PUBLIC
SIMULTANEOUS DISCLOSURE

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

INCREASE IN THE CONDITIONAL CREDIT LINE FOR INVESTMENT PROJECTS (CCLIP) FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING

(ME-X1024)

(AMENDMENT TO RESOLUTION DE-138/14)

AND

THIRD PROGRAM FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING

(ME-L1259)

LOAN PROPOSAL

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3. Environmental and Social Management Report (ESMR)

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ABBREVIATIONS

CCLIP	Conditional credit line for investment projects
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
ENIF	Encuesta Nacional de Inclusión Financiera [National Financial Inclusion Survey]
ESMR	Environmental and Social Management Report
FIE	Financial intermediary enterprise
FIRA	Fideicomisos Instituidos en Relación con la Agricultura
FND	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero
ICAS	Institutional Capacity Assessment System
INEGI	Instituto Nacional de Estadística Geográfica e Informática de México [National Geographic and Informatics Statistics Institute]
MSME	Micro, small, and medium-sized enterprises
NDP	National Development Plan
REU	Rural economic unit
SAGARPA	Department of Agriculture, Rural Development, Fisheries, and Foods
SFP	Civil Service Department
TFP	Total factor productivity

PROJECT SUMMARY
MEXICO
INCREASE IN THE CONDITIONAL CREDIT LINE FOR INVESTMENT PROJECTS (CCLIP)
FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING (ME-X1024)
(AMENDMENT TO RESOLUTION DE-138/14) AND
THIRD PROGRAM FOR PRODUCTIVE AND INCLUSIVE RURAL FINANCING
(ME-L1259)

Financial Terms and Conditions				
Borrower: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)			**Flexible Financing Facility** [a]	
Guarantor: United Mexican States			**Amortization period:**	25 years
Executing agency: FND			**Disbursement period:**	36 months
			Grace period:	5.5 years [b]
Source	**Amount (US$ millions)**	**%**	**Interest rate:**	LIBOR-based
Third program				
IDB (OC):	500	100	**Credit fee:**	[c]
Total:	500	100		
CCLIP			**Inspection and supervision fee:**	[c]
Original:	1,000			
Increase:	300		**Original WAL:**	15.25 years
Total:[d]	1,300		**Approval currency:**	U.S. dollars

Project at a glance
Objective of the CCLIP: (i) help raise primary sector productivity by improving rural economic units' access to financing to make productive investments; and (ii) promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units. **Objective of the third program:** (i) help raise primary sector productivity through improved access to financing by rural economic units to make investments in productive activities; and (ii) promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units for enhancing their incomes.
Special contractual conditions precedent to the first loan disbursement: (i) formal appointment of a program coordinator, to the Bank's satisfaction; and (ii) approval of the Program Credit Regulations, agreed on with the Bank, which will include clauses relating to socioenvironmental issues based on the Environmental and Social Management Report (ESMR), and their implementation by FND (paragraph 3.3).
Exceptions to Bank policies: None

Strategic Alignment						
Challenges[e]:	SI	☑	PI	☑	EI	☐
Cross-cutting themes[f]:	GD	☐	CC	☐	IC	☐

[a] Under the Flexible Financing Facility (document FN-655-1), the borrower has the option of requesting changes to the amortization schedule, as well as currency and interest rate conversions. When considering such requests, the Bank will take operational and risk management considerations into account.

[b] Under the flexible reimbursement options of the Flexible Financing Facility (FFF), changes in the grace period are possible, provided that the original weighted average life (WAL) of the loan and the last date of payment, as documented in the loan contract, are not exceeded.

[c] The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with applicable policies.

[d] Pursuant to Resolution DE-138/14, the original amount of the line is US$1 billion. The Board of Executive Directors is being asked to increase that line by up to an additional US$300 million, as indicated in the draft resolution attached to the loan proposal.

[e] SI (Social Inclusion and Equality); PI (Productivity and Innovation); and EI (Economic Integration).

[f] GD (Gender Equality and Diversity); CC (Climate Change and Environmental Sustainability); and IC (Institutional Capacity and Rule of Law).

I. Project Description and Results Monitoring

A. Background, problem addressed, and rationale

1.1 **Macroeconomic setting**. The Mexican economy continues to grow at a moderate pace despite the complex external environment. In 2016 it grew by 2.3%, and in the first quarter of 2017 it grew 2.6% on an annual basis, with seasonally adjusted figures. Low international oil prices and limited growth in U.S. manufacturing have affected the performance of the country's industrial sector, and accordingly, growth has come primarily from the services sector. Given the increased financial volatility due to uncertainty over the country's external context, the authorities have taken various measures. For 2017, a primary fiscal surplus is projected, which would reduce public debt as a percentage of gross domestic product (GDP). Likewise, in response to higher risk of rising inflation, the Bank of Mexico has increased its target interest rate several times during 2016 and 2017. It currently stands at 7%.[1]

1.2 **Growth and productivity in the rural economy**. The agrifood sector is considered a priority area in the design of public policies in Mexico as an important part of the overall economy, a reliable supplier of food to the population and a source of income and employment for rural people, as well as the role it plays in the country's stability.[2]

1.3 The agrifood sector comprises: (i) the primary agriculture sector;[3] (ii) agroindustry,[4] which includes firms that process raw materials all along the agricultural value chain; and (iii) productive activities in Mexico's rural commerce and services sector related to the two other areas and necessary for the proper functioning and performance of primary producers and the food industry.

1.4 The primary sector share of GDP has remained stable at around 3.0%[5] and continues to be an important source of job creation, accounting for around 12.6% of the economically active population.[6] This sector has performed strongly in recent years, with agricultural GDP growing an average of 3.3% annually between 2013 and 2016, compared to 2.4% for the economy as a whole. This strong performance continued during the first quarter of 2017 and has been reflected in the expansion of foreign trade. The annual agricultural trade deficit that had persisted since 1997 reversed in 2015, and in 2016 the surplus increased by 89%.

1.5 In rural areas, nonprimary activities have become more significant sources of jobs and GDP growth.[7] Mexico is following a pattern in Latin America in which an

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1 Sources: National Geographic and Informatics Statistics Institute (INEGI) for GDP and inflation data, Bank of Mexico for the monetary base, Department of Finance (SHCP) for fiscal data.

2 See the National Development Plan 2013-2018 (NDP), Federal Executive Branch of Mexico, 2013.

3 Includes the agriculture, rural, forestry, and fisheries subsectors.

4 Includes the food, beverages and tobacco, and leather and hides subsectors, as well as the lumber industry.

5 For the sake of comparison, in 2014, the agriculture sector of Latin America and the Caribbean accounted for 6% of GDP. Source: Food and Agriculture Organization of the United Nations, *Statistical Pocketbook World Food and Agriculture,* 2015.

6 INEGI.

7 Diagnóstico del sector rural y pesquero ["Diagnosis of the rural and fisheries sector"] of the Department of Agriculture, Rural Development, Fisheries, and Foods (SAGARPA), 2012.

increasing proportion of rural households labor in nonagricultural activities.[8] As for agribusiness activity, it accounts for 4.8% of GDP[9] and employs around 20% of the economically active population. It grew by an average of 2% annually between 2014 and 2016, and the agrifood sector has also run a trade surplus over the last two years. For their part, commerce and services account for 69% of gross production in municipios with fewer than 50,000 inhabitants.[10] Nonfarm activities employ 61.6% of the employed rural population,[11] and the share of agricultural businesses in monetary income generation in rural areas is estimated to have declined from 17.2% in 2000 to 9.1% in 2014.[12] In addition, activities in the secondary and tertiary sectors and their capacity to generate income and employment are becoming even more important and are now attracting the majority of migrants returning to the country.[13]

1.6 The growth capacity of the agrifood sector as a whole is constrained primarily by low levels of capitalization and investment, which limit productivity growth.[14] Thus, although there has been recent growth in total factor productivity (TFP) as a measure of growth in the sector, with average annual growth of nearly 3% between 2012 and 2015, the primary sector's contribution was negative during the two decades prior to 2012 (-0.23%).[15] For its part, between 1991 and 2015 the agroindustrial sector saw an average annual decline in TFP of 0.48%. The causes for this low productivity in the agrifood sector include:[16] (i) the sector's low capitalization, reflecting a lack of investment by rural economic units (REU) in productive assets such as

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8 Economic Commission for Latin America and the Caribbean (ECLAC), United Nations Food and Agriculture Organization (FAO), and Inter-American Institute for Cooperation on Agriculture (IICA), *The Outlook for Agriculture and* Rural Development *in the Americas: A Perspective on Latin America and the Caribbean 2015-2016.*

9 INEGI, considering the food and beverages and tobacco subsectors for the year 2016.

10 INEGI, 2014.

11 SAGARPA, 2012, Op Cit. Chapter I.

12 National Incomes and Expenditure Survey 2000 and 2014, INEGI.

13 Migración y empleo: Reinserción de los migrantes de retorno al mercado laboral nacional, Instituto de Estudios y Divulgación sobre Migración A.C., 2011.

