México reduced the monetary policy rate by 225 bp to 5.0 percent (in subsequent steps announced in February, March, April, May and June 2020).
- The foreign exchange commission announced an increase in the maximum amount of Non-Deliverable Forward Exchange program (NDF) from US$20bn to US$30bn.
- A temporary U.S. dollar liquidity arrangement (known as "swap line") from the U.S. Federal Reserve with Central Bank for an amount of USD 60 billion was established on March 19, 2020. Banco de México has conducted several US dollar auctions among credit institutions since.
- Banco de México reduced by 50 billion pesos the amount of the Monetary Regulation Deposit (DRM) held by commercial and development banks. Currently, the total DRM amounts to approximately 320 billion pesos.
- Central Bank reduced the cost of its Ordinary Additional Liquidity Facility that offers liquidity to commercial banks via secured credits or repos.
- The National Commission for Banking and Securities (CNBV) issued, on a temporary basis, special accounting criteria for the partial or total deferral of principal and/or interest payments for up to 4 months, with the possibility of extending it to an additional 2 months, for consumer, housing and commercial credit, for customers whose source of payment is affected by the crisis. Only borrowers that were current in their payments as of February 28th are eligible.
- The National Insurance Commission allows temporary regulatory facilities so that the Insurance Institutions can extend the terms for the payment of premiums and include in their policies risks derived from the pandemic.
- The Ministry of Finance is accelerating and ramping up its financial access agenda with focus on establishing instruments for improved access (payment system, Fintechs, unique ID system).

Fiscal/social:

- Budgetary resources were made available to ensure that the Ministry of Health has sufficient resources and does not face red tape, in the purchase of medical supplies and equipment.
- The Government made advance payments for the social pension programs for the elderly and for people with disabilities for the May-June and September-October periods in March-April and July-August periods, respectively.
- The Government has continued the coverage expansion of social programs such as social pension program for people with disabilities and the program of support to children with working mothers.
- The Government has established a new microcredit program called the financial support

(credit) to microenterprises program and scaled-up the Microcredits for Welfare Program (known as *Tandas para el Bienestar*). These programs will mitigate liquidity constraints faced by MSMEs and independent workers.
- Procurement processes and payments to suppliers are being accelerated.
- Value added tax (VAT) refunds to the private sector have been accelerated.
- Resources from a large number of off-budget vehicles have been clawed back and these vehicles have been closed. These resources will be deployed to the budget.
- A significant number of additional medical personnel is being hired.
- The Instituto del Fondo Nacional de la Vivienda para los Trabajadores (INFONAVIT) has established an emergency fund to cover affected workers' mortgages for up to three months in case of job loss and has increased flexibility to the Payment Protection Fund to protect affected workers' homes.
- The Instituto del Fondo Nacional para el Consumo de los Trabajadores (FONACOT) has established a concessional credit program to formal workers to allow consumption smoothing

Other economic:
- Development Banks made available loans and guarantee facilities to support SME and the most affected sectors of the economy.
- Measures have been implemented to ensure business continuity of banking services.

32. **The authorities' effort is now progressively moving towards designing and implementing reforms to support a more resilient and sustainable economic recovery over the medium term.** The authorities are placing urgency in establishing instruments that enable credit for working capital and new investments to spur economic reactivation. The Government has developed lending facilities to provide working capital for firms, with a focus on SMEs and all firms in the most affected sectors for a quick recovery. In times of "social distancing", and in the post-pandemic new normal, MSMEs and other firms will require further access to financial services and electronic means for making payments, receiving credit, and settling commercial transactions. In this context, reforms to enable digital finance will continue. Given the pre-existing shortcomings in access to finance to MSMEs and individuals in Mexico, the authorities have launched, are accelerating, and ramping up a new and ambitious financial inclusion policy. The authorities are also placing great importance in addressing structural challenges and institutional weaknesses. For example, emphasis has been placed on reducing the costs of firms' entry, operation, and exit, which in the past have undermined competition, job creation, and productivity growth in general.

33. **The authorities are also looking at the sustainability angle of the recovery efforts.** The authorities are looking at fiscal institutions and medium-term fiscal frameworks to make them more resilient to future shocks while minding fiscal and environmental sustainability. This includes reforms to strengthen the pension system, budget prioritization— including considering climate change issues, resilience of investments, and transparency and accountability, among other.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

34. **The current juncture and the recovery period ahead present a good opportunity to re-think policies conducive to growth, inclusion and sustainability.** Economic growth in Mexico has been low over the last three decades, and the country's income per capita has not converged to that of higher-income economies. In fact, per capita income is likely to continue to be below its 2008 level in the next few years. The SCD explained the low growth and limited poverty reduction experienced over the last decades, pointing toward a number of constrains. Among them, it underscored constraints in product and factor markets and public resource allocation and institutional policy coordination. The SCD also highlighted fiscal and environmental sustainability challenges that would hamper development and poverty reduction ahead. In this context, it is critical to tackle potential bottlenecks to the recovery that have also shown in the past to deter broad based growth and sustainability.

35. **As economic activity slowly starts to resume in the second half of 2020, the recovery is expected to be difficult, long, complex, and with a high level of uncertainty as the pandemic could resurge**. To help with a stronger, more resilient and sustainable recovery, it is important to complement fiscal, financial, and monetary policy efforts with measures to address structural challenges that would also help the private sector rebound and the public sector to provide critical public goods in a better way. Those policy and institutional reforms need to be in place now, so they can be helpful to the economic agents and public institutions over the long recovery phase. In this context, the development objective of this operation is to facilitate resilience and sustainability.

36. **The first pillar aims to support the authorities' program of facilitating economic resilience**. As bridge to the recovery phase, the operation supports measures to provide credit to SMEs, including in the most affected sectors by the pandemic, to facilitate their restructuring and economic reactivation. It also supports important policies to continue fostering digital finance, which has been critical in times of social distancing and it is becoming essential for the new normal of the economy. The operation supports reforms to reduce regulatory costs for firms and improve their enforcement, which remain challenging in Mexico, deterring entry and firms' growth and job creation. They represent large hidden taxes for firms at entry and specially during their regular operation, particularly for SMEs that employ the lion's share of workers and firms in the ***poorer states in the south of the country***. The reforms supported create a risk-based system for inspections, aimed at reducing their frequency, improving their targeting, and reducing costs of operation for firms. The reforms also include a new system of government-to-business on-line services (G2B). The aim is to reduce compliance costs (including in times of social distancing) while cutting opportunities for misbehavior in person-to-person interactions. The reforms also include dealing with the large stock of regulation and red tape piled up at the sub-national level over the years, by implementing an institutional process for review and removal of regulations that are no-longer adequate or have overlaps with and undermine the effectiveness of other regulations. These reforms also contain strong institutional building features to enhance transparency and accountability and to reduce uncertainty stemming from enforcement agencies.

37. **The second pillar supports the authorities' efforts to support fiscal and environmental sustainability.** The economic recovery represents an opportunity for the country to steer its policies and economy towards a more environmentally sustainable and climate resilient path. In any country, one of those mechanisms is to have a more climate-change conscious use of public budget resources. The reforms supported include the strengthening of climate change budget allocation tagging, which can have significant effects in terms of helping to address this challenge by enabling better prioritization and monitoring of climate change spending over the medium and long terms. It also supports the establishment of a new framework and ***institutional process*** to issue Sustainable Development Goal (SDG) Sovereign Bonds, whose proceeds are linked to sustainable expenditures in support of the fulfillment of the most pressing SDGs, particularly those related to climate action. Political opposition and social unrest have been observed in Latin American countries where low levels of pension benefits (low replacement rates) and limited inclusion in the pension system undermine public credibility of the social protection system as a whole, also placing pressures on public finances to fill gaps. The operation supports the authorities' pensions reforms that include a gradual increase in contributions to increase the currently expected low replacement rates for pensioners and enable long term sustainability to the system. At the same time, it enables an expansion of access for pensioners by reducing the minimum number of contributions, with a design that does not generate additional fiscal costs.

38. **The design of this DPF considers lessons learned from prior engagements through DPFs in Mexico.** Given its political and economic context, the country has adopted and implemented reforms in waves. A stand-alone DPF provides the needed flexibility for supporting reforms in a complex country context. Experience also shows that DPFs should also be accompanied by a broader program of technical and analytical tools to support implementation of the wider reform agenda and respond to the country's needs and demands. Technical assistance and analytical work providing the analytical underpinnings for this operation has been performed over the recent past. Complementarity between engagements has also shown to be important in the past. This operation complements the authorities' reforms and efforts supported under the Financial Access DPF approved by the World Bank Board in May 2020 and a parallel DPF focused on environmental sustainability and urban resilience reforms, all critical components to face the current situation and future challenging recovery.

39. **This DPF also considers several aspects related to crisis response support, in full alignment and without losing sight of the medium-term structural reform objectives of the CPF.** This DPF is aligned with the strategic framework of the WBG's COVID-19 crisis response outlined in the Approach Paper (AP), specifically with its pillars 3 and 4 at all three stages. Policies supported by this operation are also fully aligned with the objectives set in the CPF discussed by the Board of Executive Directors in February 2020, specifically with its objectives 1, 2, 3 and 7.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Facilitating economic resilience

Prior Action #1. *The Borrower has implemented policies to reduce the regulatory costs for businesses while enhancing public sector accountability by: (i) enacting a law to reduce unnecessary inspections and simplify inspection procedures (Ley de Fomento a la Confianza Ciudadana); and (ii) creating a national registry of inspectors (Registro Nacional de Visitas Domiciliarias – RENAVID); as evidenced by Ley de Fomento a la Confianza Ciudadana published in the Diario Oficial (DOF) on January 20th, 2020 and Lineamientos para establecer las bases de operación del Registro Nacional de Visitas Domiciliarias de los Sujetos Obligados de la Administración Pública Federal published in the DOF on February 19th, 2020.*

40. **Rationale.** Regulatory costs remain very high in Mexico, costing several points of GDP annually by some calculations, and they can undermine the economic recovery. They represent a very large hidden tax for firms at entry, and especially during their regular operation. Aside from the monetary costs for firms, the uneven enforcement of regulation creates uncertainty, which could hamper the recovery. These costs are particularly significant for MSMEs, which provide more than 70 percent of formal employment (and more than 95 percent of total employment). While these costs are high across the country, they are a massive bottleneck ***in the south of the country***. For example, commercial inspections of firms are too frequent and burdensome, deterring new entry and growth of existing firms. This also hampers job creation, which is critical to the recovery. Firms highlight that inspections are carried out without properly following regulations, and sometimes with misbehavior from inspectors.[8] The country does not have a consolidated registry of inspectors at the municipal, state and federal levels, adding yet another layer of uncertainty and personal discretion to the process.

41. **Substance of the prior action.** The reforms taken create a risk-based framework for inspections, aimed at reducing costs of operation for firms, while enhancing transparency and accountability of these regulation enforcement institutions. Under the new system, businesses and citizens will declare their compliance with current regulations; and based on this information, authorities at the municipal, state and federal levels[9], could only conduct inspections of registered businesses if they have a strong-basis under a new risk-based approach. The reforms also include important ***institutional*** building features. They encompass a formal complaint mechanism, if citizens and firms believe the inspection was not necessary or if any abuse was committed. Moreover, an online and publicly available registry of authorized inspectors was created to reduce local authorities' discretion and increase transparency and accountability.

[8] INEGI. 2016. Encuesta Nacional de Calidad Regulatoria e Impacto Gubernamental en Empresas (ENCRIGE) available at: https://www.inegi.org.mx/contenidos/programas/encrige/2016/doc/presentacion.pdf

[9] Municipal and State authorities are independent under the Mexican Constitution. They can adhere to the *Ley de Fomento a la Confianza Ciudadana* by singing an agreement with CONAMER. Mexico City signed such an agreement on February 20th 2020: *https://adip.cdmx.gob.mx/comunicacion/nota/convenio-marco-de-coordinacion-entre-la-comision-nacional-de-mejora-regulatoria-y-la-agencia-digital-de-innovacion-publicael-convenio-permitira-la-interoperabilidad-de-los-sistemas-de-ambas-dependencias-en-materia-de-responsabilidad-social-mercantil-facil*

Prior Action #2. *The Borrower has regulated the creation of an electronic platform (Expediente para Trámites y Servicios) to enable subnational/local government authorities to process more easily business services digitally while reducing the number of complex procedures; as evidenced by Lineamientos para establecer las bases de operación del Expediente para Trámites y Servicios published in the DOF on July 13th, 2020.*

42. **Rationale.** Entry costs in Mexico remain high, at a time they should be minimal to encourage new entrepreneurs into the market. Person to person interactions often translate in additional bribe opportunities, further increasing barriers to entry and heightening regular costs of operation. Citizen and business trust are low in the country, due to this type of ***institutional*** shortcomings. The Mexico SCD showed how these additional regulatory costs and red tape, have a negative effect on firms' productivity growth and job creation, which will be essential for a more resilient recovery. Moreover, they tend to affect more the ***poorer states in the south***, where the share of these costs as percentage of firms' economic activity is the highest.

43. **Substance of the prior action.** To reduce costs at entry (and through the firms' operation), the authorities reformed the system of government-to-business services (G2B), creating an electronic platform (*Expediente para Trámites y Servicios*) to enable firms and subnational/local government authorities to process more easily business services digitally while reducing red tape. The aim is to reduce compliance costs while ***cutting institutionalized opportunities for misbehavior*** in person-to-person interactions, by using an online tool that allows the public to review in real-time all the procedures and documents needed to conduct a particular business regulatory process and upload documentation into the platform to avoid presenting it again to different authorities (e.g., business licensing, permits, among many other).

Prior Action #3. *To reduce regulatory costs for firms and to foster more competition at the subnational level: (i) the Borrower has approved implementing regulation to the General Law on Better Regulation; and (ii) 25 states and Mexico City have adopted local laws in line with the National System for Regulatory Governance (SINAGER); as evidenced by the issuance of the National Strategy for Regulatory Improvement*[10] *published in the Diario Oficial (DOF) on August 30th, 2019; and the adoption by 26 local regulatory reform laws*[11]*.*

44. **Rationale.** Regulatory compliance and red tape costs are also high at the sub-national level. These costs tend to be higher as a proportion of the firms' income in the ***poorer states in the south of country.*** Moreover, as shown by the Mexico's SCD they stifle competition in local markets, with large negative impact on firms' productivity, job creation and poverty reduction. Part of the issue was that the regulatory apparatus and ***its institutions*** did not have a governance system and a mechanism that could systematically clean-up or clear out unnecessary and outdated regulation, particularly at the sub-national level. The lack of this mechanism boosted the pilling-up of unnecessary regulation, procedures and red tape for businesses, constantly increasing compliance costs for the private sector. For example, a recent nation-wide application of the Markets and Competition Policy Assessment Tool, led by the National

[10] http://dof.gob.mx/nota_detalle.php?codigo=5570896&fecha=30/08/2019

[11] Aguascalientes, Campeche, Colima, Chiapas, Chihuahua, Ciudad de México, Durango, Guanajuato, Hidalgo, Jalisco, Estado de México, Michoacán, Morelos, Nayarit, Nuevo Leon, Oaxaca, Puebla, Querétaro, Quintana Roo, San Luis Potosí, Sinaola, Sonora, Tabasco, Veracruz, Yucatan, and Zacatecas

Commission for Regulatory Improvement (CONAMER) with support of the WBG, identified 2,417 anticompetitive restrictions at the state and municipal level in three priority sectors. The negative effects of such distortions only erode the possibility of a more rapid recovery of firms' and employment growth.