14 De Olloqui and Fernandez, *Financiamiento del Sector Agroalimentario y el Desarrollo Rural*, IDB, 2017. For an international review of literature on productivity and growth in the primary sector, see Fuglie et al., 2012, *Productivity growth in agriculture: an international perspective*. For the case of Mexico, see SAGARPA, 2012, op. cit. and McKinsey, 2014, *A tale of two Mexicos: Growth and prosperity in a two-speed economy.* For evidence on the relationship between productivity, economic growth, and poverty, see Prasada et al., 2004, *Agricultural productivity growth, employment and poverty in developing countries,* 1970-2000, *International Labour Organization.*

15 INEGI. For the economy as whole, the average decline was 0.31%.

16 See: NDP; Agriculture, Fisheries, and Foods Sector Development Program 2013-2018*,* SAGARPA, 2013; and SAGARPA, 2012, op. cit, which identifies poor business management capacity as a third fundamental cause of low productivity levels.

infrastructure, equipment and other fixed assets;[17] and (ii) the low uptake of agricultural technologies and technical models[18] by REUs.[19]

1.7 To achieve comprehensive development in Mexico's rural areas, it will be necessary not only to consolidate recent gains in productivity in the primary sector but also to support nonfarming activities in rural areas, which are increasingly important for the more than 24 million people living there, 61% of whom are poor.[20]

1.8 Rural Mexico is home to a robust commerce sector that makes the country one of the world's top 10 producers and exporters of food. In contrast, the vast majority of REUs are subsistence-oriented or have limited market ties, the result being that total output is inadequate to meet the domestic demand for basic foodstuffs.[21] Of the 5.3 million REUs, only 27% are considered businesses, categorized based on sales volume:[22] in transition (E3), businesses with weak returns (E4); sound businesses (E5); and dynamic businesses (E6). E3s account for approximately 8% of all REUs and have low income levels (average annual sales of around US$5,000), which makes it difficult for them to accumulate productive assets. E4s have annual income from sales averaging US$10,000 and ranging from US$6,500 to US$15,200. More than half of the rural economic units in this category do not generate sufficient income to cover the depreciation of their assets. These REUs make up 9.9% of the total and they are the main suppliers of regional markets. E5s have average annual sales income from sales averaging US$37,500 and a maximum of around US$153,000. They make up 8.5% of all REUs and face the challenge of increasing their competitiveness. Businesses in categories E3, E4 and E5 are considered

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[17] Sector studies show, for example, that access to irrigation increases agricultural productivity (Jin et al., 2012; and Agriculture and Natural Resources Management Sector Framework Document, document GN-2709-2, IDB, 2013). In Mexico, irrigated land can be as much as four times as productive as rainfed areas in terms of value. Furthermore, international comparative studies show that the difference in productivity between countries in the agricultural sector is largely due to the gap in capital investment (Mundlak et al., 1997). Just 18% of rural economic units report having made productive investments; 29.6% do not have any type of productive assets; only 37% of farmers use a tractor; and just 28% of farm land is irrigated (Mora Rivera *et al*., 2011, *Determinantes de la Inversión en la Agricultura Mexicana* [Determinants of investment in Mexican agriculture], Centro de Estudios Económicos, El Colegio de México.

[18] With regard to the use of chemical fertilizers, insecticides and/or herbicides, improved seeds, and manure, together with the use of machinery and implements. These may be used not only to boost the productivity of existing activities or crops, but can also enable conversion towards higher value activities.

[19] SAGARPA, 2012, op. cit. In this regard, for example, cereal production—one of the crops that yields least value per hectare—occupies half of arable land, whereas fruits and vegetables produce around 70% of the value of cereals output using just 7% of the total cultivated land. Moreover, studies of the sector indicate that in the case of agricultural rural economic units, less than a third of them apply fertilizer in doses that are based on soil analysis; 76% apply irrigation sheets based on their experience rather than technical support; and more than 90% retain existing production practices or processes without incorporating new techniques or technologies. As a result of low up-take of technologies and improved techniques, efficiency in the sector is well below potential.

[20]. SAGARPA, 2012, op. cit. areas with fewer than 2,500 residents.

[21] SAGARPA, 2013, op. cit. this document includes an assessment of the factors behind the inability of agricultural output to meet domestic demand.

[22] The rural economic unit is defined as a natural or legal person—linked or not to a plot of land—who conducts agricultural or fishery activities or other productive, industrial, commercial, and services activities in rural areas. SAGARPA (2012, op. cit.).

overall to be small and medium-sized, while those in category E6 (just 0.3% of the total) are considered fully integrated with national and international markets.

1.9 It is estimated that 4.1 million REUs are primary-sector production units. The output of these small and medium-sized units is geared almost exclusively to the domestic market, and conditions are fairly unfavorable for producers, including low profit margins, informal contracts, and weak negotiating power, as well as a lack of adequate financing. The remaining REUs are engaged in other activities such as manufacturing, commerce and services.[23] The income diversity of the households and units involved in the various activities is greatest in the middle and bottom portion of the income pyramid, particularly for those units transitioning toward economic specialization (both agricultural and nonagricultural).[24]

1.10 **Access to financing is essential for boosting the sector's investment and income**. Inadequate access to financing for REUs constitutes a critical obstacle to improving the conditions that drive growth and economic opportunities in rural Mexico and to addressing low capitalization and investment.[25] Access to financing for productive purposes makes working capital available for the purchase of inputs and enables investment in equipment and infrastructure, crop conversion, and the adoption of new technologies and technical capacities,[26] which translate into greater productivity and profitability for productive units.[27] In particular, access to credit is a determining factor in rural economic units' decisions to invest in productive assets and in the number of investments they make.[28] Consequently, removing constraints on access to credit would increase the number and scale of rural producers'

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[23] According to the 2004 Economic Census, there were 795,000 economic units devoted to manufacturing, commerce and services in rural areas.

[24] IDB, 2017, op. cit.

[25] For example, see: Love, I. and S. Sánchez, 2009, *Credit Constraints and Investment Behavior in Mexico's Rural Economy*, *The World Bank, Policy Research Working Paper 5014*; Mora Rivera et al., op. cit.; and Escalante, Catalán, and Basurto, 2013, *Determinantes del crédito en el sector agropecuario mexicano: un análisis mediante un modelo Probit*. Along with a lack of access to capital, rural productive units generally invest less, particularly in innovation and technology adoption, for other reasons, such as: the benefits of innovation are not fully accessible; there is a lack of public and private capacity to provide extension services, particularly for small farmers; and there are information asymmetries concerning the benefits (i.e. rates of return) from new investments and technologies (*Development Effectiveness Overview*, IDB, 2008-2009).

[26] Access to financing can provide timely resources for the acquisition of inputs, technologies, management and production models, etc. (International Finance Corporation, 2012, *Innovative agricultural SME Finance Models*). Uaiene et al. (2009) empirically analyze the relationship between agricultural credit and technology, and show that producers with access to credit have a greater likelihood of adopting technology. Foster and Rosenzweig (2010) show that credit constraints play a major role in delays in adopting technology.

[27] International empirical evidence shows that, in the case of Peru, for example, access to credit could increase agricultural productivity by 26% (Guirkinger and Boucher, 2008), whereas in the case of China this figure could be as high as 31.6% (Dong et al., 2010). The study by Sidhu *et al*. (2008) reveals the positive correlation between credit, investment, and productivity in India (*Dynamics of Institutional Agricultural Credit and Growth in Punjab*: *Contribution and Demand-Supply Gap)*.

[28] For example, Love and Sánchez, op. cit., find broad differences in investments in physical assets between farmers and agricultural ventures subject to credit rationing, compared to those with access to formal credit. Mora Rivera et al., op cit., demonstrate the clear importance of having additional financial resources, particularly formal credit, as a determinant of investments in productive activities and their size.

investments, thus helping break the primary sector's cycle of low investment, low productivity, and low growth.