45. **Substance of the prior action.** The policies supported are essential to implement Law for Better Regulation (LGMR, for its acronym in Spanish). This law established a nation-wide policy for better regulation, and mandates subnational governments (32 states and more than 2,400 municipalities) to implement four regulatory review tools, as part of a new SINAGER. Under the new system enabled by the authorities' implementation policies, all sub-national governments must undertake an ***institutionalized review*** (and clean-up) program every year, and set a calendar of amendments to regulation and administrative procedures to CONAMER, applying a process to eliminate regulatory barriers to an efficient market functioning.

46. **Expected results for prior actions #1, #2, and #3.** A significant reduction in the average compliance costs is expected due to implementation of these reforms. The reduction is expected to grow thereafter. Critically, and beyond the timeframe for the evaluation of this DPF, a more transparent inspection system, cleaned-up regulation at the sub-national level, and a better G2B service system can be expected to reduce further costs to firms, reduce uncertainty, and provide a more leveled playing field for MSMEs, all to foster new jobs and a more resilient medium term economic recovery.

Prior action #4. *The Borrower's Central Bank established (or expanded) a number of facilities to establish liquidity conditions for banks to support MSMEs, including: (i) a financing facility for commercial and development banks to support channeling financing to MSMEs; (ii) a financing facility for commercial banks with corporate loans as a collateral to support channeling financing to MSMEs; (iii) a facility to repurchase government and corporate securities at longer terms than those of regular open market operations, to provide liquidity to financial institutions holding government debt to give them space to lend; as evidenced by: the Borrower's Central Bank Circulars 20, 30,33,and 35 published in the Official Gazette on June 2, August 19, September 11 and September 28, 2020 respectively; the Borrower's Central Bank Circular 25, 31, 32, 34, and 35 published in the Official Gazette on June 19, August 19, August 27, September 11, and September 28, 2020 respectively; and the Borrower's Central Bank Circular 18, 29, and 35 published in the Official Gazette on May 19, July 23, and September 28, 2020, respectively.*

47. **Rationale.** It is difficult to foresee a solid and sustained recovery after the economic crisis without the oxygen of financial access and a fluid financial intermediation. Yet limited access to finance had been a constraint in Mexico well before the crisis. Only 13 percent of the MSMEs have fluid access to finance[12], even as they generate the lion share of formal employment and more than 50 percent of business income. Moreover, gaps in access among regions for MSMEs and individuals exist in all countries. But ***these gaps (between north and south)*** are larger in Mexico compared to those of LAC and other emerging economies. The difference in borrowing costs between SMEs and large enterprises in Mexico is much higher than that in peer countries (6.4 percentage points versus 1.4 in OECD countries[13]), potentially increasing the costs of MSMEs during the recovery. Credit is also needed to reduce risk of permanent closure of otherwise viable MSMEs, avoid further jobs shedding, enable working capital to kick start the recovery and enable

[12] Family owned informal activities are also affected as only about 5 percent of the poorest individuals (bottom 40 percent of income) borrowed from a financial institution in 2017
[13] OECD Economic Survey of Mexico, 2019

investment capital to foster confidence. In the context, policies to support credit for the recovery and job creation, beyond the immediate liquidity relief for banks, will be critical.

48. Substance of prior action. The Central Bank established two financing facilities for commercial and development banks to strengthen credit channels and foster lending to MSMEs and individuals affected by the crisis. The Central Bank has released resources to provide additional financing at terms of between 18 and 24 months, with a cost equal to the overnight interbank interest target rate, to finance commercial and development banks' new loans to MSMEs. [14] At the same time, the Central Bank has temporarily opened a financing facility for development banks and commercial banks to channel additional financing to MSMEs which will be collateralized by credits of companies. To ensure the proper channeling of funds to MSMEs the regulation established that financial institutions must submit to the Central Bank the proportion of credit operations they assign to MSMEs and individuals as well as the number of companies that benefit from credits. Moreover, it sets clear criteria for company size and caps the maximum amount of lending for each borrower. [15] Irrespectively of how much of those funds are accessed by intermediaries, the existence of such facilities can help ensure that funding is available so viable MSMEs clients continue to have access to loans in case liquidity is further constrained. To complement the above measures and bring more fluidity to the corporate debt market, facilities for repo operations of government securities and long-term corporate debt have also been established.

49. Expected Results. As of December 2021, commercial bank credit to SMEs as a percentage of GDP would at least remain at the same level of the baseline in December 2019. Beyond the timeframe for the evaluation of the results of this DPF, this reform is expected to crowd-in participation of private financial institutions and development banks to provide financial services to MSMEs, particularly in the recovery phase after the crisis.

Prior Action #5. *The Borrower has issued the regulatory framework to authorize Application Programming Interfaces (APIs) that meet security and open source architecture requirements to enable the sharing of open data with the objective of generating greater competition in the financial sector; as evidenced by CNBVs General Dispositions referred to in the Law to Regulate Financial Technology Institutions, published in the Official Gazette dated June 4, 2020.*

50. *Rationale.* The banking sector is concentrated in Mexico – the five largest banks account for close to 70 percent of total bank assets. Open banking is a model that creates disruption and fosters more competition in the sector, reduces costs of intermediation and enables access to products in financial markets through digital Application Programming Interfaces (APIs[16]). The ultimate objective is developing

[14] MSME support operations under this liquidity facility consist of loans, leasing and/or factoring, as well as restructuring or refinancing of current credits with the MSME. Financing is guaranteed through securities that must comply with the same eligibility criteria set for the Ordinary Additional Liquidity Facility (FLAO, for its acronym in Spanish).

[15] The principal amount of these lending operations, as well as the additional amount granted as part of the restructured or refinanced operation with resources derived from these facilities must not exceed MXN 50 million for each MSME.

[16] APIs are a set of defined methods and functions that reduce the complexity of accessing technology systems and automate the interaction between systems and apps in ways that is seamless and unseen to the consumer. APIs are central to encouraging access, innovation and boosting competition, as shown by the most recent experience of FinTech in Latin America. The FinTech Law states that entities required to create APIs shall share three types of data: (i) open data, which are non-confidential; (ii) aggregate data, which are those related to the statistical information of its operations; and, (iii) transactional data, which are those related to the use of financial products and services by a consumer, with his/her previous consent.

more adequate products for users by accessing customers' transactional account data held with banks and other financial service providers in a fully digital format, without posing any risks to data privacy. APIs that provide access to the features of products and services offered by an institution also enable the development of product comparison services thus promoting transparency, competition and financial access. As a result, MSMEs, which are the most affected by the decline in economic activity, would be beneficiaries of this model. Finally, APIs are expected to help financial institutions and regulators enhance efficiencies of compliance related processes serving as an adequate tool to boost regulatory technology (Regtech) and supervisory technology (Suptech).[17]

51. Substance of the prior action. Open banking is another important element of the ecosystem for the FinTech industry that the private sector and the Mexican regulatory authorities have been building in Mexico, many of which have been supported through other World Bank operations[18]. On June 4, 2020 CNBV published the general provisions regarding standardized APIs for open data. CNBV's General Dispositions are applicable to banks and other financial institutions including the new e-money institutions (IFPEs) in relation to open financial data (which involves non-personal data), including information on services offered and access points, for now only automated teller machines (ATMs). The regulation establishes the security mechanisms to access, send and obtain data and establishes clear protocols to follow in case of any cybersecurity incident. In addition, the Central Bank has also published complementary regulation to cover central counterparties and credit reporting systems, taking into consideration open financial data and aggregate data. In this first stage of open banking regulations, the General Dispositions issued by CNBV and the Central Bank establish the technical standards to ensure the sharing of information through APIs, including their design and development standards in accordance with Article 76 of the FinTech Law.[19]

52. ***Expected results.*** It is expected that the number of data suppliers of ATMs Open Data APIs will increase from a baseline of zero in December 2019 to 46 by December 2021. However, beyond the timeframe for the evaluation of the results framework of this DPF and in conjunction to other future actions, this reform is expected to contribute to increased competition and innovation in the financial sector, help reduce the cost of financial intermediation, and support the enhancement of the quality and timeliness of data available to supervisors.

Pillar 2: Supporting fiscal and environmental sustainability

Prior Action #6. *The Borrower, through the Ministry of Finance, has established a strengthened climate change budget tagging in the Federal Budget; as evidenced by the Disposition 307-A-1552 of the 2021 Hacienda Programming and Budgeting Manual published by the Ministry of Finance (SHCP) on August 24, 2020.*

---

[17] For example, a regulator can use APIs to directly access data from a financial institution when needed, instead of following a periodic data reporting protocol. APIs would help regulators in supervising and overseeing the financial sector given the increase in the compliance processes, including anti-money laundering and counter-terrorism financing (AML/CTF).

[18] MX Financial Inclusion DPF - P167674 (approved in June 2019) and MX Financial Access DPF - (P172863 (approved in May 2020).

[19] The CNBV and the National Coordination on Digital Strategy (CEDN), through a multisectoral initiative called Labora Fintech, piloted the Open Banking Standards from the UK in Mexican financial institutions, which led to the standards published.

53. Rationale. The economic recovery represents an opportunity for the country to steer its policies and economy towards a more environmentally sustainable and climate resilient path. Several policies and mechanisms across the economy, including in the energy sector, are needed for the country to achieve its ambitious Nationally Determined Contributions (NDCs). In any country, one of those mechanisms is a more climate-change conscious use of public budget resources. Government public spending represent a quarter of the Mexican economy, yet the relevance to climate change of budget funded activities and their results have been difficult to track. By default, this limited information system deters a more informed policymaking across sectors. In 2013, the country articulated the first version of a climate change budget tool, integrated as an annex to the Federal Expenditure Budget, named Climate-Change Crosscutting Annex (AT-CC in Spanish). However, the AT-CC lacks both technical and systematic criteria to properly tag climate-responsive budget expenditures, as well as policy coherence with the respective climate-change results framework of funded activities[20]. These weaknesses have significatively limited the accountability purpose of the tool and its efficacy as an information platform for policy debate on needs and relevance of budget allocation vis-à-vis climate change objective.

54. Substance of the prior action. The SHCP has established an ***institutional setting and process*** with criteria[21] (which will also include a methodology) for climate-change budget tagging at the budget formulation stage. This budget policy will contribute to greater accountability and effective monitoring of budget allocations to guide decision-making and prompt implementation of the NDCs. The criteria for the new methodology was developed in collaboration with the Secretariat of Environment and Natural Resources (SEMARNAT in Spanish), and with the participation of several development partners. It allows to: (i) identify climate change related expenditures in the budget by program; (ii) establish the linkage to national policy goals; (iii) connect the previous with objectives of the NDCs; (iv) present budget figures using the administrative and economic budget classifiers; and (v) link national and international performance indicators and targets. The criteria also defines the public entities and line ministries that are mandated to use the new methodology in order to identify their specific program actions, associated budget, and expected results in alignment to the Climate Change National Plan (PNCC in Spanish), ensuring the relevance of all activities and budget registered under the AT-CC. The criteria introduced a two-step institutional validation mechanism. The first one is done by the program/activity responsible for preparing the information to submit to SHCP. The second one is conducted by SHCP itself, which will ensure the information submitted by all programs is consistent with budget frameworks and policy goals before integrating the AT-CC.

55. Expected Results: Revamped climate change budget tagging will allow linking the Federal budget allocations identified in the AT-CC to climate change objectives and targets by December 2021, improving transparency and accountability of the budget allocated for the attainment of Nationally Determined Contributions and in support of Mexico's efforts to adapt to growing climate change risks. Beyond the timeframe for the evaluation of this DPF, the climate change budget tagging is expected to provide an institutional decision-making platform to mobilize budget to mitigate and adapt to climate change, improve the resilience of vulnerable populations and inform policy processes to build a more sustainable and resilient society. This in turn would help make the economy more resilient to climate change and natural disasters and transform it towards a greener and more sustainable path. Finally, climate change budget tagging strengthens accountability and transparency on spending on climate change issues, which

[20] (INECC, 2017, pág. 6).
[21] Manual de Programación y Presupuesto 2021. Secretaría de Hacienda y Crédito Público. https:

is critical element for the long-term success of the issuance of SDG sovereign bonds (link to Prior action #7).

Prior Action #7. *The Borrower has established an SDG Sovereign Bonds Framework and institutional process that allows the proceedings of the issuance of sovereign bonds to be linked to eligible projects on sustainable assets and expenditures that support the fulfillment of the most pressing SDGs; as evidenced by the SDG Sovereign Bond Framework published, on February 21, 2020 in SHCP's website .*

56. **Rationale.** To achieve the United Nations' Sustainable Development Goals SDGs[22] committed under the 2030 Agenda for Sustainable Development, Mexico needs to invest billions of dollars each year until 2030 in sustainable and resilient infrastructure to provide the poor and the most vulnerable with basic services. Such investments also include those in support of urgent action to combat climate change and its impacts. International capital markets can play a decisive role in helping the government to finance these investments and support its commitment to transition to a resilient infrastructure and to achieve its climate change international commitments. However, to tap international funds committed to sustainable economic development requires a strong framework and institutional set up to give confidence to investors that the proceedings of SDG sovereign bonds are used to support sustainable projects that would indeed support Mexico's SDGs. Almost two thirds of SDG related infrastructure gaps in Mexico in 2016 were estimated to be linked to climate change related goals[23]. These infrastructure projects are key to achieve Mexico climate change international commitments on mitigation but also essential for adaptation and a to transition to a resilient infrastructure.

57. **Substance of the prior action.** Mexico has established an innovative framework[24] and an institutional process to enable the issuance of SDG sovereign bonds in international markets, the first of its kind in Latin America. The authorities have established all the ***institutional architecture*** to advance the 2030 Agenda, including through the financing side with the SDG sovereign bonds instrument. Under the new institutional setting, the Ministry of Finance will be responsible of the issuance of these bonds and ensure that SDG sovereign bonds comply with both Mexican Law and this new Framework. The SDG sovereign bonds proceeds will be linked to eligible expenditures set out in the Federal Budget that are a combination of both green, resilient and social projects. Critically, the SDG sovereign bonds proceeds will be linked to climate-friendly investments and contribute to the creation of resilient infrastructure and other projects and services, serving the poor in a sustainable and climate change responsive way. The eligible expenditures may be executed by federal and state agencies, local authorities, and households. The "Eligible Sustainable Expenditures" will also be subject to a geospatial eligibility criterion in order to ensure that they are directed toward regions where Mexico's SDG gaps are the greatest, particularly ***in the south of the country***.[25] States in the south experience the greatest climate change risks, and thus the geospatial eligibility criterion that will be applied would directly contribute to reducing observed and

[22] https://sdgs.un.org/goals
[23] https://cdn.gihub.org/outlook/live/countrypages/GIH_Outlook+Flyer_Mexico.pdf
[24]https://www.finanzaspublicas.hacienda.gob.mx/work/models/Finanzas_Publicas/docs/ori/Espanol/SDG/UMS-SDG_Sustainable_Bond_Framework.pdf
[25] This criterion builds off the "priority area" zoning policies of the national authorities with a focus on the "Social Gap Index," to further refine the target populations

anticipated vulnerabilities in that region. [26] All project infrastructure funded under SDG sovereign bonds will also incorporate an environmental sustainability analysis and would address climate change risks. The Framework adheres to the highest standards in terms of external reviews. In particular, Vigeo Eiris[27] has been commissioned to provide, prior to the issuance of bonds, a Second Party Opinion ("SPO") to independently assess the alignment of the Framework with the International Capital Market Association's Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines. The SPO will be made publicly available on the Ministry of Finance's website. It will provide bond investors with an independent assessment of the expected social and environmental benefits of the Eligible Sustainable Expenditures. The Committee of Inclusive and Sustainable Economy ("CISE"), as one of the SDG Specialized Technical Committees, will review the information provided by the Ministry of Finance. The Supreme Audit Institution of the country will also verify use of funds. The United Nations will be involved as an observer to CISE during the evaluation and selection process.