1.11 Studies focused on agriculture value chains in Mexico show that lack of access to medium- and long-term financing for businesses engaged in the rural industrialization, marketing, and services links of the chain is a major obstacle to those firms investing in infrastructure and technology to improve their productivity.[29] In this respect, the financing challenges and the need for productivity improvements in the agrifood sector are related to the issues faced by micro, small, and medium-sized enterprises (MSME).[30] For example, only 16% of MSMEs in the agrifood sector reported having access to financing, (compared to 46% in the clothing industry, 50% in the petrochemicals industry, and 78% in the metallurgy industry),[31] while 70% were using internally generated funds to finance investments.[32] Lastly, one of the major structural constraints impeding rural socioeconomic development is the restricted capacity of low-income people and small businesses to take advantage of economic opportunities, whether by undertaking new activities or diversifying their sources of income. A key determining factor here is the inability to access and amass productive assets. Lack of access to financing, or at least sufficient financing with acceptable conditions, for REUs is a critical obstacle to obtaining and amassing productive assets and putting them to work properly.[33]

1.12 However, the agrifood sector faces unique obstacles that limit the supply or increase the cost of financial services. In particular, access to credit is affected by: (i) higher risks than in other sectors (including climate, marketing, and price volatility risks, which can affect income levels and inhibit investment, as well as risk concentration in certain activities and geographical areas) and inadequate tools to manage these risks; (ii) greater limitations in terms of the collateral available and its execution, whether due to a lack of existing capital or, in some cases, the nature of land ownership; (iii) the high transaction costs involved in lending small sums to geographically scattered borrowers;[34] and (iv) the low profitability of most rural economic units, where the absence of economies of scale leads to high production costs (for seeds, agrochemicals, machinery and equipment, fuel, and other inputs), in addition to the fact that they are not generally focused on producing high value products, and production volumes are small.

1.13 These obstacles have meant that the financial sector's penetration in the rural economy is low. Just 1.8% of the economy's total bank financing goes to the primary sector.[35] The value of the total financing of the sector at year-end 2016 was, in real terms, practically identical to 2000's numbers, equivalent to around 23.7% of primary

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[29] Financiamiento de Cadenas de Valor Agrícola en América Latina: Barreras y Oportunidades en México, Perú y Honduras, Multilateral Investment Fund (MIF), 2014; Fideicomisos Instituidos en Relación con la Agricultura (FIRA), "Mapeo de Redes de Agronegocios," Information Bulletin 21, 2014.

[30] Support to SMEs and Financial Access/Supervision Sector Framework Document.

[31] INEGI, 2014.

[32] Enterprise Surveys, World Bank, 2010.

[33] IDB, 2017, op. cit.

[34] Eighty percent of agricultural producers have holdings of less than five hectares and are scattered over more than 80% of Mexico's territory (SAGARPA, 2012, op cit.).

[35] Bank of Mexico, with figures to December 2016, using data from the commercial banking system.

GDP:[36] when the agroindustrial sector is added in, financing for the agrifood sector amounts to only 11.3% of sector GDP.[37] The National Agricultural Survey shows that just 10.4% of production units had accessed credit in 2014.[38] Only 16% of MSMEs in the agrifood sector reported having access to financing, (compared to 46% in the clothing industry, 50% in the petrochemicals industry, and 78% in the metallurgy industry).[39] Moreover, financing investment projects that need medium- and long-term resources poses additional difficulties, as they require financial institutions to have the capacity to acquire resources of this kind and manage the greater risks inherent in this type of project. This is reflected in the fact that just 11.5% of primary production units with financing had access to investment credit,[40] and 70% of agrifood MSMEs were using internally generated funds to finance investments.[41]

1.14 The lack of access to credit for rural productive units is part of a wider problem of financial inclusion[42] in the country, especially in rural areas. Only 38% of the adult rural population[43] makes use of some kind of formal financial service, compared to 66% in urban areas. A global financial inclusion survey found that Mexico is one of the of Latin American and Caribbean countries with the lowest penetration of formal bank accounts in rural areas, with only 28.6% of the adult population reporting having an account.[44] The cost and travel times involved in accessing regulated financial services are higher for the majority of people living in these areas. The lack of rural financial infrastructure[45] also correlates with the poverty rate[46] and with the higher self-exclusion in rural areas (74% of rural people have never applied for a loan, a figure which drops to 52% in urban zones[47]).

1.15 Mexico is also among the countries with the lowest rural credit indicators in the region: just 5.9% of the population report having accessed credit from a financial institution in the past year, while 49% report having requested a loan from any

36 Data to 2015, considering primary sector investments by Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), FIRA, and the commercial banks, with FND, FIRA, and Bank of Mexico as sources. Financing by nonbank financial intermediaries must be added to this figure, which would raise the total by approximately 4 percentage points of GDP. By way of comparison, in Brazil the levels are around 60% and in the United States they exceed 100%.

37 Includes the agrifood, beverages, and tobacco industry. Prepared with 2015 data from INEGI, FIRA, Bank of Mexico, and FND.

38 INEGI, National Agricultural Survey (ENA) 2014.

39 INEGI, 2014.

40 National Agricultural Survey, INEGI, 2014. As well, according to SAGARPA, only 9.5% of total credit to the rural sector was intended for the acquisition of machinery and equipment, and 9.4% for the purchase of livestock or plants.

41 Enterprise Surveys, World Bank, 2010.

42 Understood as access to and use of quality formal financial services (credit, savings, insurance, and payments) by households and businesses, in a context of financial stability for the system and users.

43 National Financial Inclusion Survey (ENIF), September 2012, INEGI and National Banking and Securities Commission (CNBV). Rural towns are defined as having fewer than 15,000 inhabitants.

44 Global Financial Inclusion Database (Findex), World Bank 2012.

45 The long distances and low population density in rural areas increase financial agents' operating costs. This situation is reflected in the limited availability of bank windows catering to demand from rural areas, with four times as many branches per 10,000 adults in urban areas as in rural ones.

46 FIRA, *Factores relevantes en el desarrollo de proyectos de inversión en el sector agropecuario en México*.

47 ENIF.

source (whether formal or informal).[48] For the rest the population, alternative, informal lending mechanisms are the only credit option. These tend to be more expensive, not adequate for financing basic inputs, or not appropriate for productive investments or investments to meet special needs for funds.[49]

1.16 In addition to the low overall penetration rate, another element of the credit aspect of the rural financial inclusion issue is that lending is highly concentrated in higher-income strata and in certain geographical regions. The income disparity is reflected in the fact that whereas 51% of type E6 REUs had access to credit, this percentage dropped to 28% for E5s and 13% for E4s, and was just 7% for E3s.[50] As paragraph 1.8 points out, the low income levels of E3s and E4s make it hard for them to amass productive assets. Also, regional disparity reveals other challenges in terms of financial penetration and productivity.[51] The explanation for this disparity lies in the high correlation between income levels and access to credit. Municipios with higher levels of marginalization have much less access to financial services in general.[52]

1.17 Given the obstacles (paragraph 1.12), the participation of private banks in financing the primary sector is low. As of December 2015, their share using their own resources was 20.5%,[53] compared with 45% in 2000 and 36% in 2010, while rural development banks—comprising Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND) and Fideicomisos Instituidos en Relación con la Agricultura (FIRA)—covered the remainder. Moreover, commercial banks have concentrated on the higher-income segments. Against this backdrop, there have been efforts to develop nonbank financial intermediary enterprises (FIEs) supported by development banks, given that their specialization and local presence gives them greater capacity to serve rural and more marginalized areas. These FIEs are often the main source of formal finance in regions where there is a limited penetration of credit, and they generally serve the lowest income segment.

1.18 **Rationale for the program and for the expansion of the Conditional Credit Line for Investment Projects (CCLIP).** Aware of the sector's strategic importance, the Government of Mexico, through the 2013-2018 National Development Plan (NDP), has posed the need to build a productive primary sector that will ensure the country's food security, promote regional development and reduce poverty, driven by a strategy focused on the sector's profitability, productivity, and competitiveness. As part of this initiative, the NDP and the 2013 financial reform aim to strengthen the role of development banks as a lever for growth by promoting their participation in

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[48] Findex 2014. In Latin America and the Caribbean, the figure for formal rural credit stands at 10.7%.

[49] Around 60% of the rural population uses informal mechanisms, such as friends, family, and unregulated savings banks. The ENIF also shows that rural borrowers have a greater propensity to devote formal credit to investments than borrowers in urban areas.

[50] FIRA, based on SAGARPA data: figures to 2008.

[51] See Uc-Hernández, C. and J. Matus-Gardea, 2006, *Productividad y penetración financiera rural en México: 1978-2002.* The authors analyze the asymmetry in the distribution of rural credit between the states of Mexico and find there to be a lack of regional convergence in financial penetration and agricultural productivity.

[52] For example, access to services through branches per 10,000 adults in municipios with very high levels of marginalization is 0.10, compared with 0.47 for those with high levels of marginalization, and 1.94 for those with low levels of marginalization.

[53] Bank of Mexico. Includes national credit corporations only.

the rural sector, where their intervention is justified to correct market failures and other credit constraints. Parallel to this, the government is making a strong push on financial inclusion.[54]

1.19 **The CCLIP and its development.** In line with its public policy targets, the Government of Mexico requested, and the Bank approved in October 2014, the Conditional Credit Line for Productive and Inclusive Rural Financing (CCLIP, ME-X1024) for up to US$1 billion with an execution period of 10 years. Its objectives are: (i) to help raise primary sector productivity by improving rural economic units' access to financing to make productive investments; and (ii) to promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units.

1.20 The first program under the CCLIP (3302/OC-ME), for US$400 million, focused exclusively on the main objective of productivity and was fully disbursed between 2014 (the year of its approval) and 2016. A total of 13,942 rural economic units were financed, almost all of them small and medium-sized, and the proposed additionality of increasing REUs' productive investments was fulfilled. The second program (3531/OC-ME), approved in 2015 for US$400 million (active and 87% disbursed) maintains the productivity objective, but in contrast to the first program, focuses on largely excluded segments of the population in fulfillment of the CCLIP's second objective of promoting financial inclusion; specifically, it supports low-income units managed by women that are located in highly and very highly marginalized municipios. So far, the targets for rural economic units financed have been surpassed by 16%, and the expected outcomes in terms of investments made and financial inclusion have been achieved. It should be noted that an impact evaluation is currently being conducted (RG-K1445) to analyze the effectiveness of the productive loan channeled through FND to improve productivity. The study is using quasi-experimental methodology, and its final results are expected in 2018. The evaluation is analyzing the effectiveness of the program as a whole and will provide input for future projects.

1.21 In addition to extending and consolidating productivity efforts by providing financing for rural areas, including by helping small and medium-sized REUs export agricultural goods, the CCLIP helps the government achieve comprehensive development of Mexico's rural areas by financing nonagricultural activities, which are ever more important among rural populations and address the issue of financial inclusion (paragraphs 1.14-1.16) under the CCLIP's second objective.

1.22 **Justification of the third program.** Within the development banking system FND plays an important role in channeling resources towards the primary sector. Its mission is to help stimulate the development of agricultural, forestry, fishery, and other economic activities linked to the rural environment, with a view to boosting productivity and improving the population's living standards. To fulfill this goal, it grants credit directly to producers as well as indirectly, through some 400 regulated

[54] See Department of Finance, Financial Reform and Financial Inclusion.

and unregulated FIEs.[55] Approximately 60% of its portfolio balance as of June 2017—equivalent to US$2.8 billion—was of first-tier origin.

1.23 It should be noted that FND conducts activities ancillary to lending that help resolve several of the market failures present in the rural financial system (see paragraph 1.12) including: (i) providing technical assistance to REUs (see Economic Analysis); (ii) operating a basic compulsory insurance mechanism that covers minimum risks for its borrowers; (iii) compensating for problems of scale through so-called "strategic projects," which consist of promoting and financing producer projects associated with at least two business units in a value chain; (iv) granting credit against guarantees backed by the goods or products covered by the financing rather than requiring the posting of assets as collateral; and (v) assuming the transaction costs inherent in operating as a financial institution in the rural sector. Additionally, it helps mitigate several of the other factors affecting capitalization and technology adoption (see footnote 24), for example by informing potential beneficiaries about rates of return on investments, and in the case of the adoption of technologies and technical models, promoting existing innovations and their broader adoption by producers through their suppliers.

1.24 FND has increased its share of total financing to the agriculture sector from 18.1% in 2010 to 37.8% in 2015.[56] This has been accompanied by an increase in its clientele, with the number of end beneficiaries nearly doubling to 492,000. The recent growth in the portfolio can be attributed primarily to the program for financial inclusion and promotion of small farmers. Also, the loan portfolio has been rearranged toward longer-term credit for capitalizing the REUs: thus, at the first tier, for the first time in its history the balance of investment loans accounts for a greater proportion of the total portfolio (37%) than do working capital loans (35%).

1.25 To accomplish its goals of expanding financing programs to increase productivity and financial inclusion in order to diversify the income of the rural sector by supporting secondary and tertiary sectors linked to the primary sector, FND needs financing from external sources, as it does not have sufficient lendable funds. By

[55] A financial intermediary is a legally established institution that facilitates transactions in the financial market. This includes entities regulated by the CNBV, such as credit unions, savings and loan cooperatives, and *sociedades financieras populares* [community finance companies], as well as unregulated entities, such as multi-purpose finance companies and credit distribution entities. Second tier operations represent 45% of total FND loans. It has implemented a series of support activities aimed at training rural financial intermediaries and their graduation towards supervised entities, together with the application of evaluation tools that determine their eligibility as a borrower. In all, 70% of second-tier lending is through unregulated entities, most of which are small institutions with less than US$20 million in assets and which depend largely on FND's funding, as they are unable to take deposits. FND's past-due portfolio ratio in the second tier is 2.7%.

[56] Bank of Mexico, FND and FIRA. Includes financing by the commercial banks, the development banking system, FIRA, and FND.

law, FND can only accept financing from development banks and international finance agencies, which have supplemented the Bank's financing.[57]

1.26 The estimated range of unmet demand for rural credit from business units, most of them small and medium-sized, is between US$2.552 billion and US$12.758 billion (lower and upper limit, respectively: see Demand Analysis). These upper and lower limits assume that average demand on the part of businesses with credit limitations is 10%-50% of the average demand for those with no restrictions (a highly conservative assumption). Thus, the funds provided through the program will help to meet between 2.5% and 13.5% of such needs. There is accordingly a wide margin for implementing the intervention financed by the program.

1.27 **Justification for expanding the CCLIP.** This program is the third under the CCLIP ME-X1024. FND is requesting a third individual operation for US$500 million. However, following approval of the first two programs, the CCLIP now has only US$200 million available. In order to carry out the operation, an additional US$300 million is requested for the CCLIP through adoption of the attached draft resolution. This is justified by the following: (i) it enables the Bank to continue offering a line of funding to FND so that it can fulfill its proposed targets and comply with the government's rural productivity and financial inclusion objectives (paragraph 1.18), areas in which FND has already shown significant results (paragraph 1.24) with Bank financing; (ii) it enables the Bank to go further in meeting the broad unmet demand for rural financing (paragraph 1.26), in light of the low financial penetration in this sector and the growing importance of FND in supplying financing (paragraph 1.24), which is an indication that the additional funds will be readily absorbed by the market; (iii) FND has to date successfully executed the CCLIP, having disbursed 80% in only a third of the availability period, and the proposed outcomes have been achieved (paragraph 1.20); and (iv) the financial position of the institution is sound (paragraph 3.1). The other aspects of the CCLIP, including its objective, remain unchanged. The program is similar to the other programs under the CCLIP, inasmuch as it supports productivity through financing for farmers and also meets the CCLIP's objective of promoting financial inclusion for the rural sector, through access to productive credit for REUs, specifically those with nonagricultural economic activities that are directly linked to the primary sector.

1.28 The Bank has accumulated considerable experience in the Mexican financial sector through a wide range of operations that it has carried out with various public financial institutions.[58] With respect to rural financing, in addition to the first program under the CCLIP (paragraph 1.20, lessons were learned from the project for Rural

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[57] Based on experience with the IDB, FND has received additional support from the World Bank. In 2015, the World Bank approved the project "Expanding Rural Financing," which finances microenterprises and SMEs exclusively through a second tier and supports funding to modernize their technological platform (core banking system). This complements the CCLIP by promoting financing, although its focus is on the micro and small units and only through the second tier, and it supports institutional strengthening of FND over the medium term, whereas the technical cooperation operation ME-T1346 focuses on the short term (paragraph 2.6).

[58] The Support to SMEs and Financial Access/Supervision Sector Framework Document (document GN-2768-7) explains the lessons learned from similar operations in other countries.