58. **Expected Results.** This action is expected to place Mexico at the forefront in the innovation of sustainable financing instruments, including in the domain of innovative climate finance. On the back of this new framework and process on September 14, 2020 Mexico became the first country in the world to issue a sovereign bond linked to the SDGs in the international capital markets. The issuance of SDG sovereign bonds is expected to expand the investor base by accessing international funds committed to sustainable economic development and climate change.

Prior Action #8: *The Borrower enacted an amendment to the Social Security Law to gradually increase the total contribution rates, with the objective of increasing the replacement rates for pensioners; guaranteeing the system's sustainability; as evidenced by amendments to the Social Security Law and the Law of Savings System for Retirement published in the Official Gazette on December 16, 2020.*

59. **Rationale.** Mexico established a multi-pillar pension system in 1997, moving all non-public sector employees from a pay-as-you-go system with a defined benefit to a system with a defined contribution administered by private agents (AFORE). At the time of the reform, and considering some overly optimistic assumptions, a contribution rate was set at 6.5 percent of the employee's salary (paid in 1.125 pp by the employee, 5.515 pp by the employer and 0.225 pp by the government). This resulted in what now are projected replacement rates in the order of 19 percent (for average incomes). This level of benefit is low by any international standard and does not ensure adequate income protection for the elderly. Political opposition and social unrest have been observed in Latin American countries with low level of pension benefits (i.e., low replacement rates), undermining the public credibility of the social protection system as a whole and placing fiscal pressures. Mexico was heading in that direction. In fact, as the first workers under the 1997 reformed system are slated to become pensioners in the next years, an intense debate began in early 2020 around the adequacy of the pension system in the country. It became clear that low replacement rates from the contributory scheme represented a threat to the well-being of future pensioners and the robustness of the pension system itself. Moreover, negative social

[26] Climate change impacts in the south of the country include changes in the hydrological cycles leading to increasingly heavy rains and strong storms, longer and more frequent droughts, and net decreases in water run-off. These vulnerabilities coupled with low adaptive capacity and sociodemographic features of the affected population are exacerbating inequities in employment, health, and access to food, water and other resources.

[27] An international provider of Environmental, Social & Governance (ESG) research and services for investors and organizations.

repercussions could have promoted additional and significant pressures on public finances to fill gaps down the line.

60. Substance of the prior action. The reform to the pension system supported increases the contribution from 6.5 percent of the employee's salary to 15 percent. The increase will be statutorily contributed by the employer (understanding that labor supply and demand elasticities determine at the end who bears the burden of the tax). The increase in contribution will begin in 2023 and will be gradual. Although the increase in contributions represents an increase in non-wage labor costs and could potentially affect the incentives of formalization, there are several mitigating factors to that potential effect. The first mitigant is the potential effect that comes from prior action 9, which will in fact help reduce one barrier to formalization (see below). The second mitigating factor is that the increased contributions are purely individual savings (wholly owned by workers) and, as such, diminish the distortions that could otherwise arise from a contribution increase to a non-actuarially fair or redistributive social insurance plan.[28] The third, is that the probability that these measures incentivize informality is much lower in Mexico than in other countries, as its statutory minimum wage is still very low and not binding (even accounting for substantial increases since 2019). The fourth is that not only are workers in Mexico more likely to perceive their savings in AFORE accounts as deferred wages because of the points above, but also this is likely to be reinforced by the access they have to these savings in times of economic distress.[29] And finally, and related to the previous factors, empirical evidence from international experience shows that informality is the result of numerous factors and not always necessarily directly linked formal labor costs. As highlighted in the Mexico SCD, there are multiple and powerful obstacles to formalization in Mexico that weigh as much and even more than payroll contributions and other taxes on informality levels.[30] Very critically, this reform will also help to reduce the risk of added fiscal burdens to top up minimum benefits in the future.

***Prior Action #9:** The Borrower enacted an amendment to the Social Security Law that reduces the contribution weeks required to access minimum pension, increasing the number of pensioners; as evidenced by amendments to the Social Security Law and the Law of Savings System for Retirement published in the Official Gazette on December 16, 2020.*

61. Rationale. The reform to the pensions system of the mid-1990s, was also expected to leave a larger number of workers without pension benefits given the very high threshold of minimum number of contributions that it required (1,250 weeks). According to official estimates, less than 30 percent of the non-public sector labor force is expected be eligible for a contributory pension benefit under current parameters. Over the last years, to partly remedy that situation and help in securing adequate income protection for the elderly, the Government started the adoption of a non-contributory program of minimum pension to cover a large number of the population who would otherwise not receive pension benefits. Yet, the more expensive budget financed non-contributory schemes were bound to be

[28] After Chile, Mexico has the highest element of mandated private commitments in its wedge.
[29] A provision to give limited access was only just passed in Chile this summer, while it has been in place in Mexico at least since 2008/09 to give people some liquidity during crisis.
[30] They include: (i) the high costs of entry, operation and exit for MSMEs that could be even larger than some taxes in many cases (to some degree addressed in parts of the system by the authorities' policies supported under pillar I of this operation); (ii) large labor rigidities; (iii) issues of trust in public institutions and the added uneven and discretionary scrutiny that being "formal" may represent; (iv) the broader tax system and its enforcement, including beyond payroll taxation; and (v) even parameters of the current pension system that are being reformed, among many other factors.

pressured to be further expanded in scope and benefits over time without these reforms, generating additional fiscal costs.

62. **Substance.** The reform to the pension system supported reduces the minimum number of contributions from 1,250 to 750, with a further gradual increase to reach 1,000 weeks over the next 10 years. The reform would significantly increase the number of minimum pension recipients, expanding the coverage to obtain a minimum pension. The reform allows a lower minimum pension payout to avoid additional fiscal costs. The existing non-contributory minimum pension program would help to provide a minimum floor for those pensioners, which would also reduce pressures on non-contributory budget funded programs over the medium and long terms. Moreover, the threshold of minimum number of contributions is a factor inhibiting formalization. In the context of significant movements of workers between formal and informal jobs (or formal and informal wage reporting), workers are discouraged from contributing if they think they may not reach at the end the high threshold required for a pension annuity in the future.

63. **Expected Results for prior actions #8 and #9:** It is expected that the quantity of beneficiaries eligible for a minimum pension will increase by 300,000 by the end of 2021 and grow fast thereafter. In fact, over the medium term, it is expected that more than 55 percent of the elderly will have access to at least a minimum pension from the current less than 30 percent. Critically, and beyond the timeframe for the evaluation of this DPF, the increase in contributions is expected to more than double the replacement rate for average income groups (from 19 percent to 39, and from 18.3 percent to 37.5 for women). Similarly, women as percent of total beneficiaries of minimum pension is expected to increase from 25 percent in 2019 to 27 percent by the end of 2021. By doing this, these reforms will also likely help reduce structural causes of gender gaps in pensions, as women are relatively more affected than men by the requirement of minimum number of contributions.

Table 3: DPF Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Pillar 1: *Facilitating economic resilience*	
Prior action #1	WBG (2019-20). TA engagement of regulatory issues WBG (2019). Mexico: Systematic Country Diagnostic WBG (2011). “How to Reform Business Inspections: Design, implementations, challenges” OECD (2012). “Inspection reforms: why, how, and with what results”
Prior action #2	WBG (2019-20). TA engagement of regulatory issues WBG (2019). Mexico: Systematic Country Diagnostic WB (2015) “Business regulations and growth.” Chang-Tai Hsieh, and Peter J. Klenow. 2009. “Misallocation and Manufacturing TFP in China and India.” The Quarterly Journal of Economics, Volume 124, Issue 4, November 2009, Pages 1403–1448
Prior action #3	WBG (2019-20). TA engagement of regulatory issues WBG (2019). Mexico: Systematic Country Diagnostic WBG (forthcoming). Country Economic Memorandum of Southern States.

Prior action #4	WBG (2019). Mexico: Systematic Country Diagnostic IMF (2020) “Monetary and Financial Stability During the Coronavirus Outbreak”. WB (2020) “Macroeconomic Policy in the Time of COVID-19: A Primer for Developing Countries”. WB (2020b) Managing the Employment Impacts of the COVID-19 Crisis: Policy Options for Relief and Restructuring” WB (2020e). “Assessing the impact and policy responses in support of private-sector firms in the context of the COVID-19 pandemic.”
Prior action #5	WBG (2018-2020). FIGI TA WBG (2019). Mexico: Systematic Country Diagnostic FSAP World Bank/IMF (March 2017). “Financial Sector Assessment – Mexico” World Bank (Jan 2019) “Achieving Effective Financial Inclusion in Mexico: The Payments Perspective”.
Pillar 2: ***Supporting fiscal and environmental sustainability***	
Prior Action #6	WBG (2019). Mexico: Systematic Country Diagnostic WBG (2019) technical assistance for the climate-change budget tagging methodology designed by the counterpart.
Prior Action #7	WBG (2019). Mexico: Systematic Country Diagnostic WBG (forthcoming). Infrastructure gap in Mexico as part of forthcoming Public Finance review WBG (forthcoming). Country Economic Memorandum of Southern States.
Prior action #8	WBG (2020) TA on pension sustainability WBG (2019). Mexico: Systematic Country Diagnostic
Prior action #9	WBG (2020) TA on pension sustainability WBG (2019). Mexico: Systematic Country Diagnostic

4.3. LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

64. **Despite the crisis, the Country Partnership Framework (CPF) 2020–25 objectives remain as relevant as ever.** The CPF, discussed by the Board of Executive Directors in February 2020, is focused on three broad areas: supporting more rapid and more inclusive growth; strengthening institutions for public finance, service delivery, and economic inclusion; and enabling sustainable infrastructure and climate action. The CPF has seven specific objectives under those broad areas, as follows: (1) foster financial intermediation and inclusion; (2) reduce regulatory and competition barriers to economic growth; (3) enhance the management of public resources; (4) strengthen the institutional capacity to deliver inclusive social services; (5) strengthen the capacity of the social protection system for economic inclusion; (6) provide more inclusive and sustainable infrastructure services; and (7) support the government in reaching its goals on climate change. Despite the shock of the pandemic, and its multiple health, economic and social impacts, reforms and projects conducive to these CPF objectives not only remain relevant, but even more essential to strengthen the country through the crisis and to support a strong recovery.

65. **The pipeline and portfolio of projects under the CPF has experienced some adjustments**. With the objective dealing with the current situation and the need for a strong and better recovery, while at

the same time, advancing some key objectives of the CPF, the pipelines of FY 2020 (4th quarter) and FY 2021 have been prioritizing operations to support needed policy and institutional reforms. These include, the Financial Access DPF (P172863) and the Environmental Sustainability and Urban Development for a more Resilient Recovery (P174000). The former was approved by the Board of Executive Directors in the 4th quarter of FY20, and it was focused on a number of emergency measures, while also fostering reforms on access to credit. The latter, running in parallel to this proposed operation, focuses on medium term pressing challenges on the environment, climate change and resilience of critical urban and housing infrastructure. This proposed operation complements those efforts with a program that supports policies and institutional reforms to facilitate resilience and sustainability. Some investments projects in the pipeline on social infrastructure and transport sectors were slightly delayed for late FY2021 and FY2022. At the same time, and to enable margin for action and a buffer in the exposure envelope, the undisbursed balances of some slow-disbursing non-priority projects were cancelled in agreement with the authorities. These projects were mostly in the legacy portfolio at the sub-national level in infrastructure areas, but they had their development objectives well-advanced or fulfilled.

66. **The proposed operation is fully aligned with the WBG's COVID-19 crisis response outlined in the Approach Paper (AP), but also with the CPF**. The proposed operation is supportive of the WBG's COVID-19 crisis response outlined in the Approach Paper (AP), particularly with pillars 3 (Ensuring sustainable business growth and job creation) and 4 (Strengthening policies, institutions, and investments for re-building better). ***The operation includes inputs from the International Finance Corporation (IFC) on private sector issues***. The policies supported help address selected pre-existing constraints to growth and inclusion identified in the SCD, including: regulatory barriers hampering growth, limited financial access and inclusion, management of resources for fiscal sustainability, and climate change challenges. These same constraints have also become critical bottlenecks in enabling a better recovery. Thus, they are fully aligned with the diagnostic of issues and recommended policies underpinning key objectives set in the CPF, specifically objectives 1, 2, 3 and 7 of the CPF (above highlighted).

67. **Moreover, the program supported is aligned with the WBG Maximizing Finance for Development (MFD) approach.** Upstream policies on reduction of costs for business through less burdensome regulation and access to credit were discussed with IFC with the aim that they can meaningfully help the private sector over the recovery and beyond, while attracting fresh private resources to the economy.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

68. **The Government's reform programs include an open process of consultations.** The approval of laws and regulations, in general, follow months of consultation with public and private sector stakeholders, including financial institutions, private sector associations, academic institutions, and citizens. After the public consultation has been carried out and following publication in the Official Gazette of the Federation, the relevant authority publishes a pronouncement regarding the comments, opinions and proposals received, specifying where appropriate, which of them resulted in adjustments and specifications. These policies reflect the best practices promoted by the Organization for Cooperation and Economic Development (OECD). Moreover, in terms of regulations, CONAMER is the agency responsible for the promotion of the transparent development and implementation of regulatory reform

policies. Prior to submission to CONAMER, the government undertakes specific consultations of proposed regulations with key stakeholders.

69. **There were significant inputs from IFC on private sector issues.** IFC provided inputs and advice on benefits to the private sector stemming from the proposed policies. They particularly focused on the measures supported in the first pillar of the operation, including on reducing business regulation and access to credit for SMEs. Additionally, on the latter, the ***IFC*** has an important portfolio with financial intermediaries to support credit to SME sand also works with the WB on the Fintech policy agenda.

70. **The program supported complements (and it is coordinated with the efforts) of other development partners**. The program complements efforts of the **IADB**, **CAF**, and several bilateral development partners across issues. Together with the Inter-American Development Bank (IADB) and Development Bank of Latin America (CAF), the World Bank supports reforms aimed at reducing barriers, red tape, and the cost of regulations. Together with the ***Foreign, Commonwealth & Development Office of the United Kingdom (FCDO)***, the World Bank supports reforms to reduce regulatory costs for firms and to foster more competition at the subnational level. Finally, together with the ***French Development Agency (AFD)***, the World Bank supports Mexico's efforts on climate change and green finance. The Bank exchanges views and information and collaborates very closely with the ***IMF*** on macroeconomic and structural issues.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

71. **The policy measures supported under this DPF are expected to contribute to support the poor and vulnerable.** Measures aimed at facilitating economic resilience are expected to have positive distributional impacts over the medium term as measures to reduce regulatory costs would enable job creation and thus increased households' income growth. Similarly, measures aimed at supporting fiscal and environmental sustainability are largely expected to have positive impacts on the poor and vulnerable, through higher pension benefits and more socially and environmentally informed public spending. The expected individual impacts of prior actions under the specific pillars are described below and detailed in Annex 5.

72. **Reducing the regulatory costs for businesses and increasing competition are expected to have positive impacts on poor and vulnerable populations through job creation and labor income.** Simplifying business inspection procedures are expected to enhance the business climate and therefore promote private investment with potential positive impacts on job creation. Similarly, a national registry of inspectors is expected to enhance accountability and prevent abusive behaviors. With respect to the creation of an electronic platform for government-to-business services, there are potential medium and long-term benefits to the poor as digital government services are faster, cheaper to provide and less vulnerable to corruption. Measures to improve the regulatory environment and to foster more competition at the subnational level are expected to have positive effects on welfare, including for the poor. The absence of vigorous market competition costs the Mexican economy an estimated 1 percentage point of GDP growth each year, and this negatively affects the country's poorest households by an

estimated 20 percent more than its richest households (OECD, 2015; and Chiquiar and Ramos-Francia, 2009). Increased market concentration usually raises consumer prices, and can lead to lower employment and wages, creating an economy-wide welfare loss, and reducing the relative incomes of households, particularly of the poor. The evidence shows the welfare-enhancing effects of market competition.

73. Efforts to expand credit to MSMEs and make financial products more widely available are also expected to have positive impacts on the poor and vulnerable. Even before the pandemic, lending to MSMEs was already scarce in Mexico. With the onset of the crisis, businesses have been put under immense pressure due to the halt in economic activity. In this context, measures aimed at providing additional access to credit for working capital for MSMEs are expected to protect the poor from more severe economic losses. Moreover, boosting investment in the agricultural sector can allow vulnerable populations to maintain their employment and income and increase productivity in a sector where credit is often scarce. Similarly, open banking, a key element of the ecosystem for the Fintech industry, is expected to make financial products more widely available and allow the development of new services that address the needs of the low-income population. They are expected to increase financial inclusion and have the potential of improving competition, thus reducing costs for the vulnerable population.

74. Measures to advance the implementation of climate change budget expenditure tagging and issuing sovereign bonds aimed at supporting the SDG agenda could potentially lead to welfare improvements in the medium and long run. An adequate methodology to tag climate change expenditure can provide valuable information for the allocation, planning, implementation, evaluation and improvement of budget expenditures and foster positive climate change policy. This in turn can potentially lead to the county´s ability to promote adaptive and resilience enhancing policies that disproportionately benefit the poor. Similarly, while the creation of an SDG Sovereign Bond Framework is not expected to have short-term distributional impacts, it is expected to lead to positive impacts on the poor and vulnerable in the medium to long term if spending to address the most pressing SDGs sufficiently materializes.

75. Finally, measures to reform the pension system are expected to have mixed distributional impacts. On the one hand, the increase in employer contributions rates are expected to lead to higher replacement rates only for a small share of beneficiaries in the long term, while they are likely to exacerbate constraints to formal job creation and could lead employers to reduce wages and lean towards informal employment. On the other hand, measures to extend access to a minimum pension are expected to increase the number of minimum pension recipients and have a positive impact on poverty reduction and inequality.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

76. Prior actions supported by this operation are not expected to have any significant negative effects on the environment, forests and other natural resources. Rather, through tagging budget allocations related to climate change impact and issuance of SDG sovereign bonds for green and resilient social projects, the reforms are expected to bring longer-term positive environmental effects. The Prior Actions under the first pillar are expected to support economic resilience through diverse measures that facilitate cost reductions and access to finance particularly among MSMEs. The second pillar aims at facilitating public sector efforts for fiscal and environmental sustainability. Prior Action #6 on a methodology established to advance the implementation of climate change budget expenditure tagging is expected to lead to longer-term positive effects as it promotes strategic allocation of national budget to support climate change policies and goals to maximize mitigation and adaptation effects. Further, Prior Action #7 on issuance of a Framework for SDG sovereign bonds allows financing of SDG Green, Social or Sustainability Bonds to channel funding to address the most pressing sustainable development needs in regions where the SDG gaps are the greatest.

77. **Mexico has a solid and comprehensive national environmental legislation to promote sustainability and resilience measures supported by this operation.** The legislation was formally developed based on the General Law of Ecological Equilibrium and Environmental Protection (LGEEPA) of 1988. Since then, Mexico has established laws, policies, programs and increasingly lines of credit that set environmental requirements to investments, e.g. in terms of managing environmental impacts and waste, controlling pollution, and addressing material efficiency and climate change. Regarding the latter, the General Climate Change Law of 2012 supports the transition to a competitive, sustainable, and low-carbon economy, reduces the vulnerability of the population and ecosystems, and assigns responsibilities within government. The Government of Mexico has committed to supporting climate change mitigation and adaptation as reflected in its ambitious NDCs[31] under the United Nations Framework Convention on Climate Change (UNFCCC). Overall, adequate laws and regulations are in place at different administrative levels, while their enforcement will benefit of measures as those under Prior Action #1 on simplifying business inspection procedures and improving their transparency and accountability with potential to increase culture of compliance with environmental, health and safety regulations.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

Fiduciary Aspects

78. **The overall integrated fiduciary risk to this operation arising from Mexico's public financial management (PFM), including public procurement system and FOREX control environment is low.** The Mexican Government has introduced a number of reforms in public finances in line with international good practices. More recent reforms were related to public sector accountability, integrity and transparency with the creation of the National Anti-Corruption System, the National Transparency System and the National Auditing System (*Sistema Nacional de Fiscalización*). Additionally, Mexico established accrual accounting, harmonized accounting and budgeting norms across all levels of government and created the National Council of Accounting Harmonization (*Consejo Nacional de Armonización Contable*). The Bank is supporting the Government in reforms related to transparency and accountability efforts to improve the design, effectiveness, and implementation of open government initiatives, public integrity and anticorruption policies and tools.

79. **The analytical underpinnings confirm that the foundations of PFM systems in Mexico are in place.**[32] They are supported by the existing country's legal framework, human resources and technical skills. Reforms include the introduction of internationally recognized good practices, such as the

[31] https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/Mexico%20First/MEXICO%20INDC%2003.30.2015.pdf
[32] Fiscal Transparency Evaluation, IMF, October 2018.

publication of government budget[33] and of the financial statements - the latest four months after the end of the fiscal year. In some areas, however, PFM practices could be improved, such as for example the inclusion of missing assets/liabilities, the creation of a comprehensive framework for the financial governance and oversight of non-financial public corporations, and over PFM system integration.

80. As for external oversight, the Federal Supreme Audit Institution conducts, on a regular basis, a number of performance, financial and compliance audits on federal programs. The annual public accounts of the federal government are prepared and sent to Congress within four months after the end of each fiscal year. The external audit of the annual public accounts is undertaken by the Auditor General's office and submitted to the legislature fourteen months after the end of each fiscal year. Audit reports are comprehensive and there is a system in place to follow up on audit findings and recommendations. The results of audits by the Auditor General's office are reviewed and assessed by designated Committees appointed by Congress (*Comisión de Vigilancia de la Auditoría Superior de la Cámara de Diputados and Comisión de Presupuesto y Cuenta Pública de la Cámara de Diputados*) and made public in the Annual Audit Report on the Federal Public Accounts.

Disbursement and Audit

81. Disbursement arrangements. Once the DPF becomes effective and the Borrower complies with any withdrawal tranche release conditions, following the Borrower's request, the WBG will deposit the funds into an account denominated in US dollars owned by the Central Bank (Banco de México) for subsequent credit into the account of the National Treasury (Tesorería de la Federación). The WBG will notify the Borrower three days before making the deposit. The MoF will provide the WBG with a written confirmation of the transaction and accreditation in the budget within thirty days after the funds are disbursed by the WBG that include: (a) the exact sum received into the account; (b) the details of the account to which the local currency equivalent of the Loan proceeds will be credited; (c) the record that an equivalent amount has been accounted for in the Borrower's budget management systems; and (d) the statement of receipts and disbursement of the bank account at Central Bank.

82. The FOREX control environment into which the DPF proceeds would flow has been reviewed as part of the assessment. The Financial Management (FM) assessment was based on the experience of Mexico managing DPFs financed by the WBG, the Bank’s analysis of project flow of funds, and the review of the audited annual report of Banco de México from 2018 and 2019 with clean opinions under standards aligned with International Financial Reporting Standards (IFRS). The assessment reviewed, from a fiduciary point of view, the control environment, procedures, and regulations governing this WBG-supported operation to identify risks and related mitigation measures are needed. No additional measures have been deemed necessary for this operation.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

83. The SHCP will be responsible for collecting the data necessary and for monitoring the indicators. The SHCP, in close coordination with the Central Bank, and other authorities, will take the lead in

[33] Included as part of government budget transparency initiative at *www.transparenciapresupuestaria.gob.mx*. Mexico is part of the Global Initiative of Fiscal Transparency (GIFT) and Open Fiscal Data Package.

monitoring progress and implementation of this operation, with ongoing support from the WB. The results indicators selected to monitor and evaluate implementation progress and the achievement of program outcomes will be monitored by the institution that takes the coordination lead for the respective prior actions. While most of the indicators are new and will be collected for the monitoring of this operation, some of the indicators selected are already collected and monitored by the associated institution. The results matrix for the proposed operation can be found below in Annex 1.

84. Grievance Redress. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the WB's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the WB Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

85. The overall level of risk for the proposed operation is assessed as substantial. The risk ratings are included in the table below. The pandemic has brought multiple shocks to emerging economies. Triggered by the pandemic, the global economic landscape has deteriorated drastically, and it is still evolving. There is a high degree of uncertainty as to the duration of the pandemic in different countries, including in Mexico, and to its economic, social, and health ramifications in each economy.

86. In this context, Mexico, like most emerging economies, faces macroeconomic risks. There is uncertainty about when the transmission channels of the crisis, e.g., trade, finance, commodity prices, and the domestic supply side measures, would fully normalize and stabilize globally. Capital markets may increase their volatility, hampering access to emerging economies at reasonable rates, including Mexico. The vulnerabilities represented by PEMEX may be heightened and further measures to enable financial soundness and sustainability in the state company would be needed to avoid further credit rating downgrades on the company and its impact on the sovereign credit rating. The medium term, including 2021-2022, will be challenging on the fiscal side. With a negative output gap widening, eroded fiscal buffers, and growing spending pressures—including for higher infrastructure investment to support growth—further fiscal space will be needed. This space will likely need to come from a needed tax reform. Policies that are not conducive to private sector investment, including in key sectors such as energy (e.g., electricity) could also impact the overall investment climate. The impact of the crisis on employment and poverty could undermine the recovery through tamed consumption and high costs of formal jobs re-matching dragging productivity. Moreover, education and health impacts may also hamper longer-term growth prospects.

87. **There are also important mitigation factors.** The flexible exchange rate will continue to be the first line of defense against external shocks. Moreover, the independent Central Bank still has monetary policy and balance-sheet space to respond in the context of the volatile global capital markets. While it will require close monitoring, the financial sector entered the crisis well-capitalized and the authorities have enabled financial stability and liquidity measures timely. Mexico has a strong track record of responsible fiscal policy, which has been maintained under the current administration. On the upside, the USMCA agreement (that started on July 1, 2020) will reduce one source of uncertainty and help support future investment and export demand, which could further strengthen Mexico's recovery if the U.S rebound in 2021 remains strong.

88. **Other risks stemming from the health side of the crisis are also Substantial.** There is a high degree of uncertainty as to the duration of the pandemic in different countries, including in Mexico, and to its economic, social, and health ramifications. The lack of a vaccine, domestic constraints, and early opening of the social and economic activity could translate into a longer period of social distancing policies needed, with stubbornly high infection rates, further social and economic effects, and increases in out-of-pocket health expenditures for affected households. One risk mitigating factor is that Mexico was able to rapidly scale up its hospital capacity, intensive care (with ventilators beds), and other required treatment equipment. This has kept hospital occupation at manageable rates.

Table 4: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Moderate
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Low
7. Environment and Social	Moderate
8. Stakeholders	Moderate
9. Other	Substantial
Overall	Substantial

.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions	Results		
	Indicator Name	**Baseline**	**Target**
Pillar 1: Facilitating economic resilience			
Prior Action #1. The Borrower has implemented policies to reduce the regulatory costs for businesses while enhancing public sector accountability by: (i) enacting a law to reduce unnecessary inspections and simplify inspection procedures (Ley de Fomento a la Confianza Ciudadana); and (ii) creating a national registry of inspectors (Registro Nacional de Visitas Domiciliarias – RENAVID); as evidenced by Ley de Fomento a la Confianza Ciudadana published in the Diario Oficial (DOF) on January 20th, 2020[34] and Lineamientos para establecer las bases de operación del Registro Nacional de Visitas Domiciliarias de los Sujetos Obligados de la Administración Pública Federal published in the DOF on February 19th, 2020[35].	Reduction in regulatory cost percentage of 2019)	0% (Dec. 2019)	9% (Dec. 2021)
Prior Action #2. The Borrower has regulated the creation of an electronic platform (Expediente para Trámites y Servicios) to enable subnational/local government authorities to process more easily business services digitally while reducing the number of complex procedures; as evidenced by Lineamientos para establecer las bases de operación del Expediente para Trámites y Servicios published in the DOF on July 13th, 2020[36].			
Prior Action #3. To reduce regulatory costs for firms and to foster more competition at the subnational level: (i) the Borrower has approved implementing regulation to the General Law on Better Regulation; and (ii) 25 states and Mexico City have adopted local laws in line with the National System for Regulatory Governance (SINAGER); as evidenced by the issuance of the			

[34] https://www.dof.gob.mx/nota_detalle.php?codigo=5584368&fecha=20/01/2020
[35] https://www.dof.gob.mx/nota_detalle.php?codigo=5586900&fecha=19/02/2020
[36] http://dof.gob.mx/nota_detalle.php?codigo=5596610&fecha=13/07/2020