Financing in Mexico (loan 2656/OC-ME).[59] The lessons learned in Mexico and in other countries through development banks include the importance of having entities specializing in credit activities in the rural sector, with advantages in the acquisition and processing of private information (paragraph 1.34), and which are able to offer various financial and technical assistance services to support profitability and mitigate risks (paragraph 1.23). In addition, the Bank has supported rural financing through the CCLIP ME-X1021, Financing of Rural Sector Production Restructuring and Investment Projects in the Rural Sector, with the programs 3335/OC-ME and 3701/OC-ME through FIRA. Lastly, the Bank is also supporting Mexico in the process of regulatory reform to improve the institutional framework in support of productivity, the business climate in Mexico, and access to financing by Mexican MSMEs. This is being done through the programs 2993/OC-ME and 3739/OC-ME. Although the objectives of the other programs differ from that of the proposed program, they complement each other in that they promote access to productive credit for REUs and help address the vast investment financing needs of the Mexican rural economy, covering multiple sectors, segments, and regions.

1.29 **Alignment with Bank strategies and policies**. The operation is consistent with the Update to the Institutional Strategy 2010-2020 (UIS) (document AB-3008) and is aligned with the challenge of developing “Productivity and Innovation,” by improving access to financing for projects that will boost the productivity of MSMEs, as well as “Social Inclusion and Equality,” by bringing all segments of the now-excluded population (specifically, rural MSMEs) into the financial markets. The program will contribute to the Corporate Results Framework (CRF) 2016-2019 (document GN-2727-6) under the indicator of the number of micro/small/medium-sized enterprises financed, as well as the auxiliary indicators of beneficiaries with greater access to formal financial services and farmers with greater access to services and investments. In addition, the program is aligned with the sector frameworks on Support to SMEs and Financial Access/Supervision (document GN-2768-7) and of Agriculture and Natural Resources Management (document GN-2709-5). With respect to the latter, a key lesson learned is the importance of strengthening rural finance, and the lines of action that stand out include the need to stimulate investments to enhance productivity and help overcome liquidity constraints in the sector using financial instruments.

1.30 The program is aligned with the Country Strategy with Mexico 2013-2018 (document GN-2749) which, under the priority area of boosting productivity, includes efforts to increase the level of financing to the real economy as a strategic objective, through interventions to support the development banks in the development of programs to promote financing, including in the agricultural sector. In addition, the operation is aligned with the priority area of territorial development, in its strategic objective to promote rural development by increasing productivity in the agriculture sector. The expected impacts of the program will contribute to two of the outcomes in the Country Strategy Matrix. The project is included in the Country Program Document for 2017 (document GN-2884).

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[59] FND is also the borrower and executing agency for loan 2838/SX-ME, Financing Low Carbon Strategies in Forest Landscapes, complemented by grant GRT/SX-13509-ME, both financed from the Forest Investment Program. It has also received technical assistance in the past, through ATN/FI13334-ME and ATN/OC-12718-RG.

B. Objective, components and cost

1.31 The objective of this program is: (i) help raise primary sector productivity by improving rural economic units' access to financing to make productive investments; and (ii) promote financial inclusion to benefit the rural sector through access to productive credit for rural economic units.

1.32 The program will mitigate existing problems in the financing of rural productive development by increasing the supply of financing for REUs' investment projects that will increase the level of investment and incomes.[60]

1.33 **Sole component**. The amount of the program is US$500 million, structured around a financing component designed to increase the supply of resources available to FND so that it in turn can finance eligible projects of small and medium-sized REUs, including: (i) capital investments in the primary sector, in keeping with the program's Credit Regulations, supported by credit or guarantee instruments. In this area, FND seeks to support investments in the agroexport activities of small and medium-sized REUs, through financing instruments at the pre- and post-harvest stage; and (ii) nonagricultural activities, primarily trade and services in the rural sector.[61] While the program will primarily finance loans for the purchase of fixed assets,[62] it will also include complementary financing for working capital.

1.34 Consistent with FND's portfolio profile and the demand analysis, it is estimated that around 80% of the financing will be devoted to investments in productive assets in the primary sector, including agroexport, and 20% will go to the development of nonagricultural activities, primarily trade and services in the rural sector. FND is an entity specialized in lending to the rural sector, with advantages in the acquisition and processing of private information, ensuring appropriate selection and monitoring of beneficiaries and projects in the scope of this program.[63]

1.35 The eligible beneficiaries will be small and medium-sized REUs engaged in productive activities in the primary sector, and other economic activities in rural areas directly linked to the primary sector (whether in the secondary or tertiary sectors), pursuant to the law governing FND.[64] All the beneficiaries are classified as businesses. Upon accessing credit, these segments can accumulate productive assets and technical models in order to break the cycle of low credit-low investment-low profitability and productivity. FND may channel resources from the Bank directly

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[60] The criteria used by FND to define medium- and long-term are based on a minimum term of one year, which reflects the minimum time for investment projects to mature.

[61] This activity may be carried out in conjunction with the National Entrepreneurs Institute, which will support the operation with a manual (or a technology package) to establish the financial flows needed by a given business in a given region in order to reach its breakeven point.

[62] Capital investments include investments in infrastructure, equipment and other projects that help to boost productivity, focusing on those that incorporate better technologies than those used prior to the loan by beneficiary REUs.

[63] As a development bank, FND promotes appropriate use and maintenance of the assets acquired. This is also reflected in the high loan repayment rate.

[64] Under its organic law, FND can only cater to rural economic units in settlements of less than 50,000 inhabitants. Following the categorization of rural economic units (see paragraph 1.8), the program classifies as small producers those REUs in categories E3 and E4 in terms of income, while REUs with sound businesses (category E5) are treated as medium-sized producers. Potential beneficiaries generally do not receive funds from other government programs supporting capitalization and technology adoption.

to eligible beneficiaries or through FIEs (regulated and unregulated). The criteria and processes for identifying eligible projects, beneficiaries and FIEs will be spelled out in the Program Credit Regulations.

C. Key outcome indicators

1.36 The expected outcomes of the program are to: (i) increase productive investments by primary, secondary, and tertiary sector REUs in rural areas, whether in capitalization projects or in the incorporation of technologies and technical models; (ii) increase exports by small and medium-sized REUs; and (iii) bring new borrowers from the rural productive economy into the formal financial sector (see Annex II). This will be achieved by financing an estimated 24,000 small and medium-sized REUs in the various sectors of the rural economy. In accordance with the program's objective, the expected impact is an increase in the productivity of REUs that have received finance from the program's resources,[65] as well as greater financial inclusion in the countryside.

1.37 The economic analysis identifies the difference between income and expenditure generated in typical undertakings implemented with program-financed credit (technology packages and agricultural capitalization), based on information provided by FND. After discounting the resulting flows at the rate established by the Bank (12% real), the net present value remains positive for all scenarios considered over a wide range of variations in the relevant parameters, with a value added of US$435.7 million in the baseline scenario. The sensitivity analysis establishes the tolerance of the net present value to variations of between 10% and 20% in the expected values of the relevant parameters.

II. FINANCING STRUCTURE AND MAIN RISKS

A. Financing instruments

2.1 The program complies with the eligibility criteria for individual loan operations under CCLIPs (document GN-2246-9).[66] It will be financed with the Bank's Ordinary Capital (OC) resources, under the Flexible Financing Facility (FFF), through a global credit loan. The resources will be devoted to financing the single component described above in the amount of US$500 million in order to expand, through FND, the supply of financing for eligible investment projects as defined in the Credit Regulations. There is no provision for covering administration, evaluation, and audit expenses with program resources.

2.2 Based on FND's experience and on the two previous operations under the CCLIP, the time allocated for execution up to the last disbursement will be 36 months from the effective date of the loan. Ten percent of the program is expected to be disbursed in 2017, 50% in 2018, and the remainder in 2019. Disbursement will take the form of advances, as in previous programs. Considering that disbursements to FND may

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[65] The value per hectare of output, which is constructed so as to contain the effect of changes in total factor productivity (TFP), is used as a proxy for TFP.

[66] The operation is envisaged in the CCLIP's sectors and components; it is included in the country program; and it has the same executing agency as the previous project (3531/OC-ME), which has continued to perform satisfactorily. The previous project's performance was satisfactory, with over 75% disbursement, and compliance with the contractual conditions.

be made in Mexican pesos, via currency conversion, the estimated cash flow will be for a period of 12 months in order to facilitate financial management by the executing agency and to reduce the number of conversions required.