Prior actions	Results		
National Strategy for Regulatory Improvement[37] published in the Diario Oficial (DOF) on August 30th, 2019; and the adoption by 26 local regulatory reform laws[38].			
Prior action #4. The Borrower's Central Bank established (or expanded) a number of facilities to establish liquidity conditions for banks to support MSMEs, including: (i) a financing facility for commercial and development banks to support channeling financing to MSMEs; (ii) a financing facility for commercial banks with corporate loans as a collateral to support channeling financing to MSMEs; (iii) a facility to repurchase government and corporate securities at longer terms than those of regular open market operations, to provide liquidity to financial institutions holding government debt to give them space to lend; as evidenced by: the Borrower's Central Bank Circulars 20, 30,33,and 35[39] published in the Official Gazette on June 2, August 19, September 11 and September 28, 2020 respectively; the Borrower's Central Bank Circular 25, 31, 32, 34, and 35[40] published in the Official Gazette on June 19, August 19, August 27, September 11, and September 28, 2020 respectively; and the Borrower's Central Bank Circular 18, 29, and 35[41] published in the Official Gazette on May 19, July 23, and September 28, 2020, respectively.	Commercial bank credit to SMEs as a percentage of GDP	2.64% (Dec. 2019)	Same as 2019 baseline (Dec. 2021)
Prior Action #5. The Borrower has issued the regulatory framework to authorize Application Programming Interfaces (APIs) that meet security and open source architecture requirements to enable the sharing of open data with the objective of generating greater competition in the financial sector; as evidenced by CNBVs General Dispositions referred to in the Law to Regulate Financial Technology Institutions[42], published in the Official Gazette dated June 4, 2020.	Number of data suppliers of Open Data APIs	Zero (Dec. 2019)	46 (Dec. 2021)

[37] http://dof.gob.mx/nota_detalle.php?codigo=5570896&fecha=30/08/2019
[38] *Aguascalientes*, *Campeche*, *Colima*, *Chiapas*, *Chihuahua*, *Ciudad de México*, *Durango*, *Guanajuato*, *Hidalgo*, *Jalisco*, *Estado de México*, *Michoacán*, *Morelos*, *Nayarit*, Nuevo *Leon*, *Oaxaca*, *Puebla*, *Querétaro*, *Quintana Roo*, *San Luis Potosí*, *Sinaola*, *Sonora*, *Tabasco*, *Veracruz*, *Yucatan*, and *Zacatecas*
[39] https://www.banxico.org.mx/marco-normativo/normativa-emitida-por-el-banco-de-mexico/circular-20-2020/provision-recursos-credito-.html
[40] https://www.banxico.org.mx/marco-normativo/normativa-emitida-por-el-banco-de-mexico/circular-25-2020/reglas-aplicables-financiam.html
[41] https://www.banxico.org.mx/marco-normativo/normativa-emitida-por-el-banco-de-mexico/circular-18-2020/reporto-titulos-corporativo.html
[42] https://www.dof.gob.mx/nota_detalle.php?codigo=5594445&fecha=04/06/2020

Prior actions	Results		
Pillar 2: Supporting fiscal and environmental sustainability			
Prior Action #6. The Borrower, through the Ministry of Finance, has established a strengthened climate change budget tagging in the Federal Budget as evidenced by the Disposition 307-A-1552[43] of the 2021 Hacienda Programming and Budgeting Manual published by SHCP on August 24, 2020 on www.gob.mx.	Budget allocations linked to climate-change objectives and targets under a new methodology (percentage of budget registered in the ATCC federal budget[44])	Zero% (Dec. 2019)	100% (Dec. 2021)
Prior Action #7. The Borrower has established an SDG Sovereign Bond Framework and institutional process that allows the proceedings of the issuance of sovereign bonds to be linked to eligible projects on sustainable assets and expenditures that support the fulfillment of the most pressing SDGs; as evidenced by the "Plan Anual de Financiamiento 2020 (PAF 2020)[45]" published on January 30, 2020 in the Ministry of Finance's website.	Amount of bonds issued under the SDG Framework	Zero (Dec. 2019)	Euro 750 mil. (Dec. 2021)
Prior Action #8: The Borrower enacted an amendment to the Social Security Law to gradually increase the total contribution rates, with the objective of increasing the replacement rates for pensioners; guaranteeing the system's sustainability; as evidenced by amendments to the Social Security Law and the Law of Savings System for Retirement published in the Official Gazette on December 16, 2020.	Additional number of people that are eligible to access a minimum pension.	Zero (Dec. 2019)	300,000 (Dec. 2021)
Prior Action #9: The Borrower enacted an amendment to the Social Security Law that reduces the contribution weeks required to access to minimum pension, increasing the number of pensioners; as evidenced by amendments to the Social Security Law and the Law of Savings System for Retirement published in the Official Gazette on December 16, 2020.	Women as percentage of total beneficiaries of guaranteed pension	25% (Dec. 2019)	27% (Dec. 2021)

[43] https://www.gob.mx/cms/uploads/attachment/file/573733/307-A-1552_Comunicacion_del_Manual_de_Programacion_y_Presupuesto_2021.pdf
[44] AT-CC refers to an annex to the Federal Expenditure Budget named Climate-Change Crosscutting Annex (*Anexo Transversal de Cambio Climatico, AT-CC* in Spanish). Climate-change objectives and targets are those established in the Climate Change National Plan (objectives) and in the performance indicators matrix (targets) of every budgetary program, which jointly aim to respond to the national and international commitments established in this development agenda.
[45] https://www.finanzaspublicas.hacienda.gob.mx/work/models/Finanzas_Publicas/docs/paquete_economico/paf/paf_2020.pdf

ANNEX 2: FUND RELATIONS ANNEX

IMF Executive Board Concludes 2020 Article IV Consultation with Mexico

November 4, 2020

Washington, DC: On November 2, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation *[1]* with Mexico.

Mexico has been hit hard by COVID-19. Official statistics indicate that over 85,000 lives have been lost. About 12 million workers lost their jobs, many of whom came from the informal sector, out of which around 4 million have not returned to the workforce. The share of the population in working poverty jumped from 36 to 48 percent, as of June.

Output is expected to decline by 9 percent in 2020, the steepest contraction since the Great Depression. It is expected to recover modestly going forward. Although inflation has edged up on account of exchange rate passthrough and supply disruptions, it is projected to decline gradually as domestic demand remains suppressed by labor market dislocation, wealth effects, and concerns about the path of the pandemic.

The authorities responded to the pandemic by increasing health spending and supporting households and firms. They provided loans, reallocated some expenditure items, front-loaded spending for social pension payments to the elderly and disabled, and accelerated procurement processes and VAT refunds, among other actions. The authorities also implemented tax policy measures and introduced tax administration measures to increase tax collections. Monetary policy started easing last year and accelerated following the pandemic for cuts totaling 400 basis points, reducing the policy rate to 4.25 percent. The central bank also expanded several facilities, with access up to 3.3 percent of GDP, to support market functioning and credit provision. The flexible exchange rate has facilitated absorption of shocks. Comfortable international reserves, access to the U.S. Federal Reserve swap line, and the IMF's Flexible Credit Line have bolstered the ability to withstand external stress.

Executive Board Assessment [2]

Executive Directors generally agreed with the thrust of the staff appraisal. They commended the authorities for taking timely action to mitigate the impact of the pandemic on peoples' health and the economy, and for maintaining very strong policies and institutional policy frameworks. They noted that the economic recovery is expected to be gradual and that, against the backdrop of considerable risks and uncertainty over the evolution of the pandemic, the large social and economic costs are likely to persist. Directors emphasized the importance of limiting the damage from the pandemic, promoting a robust recovery, and pursuing strong, durable, and inclusive growth. Continued close engagement and dialogue between the authorities and staff on policy options will be important.

Most Directors recommended a further temporary, well-communicated, and targeted near-term fiscal support, with due consideration of the country's circumstances and safeguarding medium-term fiscal sustainability. A few of these Directors cautioned that limited fiscal support could lead to greater pressure on public finances through a deeper economic contraction. A few other Directors, however, saw the authorities' stance as prudent, given the uncertain path of the pandemic. Directors generally saw the need for announcement of a credible medium-term tax reform—to be implemented once the recovery is underway—to bolster the space for providing near-term support, close fiscal gaps, lower public debt, and finance needed investment and social spending. A number of Directors suggested that the tax reform plans should be announced once a firm recovery is in place.

Directors welcomed the authorities' recent steps to improve tax administration. They recommended broadening the tax base, raising subnational taxes, and reducing VAT gaps while strengthening social safety nets. They also welcomed the authorities' pension reform proposal, while urging them to consider complementary measures to mitigate labor market informality. Directors emphasized further reprioritizing public spending to promote inclusive growth by strengthening social protection and increasing public investment. They urged the authorities to revisit Pemex's business strategy and further reform its governance.

Directors considered that the actions of the central bank have supported the functioning of financial markets and the economy. They noted that the flexible exchange rate has facilitated the absorption of shocks, while comfortable international reserves, access to the U.S. Federal Reserve swap line, and the Fund's Flexible Credit Line have bolstered the ability to withstand external stress. A number of Directors considered that there may be scope for further monetary policy support, while safeguarding financial stability. Many other Directors, however, supported a more cautious approach, given increased inflation and the potential tradeoffs. Directors recommended continued close monitoring of risks in the banking sector and upholding minimum regulatory and supervisory standards while using the inherent flexibility of the framework.

Directors emphasized that steadfast implementation of structural reforms is key to delivering lasting improvements in investment and productivity and to reaping the benefits of the USMCA trade agreement. They urged the authorities to forcefully tackle labor market informality, advance governance and AML/CFT efforts, enhance public investment efficiency, improve access to credit, and leverage private involvement in the energy sector. Directors also encouraged consideration of a nationwide unemployment benefits system.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

HACIENDA
SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO

2020 AÑO DE LEONA VICARIO BENEMÉRITA MADRE DE LA PATRIA

Subsecretaría de Hacienda y Crédito Público
Unidad de Crédito Público

Oficio No. 305.-690/2020

Ciudad de México, a 17 de diciembre de 2020

David Malpass
Presidente del Banco Mundial
P R E S E N T E

La Administración encabezada por el Presidente de México, Andrés Manuel López Obrador, ha puesto en marcha una amplia agenda de fortalecimiento de la economía para generar crecimiento, más empleos y bienestar para todos los sectores de la población, particularmente para los hogares de más bajos ingresos y grupos vulnerables. Para ello, durante 2020 el Gobierno de México ha ejecutado un amplio conjunto de acciones en los ámbitos de política regulatoria, financiera y fiscal.

En materia de política regulatoria, durante 2020 se llevaron a cabo acciones para reducir el costo que enfrentan las empresas privadas para cumplir con requerimientos regulatorios del gobierno federal, así como para fortalecer la rendición de cuentas del sector público. Estas reformas se enfocaron en disminuir el número de trámites administrativos presenciales, ante dependencias y entidades gubernamentales, que realizan las empresas. Para lograrlo:

i) Se creó una plataforma electrónica para procesar digitalmente trámites ante el Gobierno Federal, generando ahorros para las empresas y el gobierno;
ii) se promulgó una ley para reducir sustancialmente las inspecciones que lleva a cabo el gobierno federal a las empresas, así como para simplificar las visitas de inspección cuando éstas sean necesarias y;
iii) se creó un registro nacional de inspectores.

Estas acciones facilitarán el cumplimiento de las obligaciones de las empresas en cuestiones administrativas y fiscales, así como una reducción en tiempo y costos de cumplimiento regulatorio en un entorno de mayor transparencia y rendición de cuentas.

Insurgentes Sur 1971 Torre III, Piso 7, Colonia Guadalupe Inn, Álvaro Obregón, Ciudad de México, C.P. 01020. T: +52 (55) 3688 1410
www.gob.mx/shcp

Adicionalmente, durante 2020 el Banco de México puso en marcha un conjunto de medidas para apoyar al sector productivo, entre las que destacan el otorgamiento de líneas de crédito a las micro, pequeñas y medianas empresas (MIPYMES) a través de la banca comercial y la banca de desarrollo. También estableció un mecanismo para la recompra de valores gubernamentales para otorgar mayor liquidez al mercado y fortalecer los canales de crédito.

En este año destaca la creación de un nuevo marco regulatorio de banca abierta (*open banking)* para apoyar el financiamiento, mediante medios digitales, de los bancos comerciales y otras institucionales financieras con el objetivo de desarrollar productos adecuados en un entorno de mayor competencia, que se traduzca en una disminución de los costos de intermediación. A través de este mecanismo se permitirá el acceso a la información de las cuentas de los clientes mediante interfaces de programación de aplicaciones.

Dichas acciones son esenciales en el ecosistema del sector financiero, para que los intermediarios financieros puedan atender a aquellos segmentos de la población que aún no tienen acceso a servicios financieros.

El segundo conjunto de reformas se enfocó en fortalecer la capacidad institucional para cumplir con los compromisos adquiridos por México a nivel internacional derivados del Acuerdo de París, con el fin de transitar hacia una economía baja en carbono. En este sentido, el Gobierno de México ha establecido políticas dirigidas hacia una economía más sostenible desde el punto de vista ambiental y social.

La publicación del Manual de Programación y Presupuesto 2021 es un esfuerzo en esta dirección al establecer un conjunto de acciones de análisis y revisión de la metodología utilizada en el Presupuesto de Egresos de la Federación en materia de cambio climático. Esta revisión se tradujo en incluir más elementos programáticos para una mejor estimación de las asignaciones presupuestales para la adaptación y mitigación de los efectos del cambio climático. Dicha política presupuestaria contribuirá a una mayor rendición de cuentas y a un seguimiento eficaz de las asignaciones presupuestarias, de tal manera que se ofrezca información relevante para la toma de decisiones, así como el monitoreo de los esfuerzos a nivel nacional en temas de gastos sustentables.

HACIENDA
SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO

2020 AÑO DE LEONA VICARIO BENEMÉRITA MADRE DE LA PATRIA

Subsecretaría de Hacienda y Crédito Público
Unidad de Crédito Público

El Gobierno de México formuló un marco de referencia de bonos soberanos sostenibles con el fin de avanzar en nuestro compromiso para fomentar una economía incluyente y cumplir con los Objetivos de Desarrollo Sostenible (ODS) de la Organización de las Naciones Unidas, como parte de la Agenda 2030. Con ello se promueve el financiamiento sostenible y responde a la demanda creciente de inversionistas por instrumentos con impacto social y ambiental. Este marco de referencia permitirá movilizar recursos de inversionistas internacionales para financiar proyectos establecidos en el Presupuesto de Egresos de la Federación que apoyen el cumplimiento de los ODS. Cabe mencionar, que gracias a este Marco México se ha convertido en el primer país en el mundo en emitir un bono soberano ligado a los ODS de la ONU.

Durante 2020, se presentó y aprobó la reforma para aumentar el número de personas que tienen acceso a una pensión, así como para incrementar el monto de los beneficios que recibirán al momento de jubilarse. Estos cambios legales se traducirán en una reducción de los impedimentos a la formalización del empleo, fomentarán un crecimiento en los niveles de ahorro de los trabajadores y contribuirán a brindar un esquema más robusto de protección social.

Por último, quiero destacar que el Gobierno de México continuará colaborando con el Banco Mundial, para conjuntar esfuerzos con el fin de implementar políticas que fortalezcan la economía dentro de un marco de sustentabilidad financiera, social y ambiental. En virtud de las acciones descritas anteriormente, agradecemos el reconocimiento del Banco Mundial a las acciones llevadas a cabo bajo la Administración del Presidente Andrés Manuel López Obrador para promover una economía más incluyente y con mayores oportunidades de desarrollo para todos los mexicanos.

Le reitero mi más distinguido respeto y consideración.

ATENTAMENTE,
EL TITULAR DE LA UNIDAD

JOSÉ DE LUNA MARTÍNEZ

Insurgentes Sur 1971 Torre III, Piso 7, Colonia Guadalupe Inn, Álvaro Obregón, Ciudad de México, C.P. 01020. T: +52 (55) 3688 1410
www.gob.mx/shcp

HACIENDA
SECRETARÍA DE HACIENDA Y CRÉDITO PÚBLICO

2020 AÑO DE LEONA VICARIO BENEMÉRITA MADRE DE LA PATRIA

Subsecretaría de Hacienda y Crédito Público
Unidad de Crédito Público

C. c. p.- Arturo Herrera Gutiérrez, Secretario de Hacienda y Crédito Público. Para conocimiento. Por correo electrónico.
Gabriel Yorio González, Subsecretario de Hacienda y Crédito Público. Para conocimiento. Por correo electrónico.

Insurgentes Sur 1971 Torre III, Piso 7, Colonia Guadalupe Inn, Álvaro Obregón, Ciudad de México, C.P. 01020. T: +52 (55) 3688 1410
www.gob.mx/shcp

UNOFFICIAL TRANSLATION

David Malpass
President of the World Bank
PRESENT

The Administration led by the President of Mexico, Andrés Manuel López Obrador, has set off an extensive economic strengthening agenda to generate growth, more employment and wellbeing across all sectors of the population, particularly amongst low-income homes and vulnerable groups. Thus, throughout 2020 the Government of Mexico has executed a wide-ranging action plan in the scope of regulatory, financial and fiscal policy.

In the matters of regulatory policy, during 2020, actions were taken to reduce the cost that private businesses encounter in order to meet regulatory requirements set by the Federal Government, as well as actions to strengthen accountability in the public sector. These reforms focused on decreasing the number of in-person administrative processes with government agencies and entities done by businesses. To achieve this:

i) A digital platform to complete processes with the Federal Government was created, generating savings for businesses and the government;
ii) A law was enacted to substantially reduce Federal Government inspections to private businesses, as well as to simplify such inspection visits when these are deemed necessary;
iii) A national inspector registry was created.

These actions will facilitate fulfillment of business obligations in administrative and fiscal matters, as well as provide a reduction of time and costs in the matters of regulatory compliance within a more transparent environment for accountability.

Additionally, during 2020, the Central Bank of Mexico put into operation a set of measures to support the productive sector, notably granting credit lines to micro, small and medium-sized businesses (*MIPYMES*) through commercial and development banks. A mechanism was also established for repurchase of government securities to provide increased liquidity to the market and strengthen credit channels.

This year notes the creation of a new regulatory open banking framework to support financing through the digital channels of commercial banks and other financial institutions with the objective of developing adequate products in the context of higher competition, that may be translated into a decrease in intermediary costs. This mechanism will grant access to the information of client accounts through programming interface applications.

Said actions are essential in the financial sector ecosystem, allowing financial intermediaries to tend to the segments of the population still lacking access to financial services.

The second set of reforms focused on strengthening institutional capacity to meet the international commitments undertaken by Mexico through the Paris Agreement, with the goal of transiting onto a low-carbon economy. In this sense, the Government of Mexico has established policies directed at a more sustainable economy from an environmental and social standpoint.

The publication of the Programming and Budget Manual 2021 is an effort made in this direction as it establishes a set of analysis and revision actions for the methodology used in the Expenditure Budget of the Federation in the matters of climate change. This revision translates into including more programmatic elements for better estimations of budgetary allocation for the adaption and mitigation of the effects brought on by climate change. This budgetary policy will contribute greater accountability and effective follow-up of budgetary allocation in order to provide relevant information for decision-making processes, as well as monitor efforts at the national level in matters of sustainable expenditure.

The Government of Mexico formed a reference framework for sustainable sovereign bonds with the goal of advancing our commitment to foster a more inclusive economy and achieve the United Nations Sustainable Development Goals (SDGs), as part of the 2030 agenda. With this, we promote sustainable financing and respond to an increasing demand from investors for instruments with social or environmental impact. This reference framework will allow mobility of international investment resources to finance projects established under the Expenditure Budget of the Federation that support the achievement of the SDGs. It is worth noting that thanks to this framework, Mexico became the first country in the world to issue a sovereign bond linked to the UN’s SDGs.

During 2020, a reform to increase the number of people with access to pension, and an increment to the sum beneficiaries receive at the time of retirement was presented and approved. These legal changes will translate into a reduction of impediments for employment formalization, promote growth in the level of savings for workers and contribute in providing a more robust framework for social protection.

Finally, I would like to highlight that the Government of Mexico will continue to collaborate with the World Bank to unite efforts in order to implement policies that strengthen the economy under a sustainable financial, social and environmental framework. In virtue of the activities described above, we thank the World Bank’s recognition of the actions undertaken by the Administration of President Andrés Manuel López Obrador to promote a more inclusive economy with greater development opportunities for all Mexicans.

I reiterate the assurances of my highest respect and consideration.

Sincerely,

José de Luna Martínez
Head of the Unit

ANNEX 4: IMPACT OF THE COVID-19 PANDEMIC AND COUNTRY PROGRAM ADJUSTMENTS[46]

1. Impact of the COVID-19 pandemic on the country and government response

Beyond the health consequences and loss of lives, the COVID-19 pandemic brought demand and supply shocks to the Mexican economy with deep impacts on firms, employment, and households. Through the channels of trade (including the U.S output drop and oil prices collapse), finance (flight to liquidity in U.S dollars and other FOREX denominated securities), investment (high uncertainty), and coupled with massive disruptions on the supply side to flatten the contagion curve domestically, it is expected that Mexico's output will drop significantly in 2020 (by 9 percent).

The pandemic has had significant human, poverty, and employment costs. The official statistics as of late-November 2020 show that more than 1 million people contracted the virus and over 100,000 died. Since mid-March, the government implemented measures to control the spread of the virus, including the suspension of all non-essential economic activities, move to at-home work and schooling nationwide, and launch a broad social distancing initiative. The government established a "traffic light" system for a gradual activity reactivation, which commenced in mid-May, but significant uncertainties remain ahead until the availability of a vaccine. The overall impact of the crisis has been significant on jobs. Total employment fell drastically in the early months of the pandemic. Since then, it recovered gradually, but with 5 million fewer jobs by July 2020 compared to the previous year, more than 1 million of them lost in the formal sector. The contraction in economic activity will likely lead to a large impact in monetary poverty, increasing the (US$5.5 line) poverty rate from 21 percent in 2019 to at least 27 percent in 2020 (or close to 8 million of new poor by this measure), with only a gradual reduction in 2021-2.

The authorities have implemented measures to face the crisis. Aside from the health response, the authorities have launched a set of monetary, financial, fiscal, economic and social measures to mitigate the impact of the crisis. On the monetary-financial side, currency swap lines, liquidity facilities, a regulatory forbearance, and other important measures were adopted. The fiscal response has been more limited for the large shock received by the economy and households. The authorities' expressed rationale is that they are trying to strike a balance between short-term larger fiscal imbalances and a sustainable fiscal framework over the medium term, considering that risks remain high and fiscal space for further action may be needed in the months ahead. The support applied was targeted to support vulnerable households, workers, and Micro, Small and Medium Enterprises (MSMEs). While implementing its broad package of emergency measures, Mexico has also prioritized efforts to foster a gradual economic reactivation to catalyze a strong, inclusive and resilient recovery over the medium term.

2. WBG support for responding to the crisis

The pipeline under the CPF[47] has experienced some strategic adjustments in alignment with the pillars of WBG's COVID-19 crisis response outlined in the Approach Paper (AP). With the objective of dealing with the current situation and the need for a strong and better recovery, while at the same time,

[46] This annex is standard in all World Bank projects approved by the Board starting January 2021 and it is not related specifically to the financing of this Project. This annex is for informative purposes.
[47] Discussed by the Board on February 2020. Report No. 137429-MX.

advancing some key objectives of the CPF (see below), the pipelines of FY 2020 (4th quarter) and FY 2021 have been prioritizing operations that support needed policy and institutional reforms. ***In support of pillar II (Protecting the poor and vulnerable)***, the Financial Access DPF (P172863) was approved by the Board of Executive Directors in the 4th quarter of FY20, and was focused on a number of emergency measures, including liquidity provisions while also fostering financial inclusion and improved digital delivery. The National Digital Identity System (P172647) also supports more efficiency in the access of vulnerable households to social programs. ***In support of pillar III (Ensuring sustainable business growth and job creation)***, the Strengthening Economic Sustainability DPF (P174150) was prepared, focusing reducing regulatory barriers hampering firms' growth, financial access to boost the recovery, and management of fiscal resources. The operation includes inputs from the International Finance Corporation (IFC) on private sector issues. The DPF on Financial Access (P172863) highlighted under pillar II (above) also had a component on access to finance and fintech in support of this pillar III. The National Digital Identity System (P172647) also supports this pillar by lifting bottlenecks to citizens, particularly the most vulnerable, to have access to finance, economic opportunities, and social programs. ***In support of pillar IV (Strengthening policies, institutions, and investments for re-building better)***, the Environmental Sustainability and Urban Resilience DPF (P174000) was prepared, focusing on measures to combat climate change, enhance air quality, and improve social housing and urban infrastructure resilience. The DPF on Strengthening Economic Sustainability (P174150) highlighted under pillar III (above) also had a component with policies to face climate change from the fiscal management perspective in support of this pillar IV.

Despite the crisis, the objectives of the WBG´s CPF for FY20-25 remain as relevant as ever, allowing flexible and strategic adjustments. The CPF is focused on three broad areas: supporting more rapid and more inclusive growth; strengthening institutions for public finance, service delivery, and economic inclusion; and enabling sustainable infrastructure and climate action. The CPF has seven specific objectives under those broad areas, as follows: (1) foster financial intermediation and inclusion; (2) reduce regulatory and competition barriers to economic growth; (3) enhance the management of public resources; (4) strengthen the institutional capacity to deliver inclusive social services; (5) strengthen the capacity of the social protection system for economic inclusion; (6) provide more inclusive and sustainable infrastructure services; and (7) support the government in reaching its goals on climate change. Despite the shock of the pandemic, these CPF objectives not only remain relevant, but even more essential to strengthen the country through the crisis and to support a strong recovery.

In this context, the operations in the pipeline for FY21 are also fully aligned with the CPF. The Strengthening Economic Sustainability DPF (P174150) tackles policies to help address selected pre-existing constraints to growth, inclusion, and sustainability identified in the SCD, including on regulatory barriers, financial access, management of resources for fiscal sustainability, and climate change challenges. These same constraints have also become critical bottlenecks in enabling a better recovery. Thus, they are fully aligned with key objectives set in the CPF, specifically objectives 1, 2, 3 and 7 of the CPF (listed above). In the same way, the Environmental Sustainability and Urban Resilience DPF (P174000) contributes directly to Objectives 6 and 7 of the CPF on infrastructure resilience and climate change. The National Digital Identity System (P172647) contributes directly to Objectives 1, 3 and 4 of the CPF by enabling financial and economic opportunities, particularly for vulnerable groups, to participate in the economic recovery.

Some projects in the pipeline and portfolio were reprioritized for late FY2021 and FY2022. They are mostly on the social infrastructure and transport sectors. At the same time, and to enable margin for action and a buffer in the exposure envelope, the undisbursed balances of selected slow-disbursing non-priority projects were cancelled in agreement with the authorities. These projects were mostly in the legacy portfolio at the sub-national level in infrastructure areas, but they had their development objectives well-advanced or fulfilled.

The ASA program was also reprioritized. The key pieces with priority focus on the short-and-medium-term economic recovery agenda, including on higher productivity (productivity report), fiscal reforms post crisis (e.g., PFR, tax and pensions), female labor force participation, and a CEM in the Southern States. ASA was also focused on just-in-time pieces focused on the impact on the crisis and policies on the recovery efforts.

There are also adjustments to the IFC and MIGA programs. IFC will be increasing its focus on credit lines for SMEs and attracting private investors to infrastructure, well-aligned with upstream policies of DPFs. MIGA has one project in Mexico, a political risk insurance guarantee in the energy sector, and is working with *NAFIN/Bancomext*, the government's export credit agency, to support SMEs and firms in the most affected sectors by the crisis.

3. Selectivity, Complementarity, Partnerships

The priority operations for FY21 complement (and are coordinated with the efforts) of other development partners. The Strengthening Economic Sustainability DPF (P174150) complements efforts of the IADB, CAF, and several bilateral development partners across issues. Together with the Inter-American Development Bank (IADB) and Development Bank of Latin America (CAF), the World Bank supports reforms aimed at reducing barriers, red tape, and the cost of regulations. Together with the *Foreign, Commonwealth & Development Office of the United Kingdom (FCDO)*, the World Bank supports reforms to reduce regulatory costs for firms and to foster more competition at the subnational level. Finally, together with the *French Development Agency (AFD)*, the World Bank supports Mexico's efforts on climate change and green finance. On the Environmental Sustainability and Urban Resilience DPF (P174000) actions on climate, forest and environmental management are coordinated with development partners, including agencies from the governments of United Kingdom (BEIS, DEFRA), France (AfD), United Sates (DOS) and Germany (BMZ, BMU, GIZ and KfW), among others. The World Bank and IMF also maintain close collaboration on macroeconomic and structural issues, which has been further intensified—the IMF has an FCL for US$61B with Mexico approved on November 22, 2019 and recently reviewed on November 18, 2020.

ANNEX 5: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Prior Action #1	This prior action is not likely to generate significant positive or negative environmental effects, but it has potential for positive indirect effects through increased culture of legality and transparency in terms of compliance with environmental, health and safety regulations.	Potential positive impacts on the poor and vulnerable.
Prior Action #2	This prior action is not likely to generate significant positive or negative environmental effects.	Potential positive impacts on the poor and vulnerable.
Prior Action #3	This prior action is not likely to generate significant positive or negative environmental effects.	Potential positive impacts on the poor and vulnerable in the medium term.
Prior action #4	This prior action is not likely to generate significant positive or negative environmental effects.	Small short-term positive impacts on the poor and vulnerable.
Prior Action #5	This prior action is not likely to generate significant positive or negative environmental effects.	Potential positive impacts on the poor and vulnerable.
Prior Action #6	This prior action is likely to generate longer-term positive environmental effects as public budget expenditure is considered through a climate lens with the objective of maximizing both mitigation and adaptation effects.	Potential positive impacts on the poor and vulnerable in the medium term.
Prior Action #7	This prior action is likely to generate longer-term positive environmental effects as more funding will be available to address sustainable development needs in regions where the SDG gaps are the greatest.	Neutral distributional impacts in the short run. Potential positive impacts in medium to long term.
Prior Action #8	This prior action is not likely to generate significant positive or negative environmental effects.	Potential negative impacts on the poor and vulnerable through potential increases in informality.
Prior Action #9:	This prior action is not likely to generate significant positive or negative environmental effects.	Positive impacts on the poor and vulnerable, particularly women.

ANNEX 6: DETAILED POVERTY AND SOCIAL IMPACT ANALYSIS

This Poverty and Social Impact Analysis (PSIA) is developed according to World Bank guidelines and is designed to provide an analysis of the potential poverty and social impacts of the policy actions outlined in the DPF. The PSIA outlines the expected impacts from a gender-informed, social and distributional perspective. The assessment is meant to provide analysis of the policy actions with outcomes in the key objectives of this operation, paying attention to marginalized and socially excluded groups, and politically sensitive issues.