Table 1. Disbursement schedule

Year of disbursement	2017	2018	2019	Total
Amount (US$ millions)	50	250	200	500
Percentage	10%	50%	40%	100%

2.3 Loans to beneficiaries and eligible projects will have the following characteristics: (i) fixed and/or variable rate, based on the program funding rate plus FND's margins[67] and, where applicable, those of the FIEs; (ii) they may be denominated in Mexican pesos or U.S. dollars; (iii) FND assumes the risks of the direct beneficiaries[68] and the FIEs and, in the case of indirect loans, the FIEs assume the risk of their loans; and (iv) the maturities will be appropriate for the projects financed.

B. Environmental and social risks

2.4 This is a financial intermediation operation, governed primarily by Directive B.13 of the Environment and Safeguards Compliance Policy (Operational Policy OP-703), and is not subject to classification. FND started implementing its Environmental and Social Risk Management System[69] in 2014. Also, due to the nature of the projects to be financed, and their main beneficiaries—mostly small and medium-sized REUs—no negative environmental and social impacts are expected. The specific requirements to be included in the credit regulations are described in the Environmental and Social Management Report (ESMR).

C. Fiduciary risks

2.5 As part of the process of approving the CCLIP in 2014, an institutional capacity assessment was carried out using the Institutional Capacity Assessment System (ICAS) methodology. Considering the significant increase in FND operations and the time elapsed since the previous ICAS, a new assessment using the same methodology was conducted in May 2017. It yielded an average weighted score of 90.55%, i.e. a satisfactory level of development and a low risk in relation to program execution and fiduciary aspects. The methodology encompassed an evaluation of the institution as the executing agency and, additionally, the operating procedures that might affect the program (see Annex III).

D. Other risks and key issues

2.6 No high or medium risks were identified. However, the ICAS did detect some low risks that represent areas for improvement in the institution, including internal control, human resource management capacity, recovery of the impaired portfolio, and information technologies. On this last point, FND is in the process of changing

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67 FND will set the interest rate in line with its policies, which consider the institution's sustainability and its character as a development agency. FND's average interest rates have been similar to market rates.

68 The financing provided under the program will be complemented with resources from the guarantee facilities managed by FND, principally the *Fondo Mutual de Garantías Líquidas* [Liquid Guarantees Mutual Fund], comprised of resources from various federal government agencies.

69 Through ANT/FI-13334-ME, FND received technical assistance for implementing it.

its core banking system with support from the World Bank, but this will be completed over the medium term and will therefore not affect execution of this program. With a view to complementing this effort in the short term, a technical cooperation project with the Bank is in the process of approval (ME-T1436, Technological Tools and Applications for Strengthening FND Intermediation) that would support application of new loan evaluation and supervision processes and tools.

2.7 **Sustainability.** In addition to the priority the government places on the rural sector and the role of development banks, the program's sustainability relies on the demonstration effect to be obtained from the positive impacts on rural producers' productivity through financing their projects, and the feasibility of serving segments previously excluded from the system.[70] This should lead to an increase in the demand for and the supply of rural credit, whether through FND and its financiers (see footnote (56) or private financial institutions (directly or via FND's second tier). In its institutional strategy, FND has included support for productivity through capitalizing the countryside and encouraging financial inclusion in the rural economy (see paragraphs 1.24 and 1.21), and it is expected to continue operating in these sectors as natural niches.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

3.1 **Borrower and executing agency (EA).** The borrower and executing agency will be FND, an entity of the federal government with its own legal status and capital. It is a sound public development financial institution that has conserved its initial and sole contribution. At the end of 2016, it had a net worth of approximately US$1.8 billion and its portfolio balance stood at US$2.5 billion, having doubled in three years.[71] The past-due portfolio is 3.7%.[72] The United Mexican States will be the guarantor for the financial obligations under the loan contract, which will be agreed between the borrower and the Bank.[73]

3.2 The FND will use its organizational structure, establishing the responsibilities and functions necessary for program implementation. It has the necessary fiduciary and operational capacity for successful program implementation, it has adequate risk management practices in place, it is governed by financial system regulations and is subject to National Banking and Securities Commission (CNBV) supervision and monitoring.

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[70] The impact evaluation now under way (paragraph 1.20) will yield information on the mentioned demonstration effect.

[71] The audited financial statements for 2016 can be found at the link: Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND).

[72] Applying the portfolio canceled with Liquid Guarantee Mutual Funds and Preventive Estimate of Credit Risks for the last 12 months, the adjusted overdue portfolio is 7.2%. If we compare the amount of cancellations with investments by year of availability, the "canceled portfolio ratio" has fluctuated between 2.1% and 4%.

[73] Pursuant to the Law establishing FND, the Federal Government is at all times responsible for FND's liabilities with international financial agencies and foreign government and intergovernmental institutions (Art.8 bis, expanded DOF 26 June 2009, amended 10 January 2014).

3.3 FND will be responsible for execution and supervision of the appropriate use of subloan resources, and for providing the needed human and technical resources in due time and form. **A special contractual condition precedent to disbursement will be the appointment of a program coordinator, to the Bank's satisfaction, who will support more effective and efficient implementation, given that program execution itself implies use of FND's organizational structure. Another special condition will be approval of the credit regulations agreed with the Bank, and their implementation by FND. The credit regulations are necessary for ensuring that the program is consistent with the standards and policies of FND and the Bank, as well as with Mexican law and financial practices. In addition, the regulations will include the principal characteristics of the program, including the eligible beneficiaries, projects and FIEs, and provisions governing environmental and social aspects contained in the ESMR.**

B. Summary of arrangements for monitoring results

3.4 **Reports.** The program will be monitored by means of semiannual reports prepared by the executing agency and submitted to the Bank within 60 days of end of each six-month calendar period, as well as a final report. These will measure progress against the outcome indicators and fulfillment of the eligibility criteria at the project and program level. Monitoring meetings will be scheduled as needed. The program's financial statements will be audited annually by an independent firm of auditors acceptable to the Bank, hired and paid by FND, and will be delivered no later than 120 days after the end of the executing agency's fiscal year, following procedures and terms of reference agreed by the Bank with the Civil Service Department (SFP).

3.5 **Information and evaluation**. The borrower and the executing agency will compile and retain all relevant information, including all the documentation required to produce the project completion report, which will be prepared six months after the close of the operation. The impact evaluation is described in the Monitoring and Evaluation Plan: it will use a discontinuous regression method to evaluate the programs under the CCLIP (paragraph 1.20).

Development Effectiveness Matrix		
Summary		
I. Corporate and Country Priorities		
1. IDB Development Objectives	**Yes**	
Development Challenges & Cross-cutting Themes	**-Social Inclusion and Equality -Productivity and Innovation**	
Country Development Results Indicators	**-Micro / small / medium enterprises financed (#)* -Beneficiaries of improved access to formal financial services (#)* -Farmers with improved access to agricultural services and investments (#)***	
2. Country Development Objectives	**Yes**	
Country Strategy Results Matrix	**GN-2749**	**(1) Increase the level of finance to the real economy, and (2) Raise productivity in the agricultural sector and improve the coverage of water services for people living in rural areas.**
Country Program Results Matrix	**GN-2884**	**The intervention is included in the 2017 Operational Program.**
Relevance of this project to country development challenges (If not aligned to country strategy or country program)		
II. Development Outcomes - Evaluability	**Evaluable**	
3. Evidence-based Assessment & Solution	**8.4**	
3.1 Program Diagnosis	**3.0**	
3.2 Proposed Interventions or Solutions	**2.4**	
3.3 Results Matrix Quality	**3.0**	
4. Ex ante Economic Analysis	**10.0**	
4.1 The program has an ERR/NPV, a Cost-Effectiveness Analysis or a General Economic Analysis	**4.0**	
4.2 Identified and Quantified Benefits	**1.5**	
4.3 Identified and Quantified Costs	**1.5**	
4.4 Reasonable Assumptions	**1.5**	
4.5 Sensitivity Analysis	**1.5**	
5. Monitoring and Evaluation	**9.2**	
5.1 Monitoring Mechanisms	**2.5**	
5.2 Evaluation Plan	**6.7**	
III. Risks & Mitigation Monitoring Matrix		
Overall risks rate = magnitude of risks*likelihood	**Low**	
Identified risks have been rated for magnitude and likelihood	**Yes**	
Mitigation measures have been identified for major risks	**Yes**	
Mitigation measures have indicators for tracking their implementation	**Yes**	
Environmental & social risk classification	**B.13**	
IV. IDB´s Role - Additionality		
The project relies on the use of country systems		
Fiduciary (VPC/FMP Criteria)	**Yes**	**Financial Management: Budget, Treasury, External Control, Internal Audit. Procurement: Information System.**
Non-Fiduciary		
The IDB's involvement promotes additional improvements of the intended beneficiaries and/or public sector entity in the following dimensions:		
Gender Equality		
Labor		
Environment		
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project		
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan	**Yes**	**The quas-iexperimental evaluation of the gains in productivity from the investments realized through the project will help demonstrate the importance of these activities for the growth of the primary sector**

Note: (*) Indicates contribution to the corresponding CRF's Country Development Results Indicator.