The policy measures supported under this DPF are expected to contribute to support the poor and vulnerable. Measures aimed at facilitating economic resilience are expected to have positive distributional impacts over the medium term as measures to reduce regulatory costs and provide much needed financing are expected generate employment including among poor and vulnerable groups. Similarly, measures aimed at supporting fiscal and environmental sustainability are largely expected to have positive impacts on the poor and vulnerable. The expected individual impacts of prior actions under the specific pillars are summarized in the table above. A fiscal microsimulation model for Mexico was adapted to integrate and estimate the impacts of the pandemic and inform this analysis. In addition, a literature review of the empirical evidence on potential impacts of these prior actions has been gathered, including academic research papers and previous evaluations by the World Bank and other multilateral organizations.

Prior Action 1: The Borrower has implemented policies to reduce the regulatory costs for businesses while enhancing public sector accountability by: (i) enacting a law to reduce unnecessary inspections and simplify inspection procedures (Ley de Fomento a la Confianza Ciudadana); and (ii) creating a national registry of inspectors (Registro Nacional de Visitas Domiciliarias – RENAVID).

Reducing the regulatory costs for businesses while enhancing public sector accountability is expected to have positive impacts on poor and vulnerable populations. Actions to simplify inspection procedures, create a national registry of inspectors, and enable digital business services are expected to have positive impacts on employment and improve accountability, while at the same time reducing the cost and administrative burden for firms and individuals. While these reforms are expected to benefit all segments of the population, to the extent that poor and vulnerable populations are more exposed to abusive behavior, these impacts will be especially positive for marginalized and vulnerable populations.

Simplifying business inspection procedures are expected to enhance the business climate and therefore promote private investment with potential positive impacts on employment. Complex and cumbersome regulations hamper entrepreneurship and economic performance and encourage informality. Excessively frequent and arbitrary inspections not only impose direct costs on the private sector but can have a deeper adverse effect on the trust and competitive climate necessary for investment and growth. In 2016, 20.2 percent of firms in Mexico declared that complying with current regulations, including inspections, was an obstacle to achieve business goals (National Survey on Regulatory Quality and Government Impact on Enterprises, ENCRIGE, 2016). Simplifying the regulations that these inspections are intended to enforce will make inspections less burdensome for businesses without making them superfluous. Studies in

Mexico have shown that successful simplification of regulations, such as business registration, had a positive effect on registered businesses and employment (Bruhn, 2008).

A national registry of inspectors is expected to enhance accountability and prevent abusive behaviors. Excessive discretionary power given to inspectors with limited transparency makes entrepreneurial activity more uncertain, which in turn deters investments and may have a negative impact on business productivity and growth. Moreover, it can distort competition by putting businesses that do not have the right connections with inspectorates at an unfair disadvantage (World Bank, 2011). In Mexico, on average, about 30 percent of all firms experienced corruption while doing a transaction or inspection. But this percentage increases to 54 percent among large firms (ENCRIGE, 2016). "Pirate" inspectors (i.e. people posing as inspectors or inspectors without a proper order) appear when there is opacity of inspections procedures and lack of identification. The 1995 inspection reform law, implemented in Mexico, requiring mandatory presentation of ID by inspectors played an important role in combating "pirate" inspectors (Blanc, 2012). Thus, in combination with the ID, a national registry would make the process more transparent and accountable and help to further and eradicate this practice.

Prior Action 2: The Borrower has regulated the creation of an electronic platform (*Expediente para Trámites y Servicios*) to enable subnational/local government authorities process more easily business services digitally while reducing complex procedures.

While the use of electronic government services is still low in Mexico, inefficient in-person services adds to the administrative burden for firms and individuals. In 2019, 32.4 percent of the population aged 18 and older had used the Internet to interact with the government at least once according to the National Survey of Quality and Governmental Impact (ENCIG) [48]. However, only 10 percent used this channel for sending filled forms to public authorities, which is below the OECD average of 36 percent[49]. At the subnational level, of all municipal and local transactions that people reported, almost all (91 percent) were process face-to-face in a government office, and just 1.1 percent were done on the Internet. Similarly, 89 percent of transactions to open business were done in a government office and only 4 percent using the Internet. Among people reporting problems when doing a transaction, 25 percent (30 percent) of users complained on facing long lines, 22 percent (26 percent) of restricted hours and 20 percent (27 percent) having to go to multiple places to process a municipal transaction (open a business). Moreover, municipal/local transactions have one of the highest incidences of corruption. About 22 percent of all people that had contact with a public servant to make a local transaction were victims of corruption. In fact, for 2019, the total cost of corruption for municipal/local transactions amounts to a total of 132.6 million pesos (0.001 percent of GDP), which represented an average additional cost of 1,344 pesos (70 US dollars) for people that experienced it (ENCIG, 2019). Red tape is particularly burdensome to smaller businesses and may act as a disincentive to new business start-ups.

Digital government services are faster, cheaper to provide and less vulnerable to corruption. On average, in the LAC region, a fully digital transaction would take 74 percent less time than face-to-face government transactions (Roseth, et. al, 2019). Moreover, e-transactions would require fewer interactions with service-providing institutions. Reducing both, time and interactions, means that the total cost of carrying out government transactions (including the time-related costs and the direct costs) would

[48] This includes just consulting the.
[49] OECD, ICT database, *https://stats.oecd.org/Index.aspx?QueryId=78415*

be much lower for the online compared to the in-person channel. In fact, a study by the OECD (2016) using the Standard Cost Model estimated that the digitization of transactions for starting businesses and requesting building permits in the Mexican states of Jalisco and Colima could reduce transaction costs by 66 percent and 44 percent, respectively. Apart from the benefits to the citizens, digital transactions would also cost less for the government. Considering the large number of government transaction carried out in Mexico, if the 400 million federal and state government transactions were performed online rather than face-to-face, the administration would save $3.5 billion USD (Roseth, et. al, 2019).).[50] Finally, digital transactions limit the discretion of civil servants and the possibility of bribe-seeking. At the aggregate level, an econometric study has shown that implementing digital services can reduce corruption (Kim, 2013).

Figure 13. Channel used to process a municipal/local transaction and open businesses, 2019

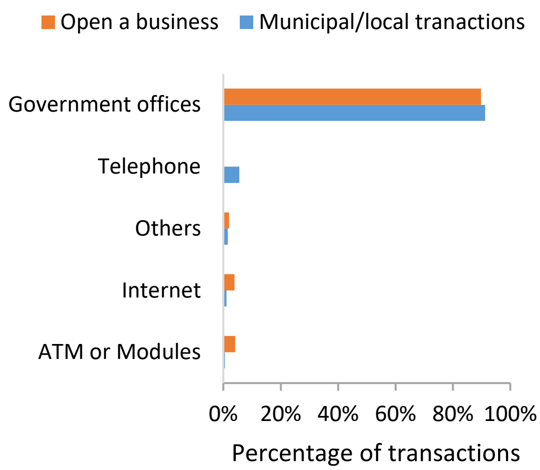
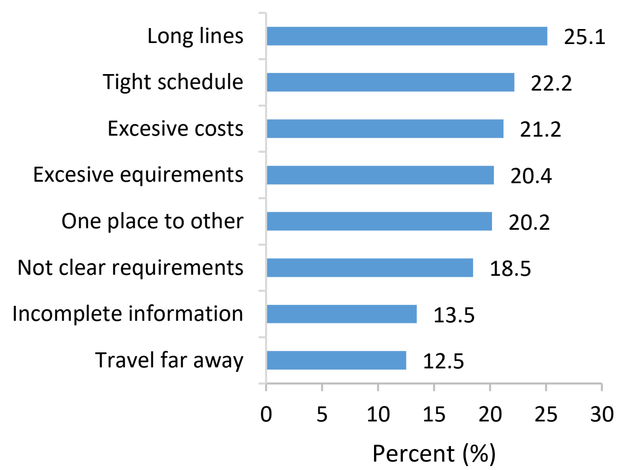


Figure 14. Percentage of the population aged 18 and older that faced…problem when doing a local transaction, 2019



Source: ENCIG, 2019
Note: Municipal and local transactions include procedures such as permits to sell on public roads and connections to water services

Prior Action 3: To reduce regulatory costs for firms and to foster more competition at the subnational level: (i) the Borrower has approved implementing regulation to the General Law on Better Regulation; and (ii) 25 states and Mexico City have adopted local laws in line with the National System for Regulatory Governance (SINAGER).

Lack of competition has damaged Mexico's overall economic performance and has exacerbated regional inequalities. Over the past several decades, stagnant productivity growth rates and large disparities in productivity across states have inhibited the growth of the Mexican economy and contributed to regional divergence. Competition in local markets remains weak, which undermines economic efficiency and adversely affects consumers, smaller firms, and entrepreneurs. Major obstacles to internal trade, local

[50] These calculations and those described below consider mainly costs associated with direct service provision (front-office) rather than back-office functions that enable service provision.

monopoly rights, and even regulated price-fixing schemes inhibit the entry of new firms, prevent smaller firms from expanding, and artificially inflate consumer prices. The absence of vigorous market competition costs the Mexican economy an estimated 1 percentage point of GDP growth each year, and this negatively affects the country's poorest households by an estimated 20 percent more than its richest households (OECD, 2015; and Chiquiar and Ramos-Francia, 2009).

Regulatory barriers to competition at the local level tend to be dispersed across legal instruments and sectors. Their potential negative impact depends on how these barriers are applied and on the features of the market that are affected, some of which are linked to strong local vested interests. Results from a recent Market and Competition Policy Assessment Tool (MCPAT) reveal the proliferation of anti-competitive regulations that limit competition in key sectors in Oaxaca, Tabasco, and the State of Mexico, in addition to 17 other states. Of the 520 restrictive regulatory provisions identified, most of them are in the retail, construction and manufacturing sectors (Gramegna, et. al, 2018). The General Law of Better Regulation, inspired by the MCPAT, is expected to transform subnational regulatory pro-competition environment.

Fostering competition at the subnational level is expected to have positive effects on welfare, particularly for the poor. Increased market concentration usually raises consumer prices, and can lead to lower employment and wages, creating an economy-wide welfare loss, and reducing the relative incomes of households, particularly of the poor. Concentration in input markets often prices out the poorest and vulnerable or implies higher relative out of pocket costs. Evidence shows the welfare-enhancing effects of market competition. Increased competition through retail globalization in Mexico in the 2000s had positive net effect on average household welfare —even though the richest households experienced higher relative gains (Atkin, et al, 2015). Similarly, higher local concentration in the retail sector has been found to raise the poverty headcount at the municipal level through higher prices (Rodríguez-Castelán and Rodriguez-Chamussy, 2015).

Prior Action 4: The Borrower's Central Bank established (or expanded) a number of facilities to establish liquidity conditions for banks to support MSMEs, including: (i) a financing facility for commercial and development banks to support channeling financing to MSMEs; (ii) a financing facility for commercial banks with corporate loans as a collateral to support channeling financing to MSMEs; (iii) a facility to repurchase government and corporate securities at longer terms than those of regular open market operations, to provide liquidity to financial institutions holding government debt to give them space to lend.

Even before the pandemic, lending to micro, small and medium enterprises was already scarce in Mexico, financial shocks are expected to increase firm vulnerability and affect employment. Only 8 percent of microenterprises received finance, while 26 percent of SMEs needed to invest but could not do so due to financial constraints.[51] Moreover, only about 5 percent of the bottom 40 percent borrowed from a financial institution in 2017.[52] Also worrisome is that 46 percent of women lacked access to any type of credit in 2018, limiting their business opportunities and options to deal with unexpected

[51] According to Encuesta Nacional sobre Productividad y Competitividad de las micro, pequeña y medianas empresas (ENAPROCE), 2018
[52] Global Findex (Global Financial Inclusion Database), World Bank, Washington, DC, https://globalfindex.worldbank.org/ .

expenses.[53] In the context of the pandemic, firms can be affected by two types of financial shocks: i) related to the structural characteristics of the firm in the presence of a credit crunch (long-term), and ii) related to financial needs in terms of working capital (short-term). Some firms can even be affected by both shocks at the same time. In Mexico, firms with financial vulnerability account for 4 percent of employment and 1.7 percent of the national wage bill, and most of the firms of this group are vulnerable in the short-term (Iacovone and Pereira, 2020).

Businesses have been put under immense pressure due to the spread of the coronavirus and the halt in economic activity. The pandemic affects firms through different, but mutually reinforcing, channels: lockdown, demand shock, supply shock, financial vulnerability and indirect effects. A recent study in Mexico, estimates that nearly 12 million workers are exposed to the pandemic through these channels, and the yearly wage bill for these workers is more than 600,000 million pesos. Small businesses are figuring out ways to retain their employees and pay them, which is heavily dependent on cash flow and access to financing. The magnitude of the shocks, particularly the shut-down and the demand shock, has been very large, and the risk is that businesses that are profitable may be forced to close-down because the liquidity crunch generates a solvency problem.

Providing additional liquidity can enhance the role of bank lending during the crisis and protect the poor from more severe economic losses. Recent literature highlights the effect of bank liquidity on lending. Cornett et al. (2011) find that banks' efforts to manage liquidity caused a decline in bank lending during the 2008 financial crisis. Ivashina and Scharfstein (2010) show that the decline in bank lending was greater for banks with less access to deposit financing and higher exposure to credit line drawdowns. Results from U.S. commercial banks over the period 1993–2010, find no evidence that bank liquidity mattered for the relationship between bank capital and lending in small and medium-sized banks. However, the authors find that for large banks, greater liquidity was associated with a stronger positive correlation between bank capital and lending, particularly during the global financial crisis (Kim and Sohn, 2017). These findings suggest that Basel III liquidity requirements complement capital requirements and can help smooth lending by large banks during times of crisis (World Bank, 2020).

Supporting credit to the agricultural sector can allow vulnerable populations to maintain their employment and income; and increase productivity in a sector where credit is often scarce. Economic reactivation of the agricultural sector is important as 12.5 percent of the working population is employed in it and workers are more likely to have lower earnings (ENOE 4T, 2019). Lack of credit is sometimes an obstacle that limits rural economic activity. The agricultural sector plays a key social role given that income derived from it constitutes a large share of total income for the rural poor. Data from the 2007 Agricultural Census shows that only 3.6 percent of farmers have access to credit, 0.3 percent have access to insurance and another 0.3 percent had access to both credit and insurance (Agricultural Census Frame Update, 2016).

Prior Action 5: The Borrower has issued the regulatory framework to authorize Application Programming Interfaces (APIs) that meet security and open source architecture requirements to enable the sharing of open data with the objective of generating greater competition in the financial sector.

[53] According to Encuesta Nacional de Inclusión Financiera (ENIF), 2018

Open APIs are "digital rails" that make financial products more widely available and allow the development of new services that address the needs of the low-income population. Low-income people are already using technology for their financial transactions, most commonly for payments. In 2017, 20.2 percent of the bottom 40 made or receive digital payments over the last year according to Findex. But digital payment providers cannot offer a full range of other financial services such as credit, savings or insurance. On the other side, Fintechs, start-ups and digital banks have better knowledge of niche segments, new technology, new products and lower cost, but often do not have access to the large-scale payment providers. Therefore, by opening their payment platforms to third parties, financial products are more widely available to a broader group of people, and providers allow the development of innovative products that respond to the needs of particular groups like low-income customers. In that sense by connecting third parties to established platforms, open APIs turn providers' platforms into "digital rails" that a developer can leverage to deliver new services that address the needs of many customers (Morawczynski, et al, 2016).

The information gathered through open banking could reduce heavy collateral requirements. As a track record and new nontraditional sources of data are created through open APIs, the poor -who would otherwise be screened out- might the able to get credit or insurance as a provider can gather information about them. Alibhai et. al (2017) describe the potential that new technologies have for generating data on borrowers that can replace heavy collateral requirements. Financial institutions hold plenty of information on their customers that is barely used (business cash flow, assets, education, employment, etc.). However, this information can bridge the asymmetry between borrowers and lenders through a credit score that determines the probability of defaulting on a loan. Thus, an algorithm can be used to predict the credit worthiness of new borrowers instead of relying on high collaterals. This could be particularly important for the financially excluded women, who are less likely to than men to own high-value assets that can served as collateral to obtain loans. In 2018, according to the ENIF, only 35 percent of women declared they owned property or a high-value asset[54] compared to 58 percent of men.

APIs also have the potential of improving competition in the sector, which will have positive distributional impacts. The banking sector remains concentrated in Mexico. The five largest banks account for about 70 percent of total bank assets.[55] Due to the lack of competition, overhead and administrative costs in commercial banks have not declined and intermediation margins have increased over recent years. Banks appear to allocate credit based on strong balance sheets and stable profits, common in firms with market power, and less on productivity growth, output, or wage growth rates. Ramos-Francia and Garcia-Verdu (2017) show that sectors with high levels of concentration in Mexico tend to obtain a high share of credit from banks, relative to firms in less concentrated sectors, with little regard to productivity growth. Thus, more credit is being allocated to less productive sectors, limiting the growth of the less concentrated sectors; while more concentrated sectors could be producing less than the socially optimal. Lopez (2017) estimates that the misallocation of resources due to credit constraints is estimated to lead to a loss in TFP of 10 percent, which represents 23 percent of the TFP gap between the US and Mexico.

Prior Action 6: The Borrower, through the Ministry of Finance, has established a strengthened climate

[54] This includes land, vehicles, houses, offices, businesses, storages or any other kind of property.
[55] Estimated from CNBV data (2017)

change budget tagging in the Federal Budget

Mexico's current methodology to classify the federal expenditure related to climate change has important limitations. The annual budget allocated to climate change is reported in the Anexo Transversal 16 del Presupuesto de Egresos de la Federación para la Adaptación y Mitigación de los Efectos del Cambio Climático (AT-CC). Nevertheless, it is not possible to identify the amount of resources from the AT-CC that are contributing to the achievement of the mitigation and adaptation goals that are part of Mexico's Climate Change Policy (INECC, 2017). Furthermore, the design and monitoring of the AT-CC makes it impossible to assess its coherence towards the delivery of national and international commitments (Ibid.)

Updating and improving Mexico's climate change expenditure tagging methodology is consistent with national requirements and international efforts. In 2017, the Coordination of Evaluation (the entity that by law is in charge of evaluating Mexico's Climate Change Policy), evaluated the AT-CC. The proposed improvements to the green expenditure methodology follow the main recommendations that resulted from that evaluation. They are also aligned with the Paris Collaborative on Green Budgeting, an OECD initiative that aims to help countries align public revenue and spending processes with environmental and climate goals (OECD, 2019).

An adequate methodology to tag climate change expenditure can provide valuable information for the implementation, evaluation and improvement of climate change policy. Clearly identifying and classifying climate-relevant expenditures in the government budget enables the monitoring and tracking of those expenditures (UNDP, 2019). This can help identify funding gaps and under-resourced climate priorities; transparency can also promote citizens' engagement (OECD, 2019). Under some circumstances, as has been the case in Indonesia, climate budget tagging can help to achieve the issuance of green bonds (UNDP, 2019).

Prior Action 7: The Borrower has established an SDG Sovereign Bond Framework and institutional process that allows the proceedings of the issuance of sovereign bonds to be linked to eligible projects, and sustainable assets and expenditures that support the fulfillment of the most pressing SDGs.

An SDG Sovereign bond framework and process are not expected to have any short-term distributional impacts, but it could lead to positive impacts on the poor and vulnerable in the medium to long term if it leads to spending that can address the most pressing SDGs. After committing to the 2030 Agenda, Mexico has implemented steps to integrate the 17 SDGs into its national planning and budgetary and fiscal policies and has set the following priority themes, linked to SDGs 1 (no poverty), 10 (reduced inequalities), 13 (climate action), 15 (life on land), and 16 (peace, justice, and strong institutions. The SDG Sovereign Bond Framework allows the government to pinpoint eligible projects, assets and expenditures that support Mexico's fulfillment of the most pressing SDGs. The SDG Bonds issued by Mexico can take the form of either SDG Green Bonds, SDG Social Bonds or SDG Sustainability Bonds. Eligible Sustainable Expenditures to be financed by these bonds are expenditures within Mexico's budgetary programs, which are also aligned with the relevant SDGs. The framework includes geographical eligibility criteria to prioritize vulnerable populations living in landlocked and disadvantaged areas. The Framework's design is based on granular open data collected through the Census of Population and Housing to target the most territories and populations most in need. The establishment of an SDG Sovereign bond framework on its own is not expected to have distributional impacts in the short term. However, to the extent that it can help direct resources and attention to the most vulnerable communities, it has the potential to lead to large positive impacts in the medium to long term.

Prior Action 8: The Borrower enacted an amendment to the Social Security Law to gradually increase the total contribution rates, with the objective of increasing the replacement rates for pensioners; guaranteeing the system's sustainability.

The World Bank has done a thorough analysis to estimate how the pension reform supported by this DPL will help the most marginalized groups in Mexico. The analysis shows that the percentage of workers that contribute to social security in Mexico is low, hovering at 37 percent since 2010 (Apella and Arakaki, 2020). This share is low by international and regional standards. Rofman and Apella (2020) find that in 2015, the percentage of workers contributing to social security in Mexico was 3.5 pp below the regional mean of 39.5 percent. In addition to low coverage, better off populations are more likely to be affiliated to social security (urban individuals and those with higher levels of education). For example, while only 15 percent of those who only have primary education contributed to social security in 2018, about 60 percent of those with college degrees did (ENIGH 2018). Similarly, social security coverage was 41.8 percent in urban areas but only 18.2 percent in rural areas. Differences are even more striking when looking at income deciles, only 5.8 percent of households contribute to IMSS, while close to 56 percent of household in the top decile did.[56]

Higher contributions rates will help increase replacement rates, particularly for the lower pensioners. In Mexico replacement rates are on the order of 19 percent, a level of benefit very low by any international standard. This replacement rate does not ensure adequate income protection for the elderly. It is clear that low replacement rates from the contributory scheme represent a threat to the well-being of future pensioners and the robustness of the pension system itself. The reform to the pension system (increasing contribution from 6.5 percent of the employee's salary to 15 percent) will be statutorily contributed by the employer starting in 2023 and will be gradual. Although the increase in contributions represents an increase in non-wage labor costs, and could potentially affect the incentives of formalization, this will be very unlikely for several reasons. First, because higher contribution rates are combined with lower requirements to access a pension, which reduce barriers and create larger incentives to formalization. Second, because increased contributions are purely individual savings diminishing the distortions that could otherwise arise from a contribution increase to a non-actuarially fair or redistributive social insurance plan. Third, because statutory minimum wage is still very low and not binding. Finally, because empirical evidence from international experience shows that informality in Mexico is the result of numerous factors and not always necessarily directly linked formal labor costs.

Prior Action 9: The Borrower enacted an amendment to the Social Security Law that reduces the contribution weeks required to access to minimum pension, increasing the number of pensioners.

Noncontributory pensions have increased coverage and benefited the bottom of the income distribution. Over the last 10 years, noncontributory pensions have doubled coverage of the elderly population, reaching 55.8 percent of adults aged 65 and over covered by a pension in 2018 (ENIGH, 2018).

[56] Deciles use market income from Mexico Microsimulation Tool based on ENIGH 2018

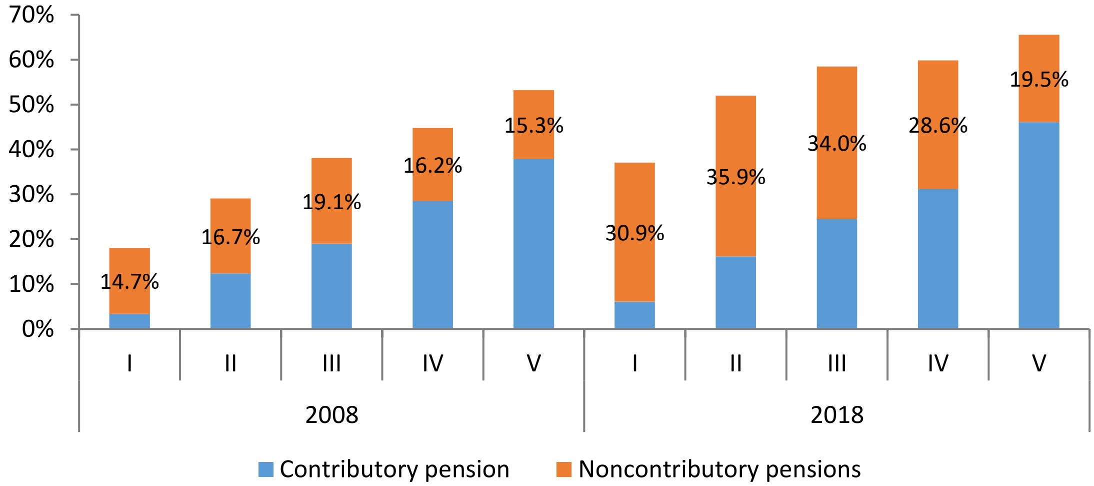
Although coverage has increased across all quintiles between 2008 and 2018, the increase is larger in the bottom end (16.3 pp in quintile I, 19.1 pp in II, 14.9 in III, 12.4 in IV, and 4.2 in V) (Figure A1). But coverage has expanded at an additional fiscal cost. For the 8 million beneficiaries in 2019, the monthly total expenditure is about 10,483 million of pesos (about 0.04 percent of GDP). Just to put this in perspective, more progressive programs with a higher marginal contribution to poverty, such as *Becas Benito Juarez*, cost about 0.01 percent of GDP. Not surprisingly, the average contributory pension is much higher than noncontributory pensions (about 10 times according to the ENIGH 2018).

For most workers that started contributing after 1997, informality will offset their efforts to save for a pension and could even be neglected from medical attention during their retirement Given the high transition between formality and informality, contribution density in Mexico is lower than 50 percent (Apella and Arakaki, 2020). Moreover, Castañon and Ferreira (2017) show that between 1997 and 2005, 39 percent of the workers who were formal at some point, only contributed 20 percent of their time. In fact, under the current situation 10.2 million affiliated workers would not accumulate the minimum contribution and, thus, would not receive a pension. Moreover, 7.9 million will not even have access to medical attention. In other words, almost 4 out of 5 workers affiliated to IMSS under the 97 Law would not reach the minimum (Azuara et al 2019). Researchers have shown that the high turnover between formality and informality is not only a restriction to accumulate the minimum contributions, but it can also have negative consequences on the replacement rate (CONSAR, 2015; Villagómez, 2015; OECD, 2016; Azuara et al, 2019; Ramirez Lopez, 2019).

Reducing the minimum number of contributions would increase the number of minimum pension recipients, and have a larger impact on poverty reduction and inequality. Using estimates of March 2020, by lowering the minimum number of contributions from 1250 to 750 about 2.3 million affiliated workers would classify under this group. Of those, some would meet the age condition to receive a guaranteed pension that previously did not have access. Contributory pensions have an important effect on poverty reduction, and it has increased over time. While in 2008, pensions reduced poverty by 12.4 pp among the elderly population, ten years later this effect increased to 16.9 pp.[57] Moreover, contributory pensions had a larger effect on poverty reduction than noncontributory pension without the additional fiscal cost. In 2018, contributory pensions had an effect of 13.6 pp on poverty reduction, while this effect was only 2.2 pp for noncontributory pensions (Figure A2).[58] This difference is probably explained by the amount of the transfers in each case. In terms of inequality, pensions had a positive distributive effect, as the Gini coefficient would be higher without them. Furthermore, contributory pensions have a slightly larger effect as the Gini coefficient would be 0.521 instead of 0.471, while inequality without noncontributory pensions would be 0.519.

[57] Apella and Arakaki (2020) estimate the poverty incidence by age group, Lorenz curves and Gini coefficients, considering the total income of the household with and without pensions (contributory and noncontributory) for 2008 and 2018. Estimates do not account for behavioral changes and, thus, this is a partial analysis.
[58] It is important to note that for this analysis most of the elderly receiving a contributory pension receive the benefit under the 1973 Law, and thus transfers and effects of the current Law 97 are expected to be lower.

Figure 15. Percentage of the population that receives a pension by per capita household income and type of transfers, 2008 and 2019

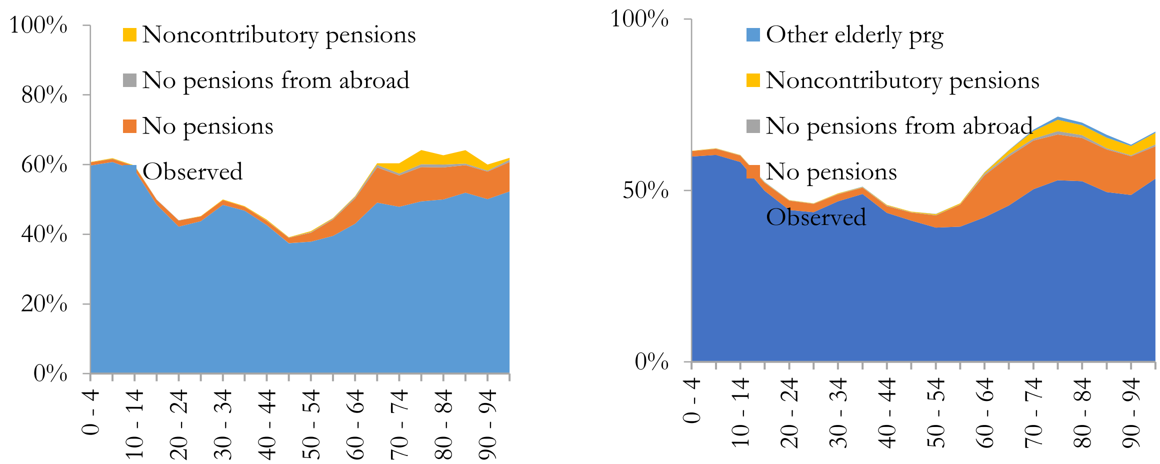


Source: Apella and Arakaki, 2020

Figure 16. Percentage of individual in poor households by age group before and pensions, 2008 and 2018

a) 2008

b) 2018



Source: Apella and Arakaki, 2020