Despite growth in Total Factor Productivity (TFP) of Mexico's rural sector between 2012-2015, it had been steadily trending downward during the two decades prior to 2012 (-0.23%). Moreover, the agroindustry sector underwent a decline in its TFP between 1991-2015 of -0.48%. The primary sector and the agroindustry sector together employ 34% of the economically active population. The deficiency in productivity is linked to a low capitalization of the sector which in turn is related to a lack of access to credit. In 2014 only 10.4% of the rural economic units (REUs) of the primary sector had obtained access to credit and 16% of those in agroindustry. Only 11.5% of the REUs in the primary sector had access to finance for investment. The project exists as the third of a CCLIP that seeks to address this scenario and elevate the productivity of the primary sector via higher access to finance by the REUs. In addition to contributing to the productivity of the primary sector through financing this third operation seeks to promote financial inclusion of the rural sector incorporating the secondary and tertiary sectors.

This final program under the CCLIP solicited additional funds in the order of $300MM for a total placement of $500MM geared toward this end. This request is justifiable given: (i) the context of the priority the Mexican government gives to strengthening the rural sector; (ii) the success FND has had in its operations with an index of nonperforming loans of 3.7%; (iii) the low financial penetration of the sector which allows for this type of intervention and the growing importance of FND in meeting its needs with a share of 38% of the sector and (iv) the estimation of an ample unmet demand that demonstrates the additional resources will easily be captured by the market.

The program's vertical logic and its cost benefit analysis are adequate. The monitoring and evaluation plan puts forth an impact evaluation.

RESULTS MATRIX

Project objective:	Help raise primary sector productivity by improving rural economic units' (REUs) access to financing to make productive investments; and promote financial inclusion to benefit the rural sector through access to productive credit for REUs.

EXPECTED IMPACT

Indicators	Unit of measure	Base-line	2017	2018	2019	Final target	Means of Verification	Comments
IMPACT 1: INCREASED PRODUCTIVITY[1] OF REUS IN THE PRIMARY SECTOR FINANCED BY THE PROGRAM								
Indicator 1: Sales per Ha of REUs that have received financing increase in relation to comparable non-beneficiary REUs, for 2019	%	n/a*			20%	20%	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), based on the ex post impact evaluation as described in the Monitoring and Evaluation Plan	Indicator is equal to: {[(Xt-Xb)/Xb] - [(Yt-Yb)/Yb]} x 100 where Xt, Xb are sales per Ha by REUs supported with capitalization programs in year t and in the base year, respectively, and Yt, Yb represent the same concepts for units of the control group. The control group is determined as explained in the evaluation proposal. *The baseline is currently being constructed as part of the evaluation for the first operation under the CLIPP and will be incorporated in the future. Provisional results should be in hand in the fourth quarter of 2017.
IMPACT 2: GREATER FINANCIAL INCLUSION IN RURAL AREAS								
Indicator 1: Incomes of REUs that have received financing increase in relation to comparable non-beneficiary REUs, for 2019	%	n/a*			20%	20%	FND	Refers to units of the secondary and tertiary sectors in localities of up to 50,000 inhabitants. Indicator is equal to {[(Xt-Xb)/Xb] - [(Yt-Yb)/Yb]} x 100 where Xt, Xb are the incomes of REUs supported with capitalization programs in year t and in the base year, respectively, and Yt, Yb represent the same concepts for units of the control group. The control group is determined as explained in the evaluation proposal.

[1] The value per hectare of production, which is constructed so as to contain the effect of changes in total factor productivity (TFP), is used as a proxy for TFP.

EXPECTED OUTCOMES

Indicators	Unit of measure	Base-line	2017	2018	2019	Final target	Means of Verification	Comments[2]
OUTCOME 1: INCREASED PRODUCTIVE INVESTMENTS BY REUs[2]								
Indicator 1. Productive investments by REUs in the primary sector made under the program	US$ millions	0	90	210	200	500	FND information systems	This indicator corresponds to total investments that could be made on the basis of financing from the program. Assuming a typical investment pattern for a REU (see Economic Analysis), financing by FND should represent around 80% of total investment. The intent of this indicator is to record the total flow of investment under the program, including the share of own funds.
Indicator 2. Productive investments by REUs in the secondary and tertiary sectors in rural locales made under the program	US$ millions	0	22.5	52.5	50	125	FND information systems	This indicator corresponds to total investments that could be made on the basis of financing from the program. Assuming a typical investment pattern for a REU (see Economic Analysis), financing by FND should represent around 80% of total investment. The intent of this indicator is to record the total flow of investment under the program, including the share of own funds.
OUTCOME 2: IMPROVED FINANCIAL INCLUSION INDICATORS								
Indicator 1. Percentage of FND beneficiaries receiving formal credit for the first time	%	2%				4%	FND information systems and Credit Bureau	This indicator corresponds to the percentage of direct and indirect borrowers from FND belonging to the secondary and tertiary sectors who receive formal credit for the first time. The baseline is 2016.
OUTCOME 3: IMPROVED EXPORT INDICATORS								
Indicator 1. Difference in mean value of exports of REU beneficiaries under the program in relation to comparable non-beneficiary REUs, for 2019	US$ thousands	0				25	FND information systems	This indicator corresponds to the increase in the value of exports by REUs in the primary sector (see Economic Analysis). Currently, the mean value of exports is US$250.000.

[2] These figures could change in response to variations in the exchange rate.

OUTPUTS

Outputs	Unit of measure	Base-line	2017	2018	2019	Final target	Means of Verification	Comments
Sole component: FINANCING LINE FOR PRODUCTIVE INVESTMENTS (TOTAL COST =US$500 MILLION)								
Output 1: Number pf small and medium-sized REUs in the primary sector with financing under the program[3]	Number of REUs	0	3,545	8,272	7,878	19,696	FND reports	Measures the number of REUs in the primary sector that have received productive credit with program resources. Assumes an average credit amount of around US$28,335[4] per REU.
Annual cost:	US$ millions	0	72	168	160	400		
Output 2: Number pf small and medium-sized REUs in the secondary and tertiary sectors with financing under the program	Number of REUs	0	759	1,772	1,688	4,219	FND reports	Measures the number of REUs in the secondary and tertiary sectors in localities with fewer than 50,000 inhabitants that have received productive credit with program resources. Assumes an average credit amount of around US$18.849[5] per REU.
Annual cost:	US$ millions	0	18	42	40	100		

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[3] Productive investments primarily include capitalization projects (or investments in productive assets) and projects for the adoption of technologies and technical models, as well as permanent working capital. The cost-benefit study assumes that 70% is devoted to capitalization and 30% to technology adoption.

[4] Equivalent to 510,034 pesos, considering an exchange rate of 18.00 MXN/USD.

[5] Equivalent to 339,283 pesos, considering an exchange rate of 18.00 MXN/USD.

FIDUCIARY AGREEMENTS AND REQUIREMENTS

Country:	Mexico
Project number:	ME-L1259
Name:	Increase in the Conditional Credit Line for Investment Projects (CCLIP) for Productive and Inclusive Rural Financing (ME-X1024) (Amendment to Resolution DE-138/14) and Third Program for Productive and Inclusive Rural Financing (ME-L1259)
Executing agency:	Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)

I. EXECUTIVE SUMMARY

1.1 The Bank will contribute to the efforts of the FND to boost the productivity of the primary sector through greater access to financing on the part of Rural Economic Units (REUs), and to promote financial inclusion to benefit the rural sector by providing access to productive credit for REUs in the secondary and tertiary sectors in order to increase their incomes, particularly in those segments with the greatest restrictions on access to formal credit facilities for making productive investments.

1.2 This program is part of the ME-X1024 CCLIP that has been supporting the FND in the rural sector since 2014.

II. THE EXECUTING AGENCY'S FIDUCIARY CONTEXT

2.1 The executing agency will be the FND, which is a decentralized agency of the federal government with independent legal status and capital, located in the Department of Finance (SHCP), specifically within the Executive Directorate of Programs and Products.

III. FIDUCIARY RISK EVALUATION AND MITIGATION ACTIONS

3.1 The Bank conducted an initial institutional capacity assessment of the FND using the ICAS method in 2009, and a second one in 2014, for loan 3302/OC-ME. A third such assessment was performed in 2017, the weighted results of which reflect a satisfactory level of development and a low level of risk, as summarized in the following table:

Table 1. ICAS results 2017

Consolidated results Capacities	Quantification			Development (ND, ID, MD, SD)	Risk level (RA, RS, RM, RB)
	Rating %	IR%	Weighted %		
Programming and organization capacity	90.35	25	22.59	SD	RB
Execution capacity	94.13	45	42.36	SD	RB
Control capacity	85.33	30	25.60	SD	RB
TOTAL		100	90.55	SD	RB

IV. Considerations for the Special Provisions of Contracts

4.1 The following agreements and requirements will be considered in the special provisions of the loan contract:

a. **The exchange rate agreed with the executing agency for rendering accounts:** This will be the exchange rate on the payment date recorded in the FND's financial and accounting systems in accordance with Mexican government regulations.

b. **Audited financial statements:** The FND will submit audited financial statements annually during the execution period within 120 days after the end of the fiscal year, and a final audited financial statement 120 days after the last disbursement.

c. **Semiannual financial reports:** not required.

V. Agreements and Requirements for Procurement Execution

5.1 When the executing agency undertakes any procurement using the loan proceeds, the following provisions will apply:

a. **Procurement execution: Procurement of works, goods, and nonconsulting services:** Contracts for works, goods, and nonconsulting services[1] arising under the project and subject to international competitive bidding (ICB) or national competitive bidding (NCB) will be executed using bidding documents harmonized between the Civil Service Department (SFP) and the Bank. These are available online at: (http://www.funcionpublica.gob.mx). The review of the technical specifications for procurement during the preparation of selection processes will be the responsibility of the project's sector specialist

b. **Selection and contracting of consulting firms**: Contracts for consulting services to be provided by consulting firms financed with project resources will be executed using the standard request for proposals agreed on by the Bank and the SFP. These may be consulted online at: http://www.funcionpublica.gob.mx. The review of the terms of reference for contracting consulting services is the responsibility of the project's sector specialist.

1 Policies for the Procurement of Goods and Works Financed by the Inter-American Development Bank (document GN-2349-9) paragraph 1.1: Nonconsulting services will be treated as goods

c. **Selection of individual consultants**: Contracts for consulting services with individual consultants will be executed using the model contract for individual consultants agreed with the Bank, which may be consulted at: (http://www.funcionpublica.gob.mx).

d. When the end borrowers are private entities, they will use market-standard procurement procedures acceptable to the Bank, in accordance with Annex IV of the Bank's Procurement Policies. The requirements of paragraph 3.12 "Procurement in Loans to Financial Intermediaries" of document GN-2349-9 or paragraph 3.14 "Commercial Practices" of document GN-2350-9 will also be met.

A. Table of threshold amounts

5.2 For the executing agency's procurement processes, the following selection and contracting methods will be used, based on the specified threshold amounts below:

Table 2. Table of threshold amounts

Works			Goods[2]			Consulting services	
International competitive bidding	National competitive bidding	Shopping	International competitive bidding	National competitive bidding	Shopping	International advertising - consultants	Shortlist 100% national
≥15,000,000	<15,000,000 and ≥500,000	<500,000	≥3,000,000	<3,000,000 and ≥100,000	<100,000	≥ 200,000	<500,000

B. Main procurement processes

5.3 No procurement by the FND is planned, and in the event that some contracting were identified, this would be governed in accordance with Bank policies. Loan proceeds will be used by the FND to channel financing to the rural economy. If the REUs should engage in any procurement, this will be governed by the procedures described in Annex IV to the Bank's procurement policies for the private sector.

C. Procurement supervision

5.4 In view of the project's low fiduciary risk, one inspection visit will be made each year. Similarly, when establishing the supervision arrangements, the executing agency's experience from previous operations was taken into account

5.5 As no procurement by the FND is planned, no provision is made for the review of procurement.

Table 3. Threshold for ex post review

Works	Goods	Consulting services
15,000,000	3,000,000	500,000

Note: the thresholds set for ex post review are based on the executing agency's fiduciary capacity for execution and may be modified by the Bank as that capacity varies.

2 Includes nonconsulting services.

D. Special provisions

5.6 **Measures to reduce prohibited practices**. The executing agency will diligently observe the provisions on prohibited practices established in the Bank's procurement policies.

E. Records and files

5.7 The basic original documentation for the substantiation of expenses with the Bank as well as the procurement files will be held by the FND.

VI. FINANCIAL MANAGEMENT

A. Programming and budget

6.1 The planning and programming functions and responsibilities are documented in the Financial Planning and Programming Manual and in its planning and policies, which are authorized by the FND's board, pursuant to the law establishing the agency. Clear procedures for programming and budgeting exist, certified under ISO 9001-2000.

B. Accounting and information systems

6.2 The FND has an accounting system, the processes of which are for the most part certified annually under ISO 9000. The credit system used is the TERFIN system, which issues daily reports and reconciles them with the accounting system.

C. Disbursements and cash flow

6.3 Program resources will be deposited in a special or program-specific bank account. Once the FND has identified the operations that will be financed by the IDB, it will record them in TERFIN for each loan and disbursement tranche.

D. Internal control and internal audit

6.4 As a result of the financial reform of January 2014, the internal control body ceased reviewing the substantive functions of the FND, specifically its core banking, and review of these functions was transferred to the internal audit area. The internal audit department comprises six persons. Given this situation, it is recommended that this area be strengthened.

E. External control and reports

6.5 As noted above, the FND is audited periodically by the office of the Federal Auditor General (ASF), the National Banking and Securities Commission (CNVB), and an external audit firm appointed by the SFP. The SFP is responsible for appointing the external auditors to conduct audits on projects funded by the Bank.

The FND will deliver an audited financial statement to the Bank annually within 120 days after the end of the accounting period, issued by an eligible firm and with terms of reference agreed by the IDB and the SFP.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

Mexico. Individual Loan ____/OC-ME to Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)
Third Program for Productive and Inclusive Rural Financing

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), as Borrower, and with the United Mexican States, as Guarantor, for the purpose of granting the Borrower a financing aimed at cooperating in the execution of the third program for productive and inclusive rural financing, individual operation under the Conditional Credit Line for Productive and Inclusive Rural Financing (ME-X1024) approved by Resolution DE-138/14, dated October 22, 2014, and by Resolution DE-__/17, dated __________, 2017. Such financing will be in the amount of up to US$500,000,000, from the resources of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

(Adopted on __ __________ 2017)

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ME-L1259

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/17

Mexico. Increase of the Conditional Credit Line for Investment Projects (CCLIP) for the Productive and Inclusive Rural Financing to Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND)
(Modification of Resolution DE-138/14)

The Board of Executive Directors

RESOLVES:

To modify Resolution DE-138/14, adopted on October 22, 2014, to read as follows:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such agreement or agreements as may be necessary with Financiera Nacional de Desarrollo Agropecuario, Rural, Forestal y Pesquero (FND), to establish a Conditional Credit Line for Investment Projects (CCLIP) for the Productive and Inclusive Rural Financing for up to the sum of US$1,300,000 chargeable to the Bank's Ordinary Capital to cooperate in the execution of the third program for the productive and inclusive rural financing.

2. That the resources allocated to the above-mentioned Credit Line shall be used to grant Loans to finance individual Operations in accordance with: (a) the objectives and regulations of the Conditional Credit Line for Investment Projects approved by Resolution DE-58/03 of July 16, 2003, and as amended by Resolution DE-10/07, of January 31, 2007; and (b) the specific provisions set forth in document GN-2246-9.

3. That the amounts authorized to finance individual Operations chargeable to the Credit Line shall be granted as individual loans subject to the usual financial terms and conditions applicable to financing from the resources of the Bank's Ordinary Capital in force at the time that each individual operation is approved. Such terms and conditions shall be specified in the project summary of the corresponding loan proposal.

4. That the effectiveness of the agreement or agreements signed by the Bank with FND for each individual operation shall be subject to the effectiveness and validity of the agreement for the establishment of the Credit Line.

(Adopted on __ __________ 2017)